Domestic bank intermediation: domestically owned versus foreign-owned banks in Israel

David Marzuk[1]

1. The Israeli banking system – an overview

A. The structure of the banking system and its scope of activity

Israel has a highly developed banking system. At the end of June 2009, there were 23 banking corporations registered in Israel, including 14 commercial banks, two mortgage banks, two joint-service companies and five foreign banks.

Despite the spate of financial deregulation in recent years, the Israeli banking sector still plays a key role in the country's financial system and overall economy. It is also highly concentrated – the five main banking groups (Bank Hapoalim, Bank Leumi, First International Bank, Israel Discount Bank and Mizrahi-Tefahot Bank) together accounted for 94.3% of total assets as of June 2009. The two largest groups (Bank Leumi and Bank Hapoalim) accounted for almost 56.8% of total assets.

The sector as a whole and the large banking groups in particular are organised around the concept of "universal" banking, in which commercial banks offer a full range of retail and corporate banking services. Those services include: mortgages, leasing and other forms of finance; brokerage in the local and foreign capital markets; underwriting and investment banking; and numerous specialised services. Furthermore, until the mid-1990s, the banking groups were deeply involved in non-financial activities. However, a law passed in 1996 forced the banks to divest their controlling stakes in non-financial companies and conglomerates (including insurance companies). This development was part of a privatisation process which was almost completed in 2005 (with the important exception of Bank Leumi).

The privatisation of the Israeli banking system has received particular attention in recent years. The government sold almost all of its shares in Bank Hapoalim Ltd, the largest bank in the Israeli banking system, during the 1990s. In 2005, the state completed the sale of all its remaining shares in the bank and it therefore no longer has any holdings in Bank Hapoalim Ltd (Table 1).

In the last few years, Israel's banking system has been undergoing a slow, moderate process of mergers: small banks are being bought by large- and medium-sized banks in order to take advantage of economies of scale and scope. Thus, nearly all mortgage banks have been merged with their parent companies. In addition, there has been a process of ownership changes of special purpose banks: three subsidiaries of Bank Hapoalim (Bank Massad, Bank Yahav and Otsar Hahayal) have been taken over by medium-sized banks. These changes strengthen medium-sized banks at the expense of large ones, thereby increasing competition in the banking system. It appears that some, albeit weak, signs of this are visible in the slow downward trend in indices of concentration (H and CR2), evident since the beginning of 2006.

[1] With the assistance of Herman Litman, Hany Perets, Merav Shemesh and Shlomo Yemini.

Table 1

Privatisation of major nationalised banks

	Date of re-listing	December 1992	June 2009		
		Government	Government	Significant holders	Public
Bank Hapoalim	06/1993	99.9	–	25.74	74.26
Bank Leumi	09/1993	95.0	11.46	9.59	78.95
Israel Discount Bank	03/1996	87.0	25.0	26.0	49.0
Mizrahi-Tefahot Bank	06/1998	97.0	–	45.66	54.34
First International Bank	01/1993	–	–	80.86	19.14

Five foreign banks are operating in Israel – although they have only entered the market over the last decade or so, two of them have been operating in Israel since the turn of the century (Citibank (United States) and HSBC (United Kingdom)). Those two banks were joined by a further two in 2006–07: BNP Paribas (France) and the State Bank of India. In addition to those four branches, a subsidiary of the international Dexia group is operating in Israel.

In January 2005, the Israeli Government sold 26% of the Israeli Discount Bank's equity to the foreign investor group Treetops Acquisition Group (Canada), led by Matthew Bronfman. This move created the third largest banking group in Israel held by a foreign entity. Although, under the terms of the Israeli Banking (Licensing) Law, this bank is considered a foreign-owned bank, it will be referred to in the present paper as a domestic bank.

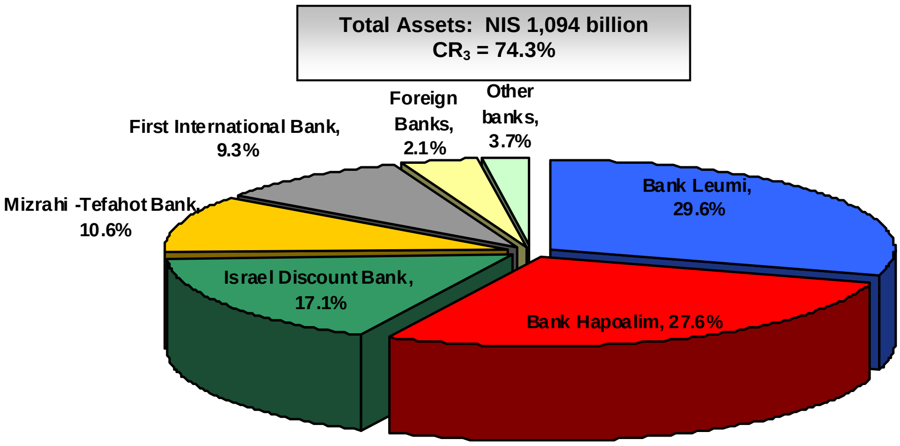
Total consolidated assets of the banking system (including foreign banks operating in Israel), were new Israeli shekel (NIS) 1.09 billion as of end-June 2009, compared with NIS 1.07 billion at end-2008. The five major banking groups account for 94.3% of total assets, with similar shares of total loans and deposits. The share of other banks and foreign banks were 3.72% and 1.95%, respectively (Figure 1).

In addition to their classical banking intermediation activity, the banking groups also operate via their subsidiaries in areas that complement their commercial activities. The main activity complementing their classical banking activity is in credit cards, which has been continuously increasing over the last few years. Banks' capital market activity has shrunk considerably over recent years as a result of the limitations on investment coming into effect, which greatly restricted the permitted level of holdings, so that banks could not control underwriting companies. At the same time, banks started providing banking and financial services to all capital market players as well as pension consultancy to the general public.

Figure 1

The structure of Israel's banking system

(Consolidated basis, June 2009)



Note: Other banks include: Union Bank and Bank of Jerusalem.

Israeli banks own banking subsidiaries abroad, mainly in the major global financial centres. Previously, these companies had great difficulty in competing with the large local banks and, as a result, their profits were low. In the last few years, Israeli banks have extended their activity abroad, both because of the partial contraction of their activity in Israel and because of their desire to extend their profit sources, utilising the advanced knowledge and technology developed in the domestic market. They have done this mainly by buying local banks, especially in emerging markets, in the expectation that those banks would be better able to compete with other local banks.

In recent years, the government has sought to lessen the domination of banks over financial intermediation and increase competition in the financial market. Following the recommendations of the Bachar Commission in 2005, measures were introduced to encourage both intermediation through the capital markets and diversification in forms of wealth holdings. Consequently, non-bank sources now account for a rising share of credit to the business sector while the domestic bond and equity markets have expanded considerably. At the same time, the gains from increased competition at the retail end of the market have been less impressive.

The Israeli banking system is active in three indexation segments: the unindexed local currency (nominal) segment (which amounts to approximately 40% of the group's total assets), the indexed (to the consumer price index) segment; and the foreign currency (denominated or linked to the foreign exchange) segment. The share of the last two segments in the group's total assets is approximately 30% each.

B. The global financial crisis and its effects on Israel

Israeli banks experienced a strong uptrend in profitability from 2003 until late 2007. Since then, Israeli banks have been negatively influenced by the global financial crisis and the subsequent series of developments that have forced them to make large provisions and have either reduced their profits or pushed them into an outright loss. Nevertheless, all banks have remained sound and stable and there have never been any concerns that a local bank might fail.

The developments began in late 2007 with the collapse of the special investment vehicles (SIVs), collateralised debt obligations (CDOs) and mortgage-backed securities markets that were not guaranteed by US government agencies and continued through to the collapse of Lehman Brothers in September 2008. Israeli banks suffered substantial losses from their exposure to Lehman Brothers as well as to other failed financial institutions.

During 2008, the crisis started to adversely affect Israel's real economy, mainly through a decline in the pace of economic and capital market activity, which suppressed the banks' revenues from lending and other activities. Banks also had to make higher provisions against their corporate loan portfolios, especially for companies active in overseas real estate markets.

In sharp contrast to most other countries, the Israeli banking system has at no time experienced liquidity shortages; on the contrary, the system has enjoyed a high level of liquidity in both local and foreign currency and was the beneficiary of net inflows of foreign currency during 2008.

Compared with other banking systems, the Israeli banking system exhibited resilience to the shocks in the global financial markets and to their implications on the real economy. This can be ascribed to the following: the local banking system does not depend on credit lines from abroad; the lack of advanced money markets and limited securitisation cushioned the impact of the global crisis on Israel; the banking system was not a significant counterparty investing in the structural products market in the United States and Israeli banks were not plagued by a confidence crisis from domestic or foreign investors; Israeli banks depend primarily on retail funding rather than wholesale funding from financial institutions and capital markets; and, as Israeli banks have a considerable net liquidity position in foreign currency, the Finance Ministry accepted their surpluses in the form of deposits in foreign currency. In addition, the favourable macroeconomic conditions of recent years have enhanced the financial system's ability to absorb losses. Banks' credit risks declined while their capital adequacy was maintained.

Although the exposure of the Israeli banking system to the global financial crisis was limited, the crisis has also affected the capital markets and non-bank financial institutions and put them under strain, as globalisation has created a high degree of correlation between Israeli capital markets and world markets. As a result of the financial crisis, the positive correlation between share indices in Israel and those in developed countries increased even further. Thus, the Israeli capital market was influenced by the major declines and increased volatility that characterised the global capital markets. The stock exchange fell sharply in September 2008 and the trend intensified during October and November. The corporate bond market was also characterised by a sharp decline in prices. Fears among investors regarding the redemption of bonds, together with the uncertainty in the financial markets, led to a preference for solid investment channels and a wave of withdrawals from bond funds. During the second half of the year, the financial crisis spilled over into real activity. The economy's rate of growth slowed following several years of prosperity and, during the last quarter of the year, the economy entered a recession, with negative GDP growth of 0.5%, annualised.

As the crisis worsened, the Supervisor of Banks enhanced surveillance by increasing the frequency of certain returns and by introducing a number of new reports in areas that were expected to be most affected by the crisis (for details, see section C below).

Additional measures taken by the government and the Bank of Israel include: the provision of government guarantees in the amount of NIS 6 billion for subordinated debt to be issued by banks – although this measure was taken to facilitate banks' ability to increase their Tier-2 capital at reduced cost, no bank has thus far found it necessary to use these guarantees; and the creation of investment funds ("leverage funds") to expand the supply of non-bank credit by NIS 5 billion – since the announcement of this programme at end-2008, the Tel-Bond 60 broad index of corporate bonds has gained more than 15%, taking it back to its pre-crisis level. Risk premia have narrowed and activity in the primary market has picked up:

issuance in the first half of 2009 amounted to NIS 16 billion, compared to NIS 22 billion for all of 2008; credit officers have been appointed to assist companies in dealing with the difficulties of rescheduling tradable bonds issued by them; and tax breaks have been established to encourage foreign investment in the Israeli economy and the inflow of funds from foreign companies controlled by Israeli residents into Israel. The government has created a defined safety net for pension savings with the goal of ensuring a basic pension for savers close to retirement whose pension savings have significant exposure to the capital market. In addition, the Bank of Israel has initiated a series of measures using monetary instruments with the goal of improving the liquidity situation in the economy and reducing costs for the business sector.

C. Banking Supervision Department – activity and reforms

Maintaining the stability and resilience of the banking system in a changing economic environment is one of the Banking Supervision Department's principal goals. The Department's continuous and ongoing actions in pursuit of this goal, such as adopting the Basel II Directives, were augmented this year in view of the financial and real crisis in a series of special measures.

Prior to the global financial crisis and in light of it, the Supervisor of Banks implemented several measures in order to maintain confidence in the banking markets and enhance Israel's responsiveness in countering the adverse impact of this crisis.

a. Israeli banking groups were expected to reach a total risk-based capital ratio of 12% by year-end 2009. This target is in line with the implementation of the Basel II regime in Israel. The Supervisor of Banks strongly encourages Israeli banks to continuously upgrade their risk management systems within the Basel II framework.

b. The Supervisor of Banks established ad hoc task force teams to scrutinise banks' risk exposures and to monitor their operations and liquidity positions. In addition, banks were required to adhere to several guidelines and to enhance the transparency of their financial reporting. The Supervisor is taking a proactive approach in dealing with the crisis and is conducting reviews via the supervisory functions in the Banking Supervision Department.

c. The Supervisor of Banks announced in January 2007 that Israel would adopt the Basel II regime by end-2009. It was anticipated that, during the preliminary phase of the Basel II regime, banks would implement the Standardised Approach to credit risk and the Basic Indicator Approach or the Standardised Approach to operational risk. The Supervisor promulgated temporary directives regarding the Basel II framework incorporating national discretions (including the advanced methods for credit risk but not the advanced methods for operational risk).

As mentioned above, in 2008, mainly in the second half of the year, the Banking Supervision Department addressed several important issues relating to the ongoing stability of the banking system amid the global and domestic financial and real crisis. It instructed banks to increase the frequency of some of their returns as well as introduce new ones:

- **Reporting exposures to foreign financial institutions and countries:** in September 2008, Israeli banks were instructed to report to the Banking Supervision Department more frequently regarding their exposures to foreign financial institutions wherever such exposures exceeded a certain percentage of the bank's equity.
- **Reporting large exposures directly affected by the global crisis:** Israeli banks were instructed to review, map and estimate their exposures to entities, other than foreign financial institutions, that were directly or indirectly exposed to the crisis.

- **Reporting large customers' exposures to non-bank entities:** Israeli banks were asked to provide special reports on large borrowers' exposures to non-bank entities.
- **Reporting large customers showing adverse indications:** Israeli banks were instructed to report to the Supervisor of Banks regarding any borrower that had issued at least one bond series which was subsequently traded at a yield to maturity greater than 15% and whose net indebtedness exceeded a certain percentage of the bank's capital base or sums to a certain amount. The report specified the borrower's indebtedness, credit rating and classification at the time of the review as well as the results of an examination of the borrower regarding the extent to which its non-banking debt affected its ability to settle its debts to the bank by means of a detailed analysis of its payback ability.
- **Reporting capital market exposures:** Israeli banks were asked to advise the Supervisor of Banks of all exposures originating in capital market activity, including credit exposures that surpassed a certain percentage of the bank's capital base.
- **Assessment of the quality of the credit given for the financing of acquisitions of controlling interest:** in view of the considerable disparities between the value of the collateral in terms of securities prices on the exchange and the credit that the banks had given to some borrowers for the acquisition of controlling interest, the Supervisor believed it necessary to apply much greater caution in weighing the classification of such credit as impaired debt or making provisions in that regard.

One of the reforms taken in recent years in the Israeli banking system refers to anti-money laundering. The Anti-Money Laundering Law was enacted in August 2000 and the sections pertaining to the obligations imposed on financial entities took effect in February 2002. In January 2001, the Governor of the Bank of Israel issued the Prohibition on Money Laundering Order. This Order includes requirements regarding identification, reporting and recordkeeping by banking corporations. The regulation regarding business customer identification and recordkeeping (a regulation that has been in effect since 1995) has been amended in light of the declaration of principles of the Basel Committee on Banking Supervision of October 2001 on "Customer due diligence for banks". The regulation now incorporates directives on customer acceptance policy and the management and monitoring of high-risk accounts such as private banking, correspondent banking accounts and politically exposed persons (PEPS).

The Banking Supervision Department conducts on-site examinations on an ongoing basis to determine banks' compliance with anti-money laundering laws and directives. A Sanctions Committee, authorised to impose financial penalties for infractions, commenced operations in April 2003. In early 2005, the Prohibition of Terrorism Financing Law came into effect and Israel's banking directive was modified to include combating terrorism financing. This modification stemmed from the international collaborative efforts in the areas of anti-money laundering and combating terrorism financing, which are reflected in the standards set by the Basel Committee (Consolidated KYC Risk Management, October 2004) and Israel's legislation.

Additional steps in the fight against terrorism financing were taken in November 2006, when the Knesset approved an amendment to the Prohibition on Money Laundering Order and approved regulations on the Prohibition of Terrorism Financing. The Prohibition on Money Laundering Order was expanded and now requires financial institutions to check the identification of parties to a transaction against a list of declared terrorists and terrorist organisations, as well as obligations to report the type and size of transactions above NIS 5,000 whenever a high-risk country or territory is involved. The amended Order also requires credit card companies to identify the parties to transactions, report to the Israel Money Laundering Prohibition Authority and maintain records of transactions.

D. Financial results – developments and trends

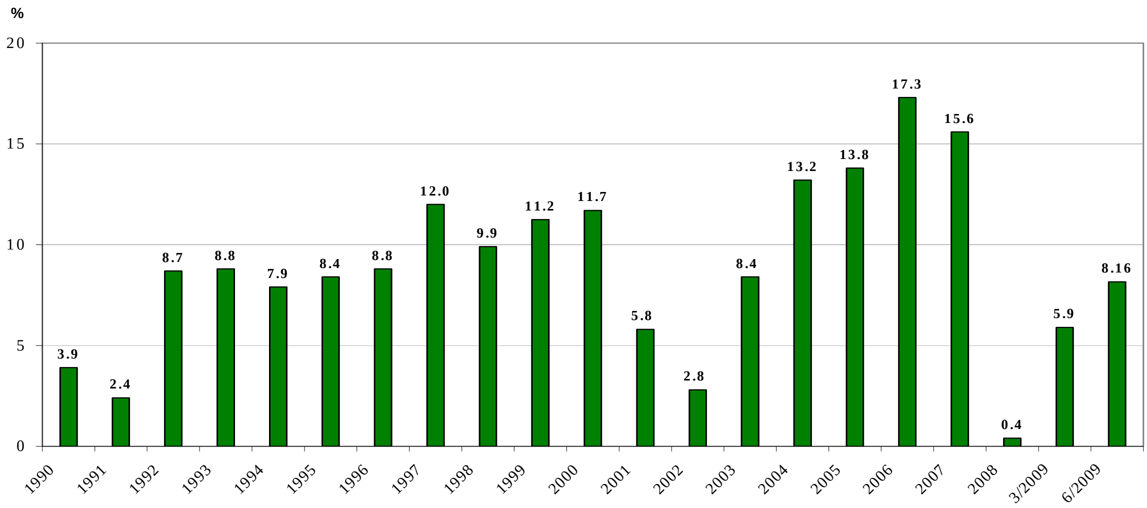
(The five largest domestic banking groups (Israeli banks)):

1. After five years of growth, the net return on equity (ROE) dropped sharply in 2008 to 0.4% compared with 15.6% in 2007 and 17.3% in 2006. The decline was a result of the realisation of losses in parts of banks' securities portfolios; writedowns due to the non-temporary nature of fair value adjustments of securities; and exposures to foreign financial entities and their adverse effect on the real economy. Until mid-2009, financial institutions, including Israeli banks, continued to exhibit resilience and banks became profitable again, with an ROE of 8.16% (Figure 2).

Figure 2

Annual return on equity (ROE) of the five major banking groups (Israeli banks)

(1990 to June 2009)[1]



[1] As of 2005–07, banking corporations are required to calculate their ROE according to the method customary in the United States and other countries, ie as net income adjusted for the dividend for preference shares not recorded as expenditure in the profit and loss statement and declared in the reporting period only *divided by* the average equity. In this respect, the average equity is the total of all equity *minus* the average balance of external shareholders' rights *minus/plus* the average balance of losses/gains not yet realised from the adjustment of negotiable bonds at fair value, as well as the losses/gains from saleable bonds included in the equity.

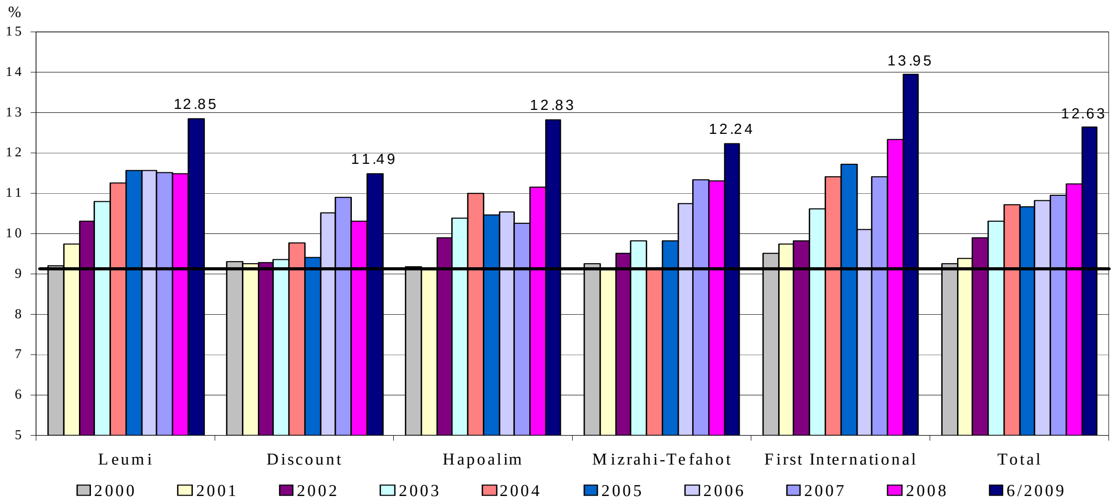
2. Israeli banks' capital increased by 6.9% in June 2009 after decreasing by 1.5% at year-end 2008 for the first time since the recession years (2001–03). The decrease was caused by the substantial negative charge to the capital account of approximately NIS 5 billion attributed to provisions of a temporary nature due to adjustments made to the fair value of securities (primarily mortgage-backed securities guaranteed by US government and federal agencies). Dividend distribution was very sparse and only two large banks disbursed in the first half of 2008.

   The total risk-based capital ratio reached 12.6% in June 2009 (Tier 1 ratio 7.9%), up from 11.2% (Tier 1 ratio 7.5%) at year-end 2008 (Figure 3). Having said that, the composition of Tier 1 capital exhibits a higher quality grade, as the Tangible Common Equity ratio is estimated to have reached over 6% in the last two years due to the small amount of preferred shares and innovative instruments issued by Israeli banks.

Figure 3

Risk-based capital ratio[1] of the five major banking groups (Israeli banks)

(2000 to June 2009)



[1] Minimum capital ratio since March 1999 (9%).

3. In 2008, Israeli banks incurred losses due to the depressed asset prices prevailing in the capital markets, which caused a decline in the income generated from the bond portfolio. This constituted a major factor in the 21.7% decrease in net interest income before loan loss provision expenses which amounted to NIS 17.9 billion in that year (down from NIS 22.9 billion in 2007). A significant component of that was a large bank's investment in the structured product market, particularly in mortgage-backed securities, which were not guaranteed by US government or federal agencies. This resulted in an NIS 3.9 billion loss during 2008 (an NIS 1.2 billion loss was recorded in 2007), which was reflected in the lower net interest income item. During the first half of 2009, the aggregate net interest income of Israeli banks increased by 31% compared with the corresponding period in 2008.

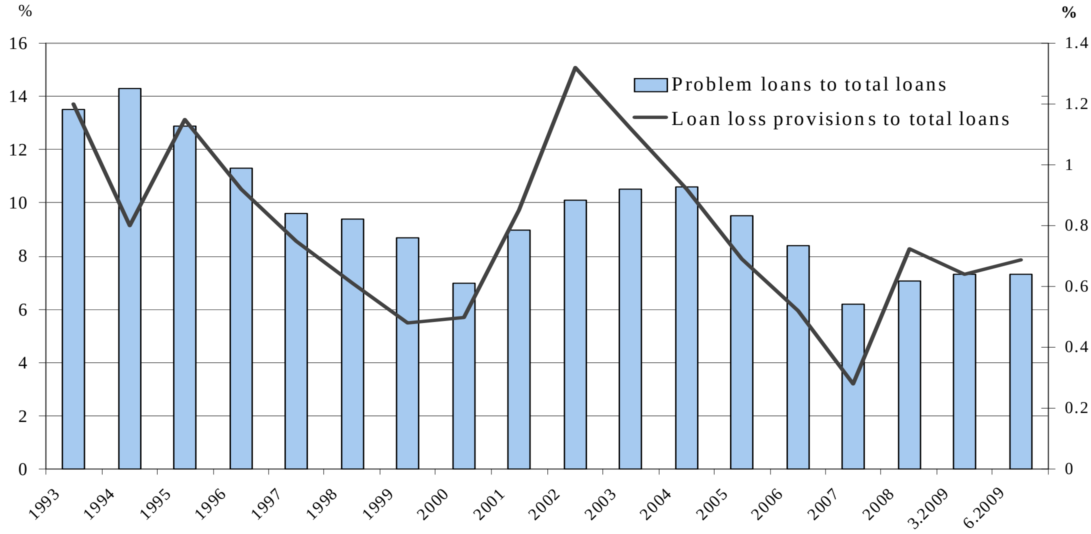
4. Israeli banks considerably increased their loan loss provision expenses during 2008, which rose by 186%, from NIS 1.78 billion in 2007 to 5.08 billion in 2008. The ratio of expenses to total loans amounted to 0.72% in 2008 compared with a mere 0.28% in 2007 (Figure 4). Most of the increase in expenses is attributed to loans to the construction and real estate, manufacturing and financial sectors. Notwithstanding the above, mortgage lending was resilient and problem loans to households increased by only 3.2%. The sum total of non-accrual loans amounted to NIS 10.3 billion after increasing by 10.8% in 2008. The ratio of non-accrual loans to total loans remained steady during 2008 at approximately 1.46%.

   During the first half of 2009, loan loss provisions remained high and rose by 100% compared with the corresponding period in 2008. The increase was a result of the adverse effect of the financial crisis on the real economy in general and the business sector in particular.

Figure 4

Ratio of loan loss provisions and problem loans to total loans (balance sheet) of the five major banking groups

(1996 to June 2009)



5. Israeli banks showed an increase in domestic activity in 2008 (a 13.5% rise in local currency) as credit to the public sector increased by 10.3%, a trend that demonstrated that credit markets in Israel were not suffering from the repercussions of the credit crunch that had emerged in some developed economies. This increase was partially due to the shifting of clients from the non-bank credit markets that had waned, while the cost remained substantially high due to the credit risk inherent in the non-bank credit markets. During 2009, that trend changed and credit to the public sector decreased by 1.4% as a result of the decline in economic activity and the recovery of the capital markets (ie the non-bank credit sector).

6. Due to the above – primarily the increase in loan loss provision expenses and the decrease in net interest income – Israeli banks' net income amounted to a diminutive NIS 205 million in 2008 compared with NIS 8.9 billion in 2007. In 2008, net profit from non-recurring items was NIS 815 million – half of the 2007 profit – thus, net operating profit was a negative NIS 610 million in 2008.

2. Domestically owned banks versus foreign-owned banks

A. Foreign banks in Israel

Until the beginning of the decade, foreign banks showed little interest in Israel's economy for political as well as economic reasons including: the Arab boycott of companies with business relations with Israel and interests in Arab countries that acted to prevent companies engaging in activities in Israel even after the lifting of the boycott; the existence of an advanced banking industry which does not offer exceptional opportunities to the same extent as emerging economies; the lack of economic stability (high inflation, large deficits in the balance of payments and in the budget); and foreign exchange control.

Over the last decade, foreign banks have exhibited a growing interest in the possibility of opening representative offices or branches in Israel in the light of processes which were reflected in Israel's improved credit risk rating, including: an improvement in Israel's macroeconomic features (lower inflation and budgetary restraint); the invitation to join the Organisation for Economic Co-operation and Development (OECD); and the liberalisation and deregulation measures taken to promote and refine the financial market in Israel, for instance the process of removing foreign exchange control, which enabled Israel to participate in the globalisation trend. In addition, the development of Israeli high-tech companies opened up business opportunities for foreign banks to offer their services to such companies as well as to provide private banking facilities to the directors and managers of those companies who had amassed great wealth, thereby broadening the potential customer base for such services in Israel.

Foreign banks' activity in Israel is still in its infancy. Their entry into the market is usually through the opening of branches and not through the purchase of a domestic bank. Possible explanations for that are, as mentioned above: the fact that foreign banks do not have a technological advantage over local banks; and that Israel is a small economy with closed borders, which limits foreign banks in their provision of banking services to the local population and their ability to benefit from using the activity in Israel as a centre for banking services to neighbouring countries.

Similarly to local Israeli banks, foreign branches operating in Israel did not experience severe shocks following the global financial turmoil and managed to remain sound. Nevertheless, foreign banks made some changes to their business strategies, most of which were needed, either due to the worsening conditions of the parent bank or to the economic environment in the home country, and were less affected by local factors. In addition, two groups expressed their confidence in the Israeli economy by making a business decision to expand their activity in Israel: Citibank – through the decision to allow two branches of the group to provide personal banking services in Israel, either through a branch or a representative office; and BNP Paribas – by opening a new representative office of the Swiss subsidiary (for more details see below). Unlike foreign banks operating around the world, most of the adjustments made by the foreign banks in Israel as a result of the crisis were made predominantly because of changes in the situation of either the parent bank or the home country and less because of factors related to the Israeli economy (the host country).

Though they remained stable, several branches made some adjustments to their business strategy and personnel in light of the new economic and financial reality. Citibank (United States) and, to a lesser extent, HSBC (United Kingdom), the two foreign banks with the most established presence in Israel, made some changes to their credit policy and reduced their credit vis-à-vis Israeli corporate borrowers in the first six months of 2009 (although total credit to the public sector continues to grow).

As for representative offices, Lehman Brothers (United States), which until its collapse was the foreign investment bank with the largest Israeli office, sold its Israeli business to Barclays Capital (United Kingdom). Barclays is now consequently expanding in Israel across a range of activities and may become more active in corporate lending when the environment improves. Merrill Lynch (United States) was also very active in Israeli investment banking; it remains to be seen whether its new owner, Bank of America (United States), will assume this role in the Israeli market. Other foreign banking groups active in Israeli investment banking such as UBS (Switzerland) and Deutsche Bank (Germany) have scaled back their activities as part of a global retrenchment.

It should be mentioned that the branches of foreign banks in Israel also facilitate the business of Israeli firms and other customers with branches and units of their parent group around the world. Therefore, local data do not reflect full activity.

A foreign bank can operate in Israel in three different forms: through a representative office, a branch or a subsidiary.

1. *Representative office*

The representative office of a foreign bank in Israel may engage only in providing information and promoting the bank's business in Israel and in activities relating to a customer's request to open a bank account as determined periodically by the Supervisor of Banks.

No permit is required under the Israeli Banking (Licensing) Law to open a representative office in Israel. However, if the intention is to use the word "bank" or a derivative of it in the name of the representative office, it must obtain the consent of the Governor of the Bank of Israel. A representative office and its activity are not supervised by the Supervisor of Banks (unless a doubt arises regarding the nature of its activity). In the near future, as part of the process of joining the OECD, the regulations may change in a way that will allow banks incorporated in one of the OECD countries to open a representative office only by pre-notification to the Bank of Israel.

There are currently 10 representative offices of foreign banks in Israel (not including the offices of domestic banks' subsidiaries) which have received the Governor's consent to include the word "bank" as part of their name. There were previously another four such banks which ceased their activities as representative offices in Israel (one expanded its activities and opened a branch in Israel). The offices currently operating in Israel are:

- Bank Hapoalim (Switzerland) Ltd
- Bank Leumi le-Israel (Switzerland)
- Bank Leumi (Luxembourg)
- Bank Leumi (United Kingdom)
- Banque J Safra (Switzerland)
- Banque Privée Edmond De Rothschild (Luxembourg)
- Banque Safdie SA (Switzerland)
- CALYON, Corporate and Investment Bank, Credit Agricole Group (France)
- Credit Industriel et Commercial, CIC (CIC Banques) (France)
- HSBC Bank USA NA
- HSBC Private Bank (Switzerland) SA
- IDB Bank, Israel Discount Bank of New York
- IDB (Switzerland) Bank Ltd
- JPMorgan Chase Bank NA (United States)
- Union Bancaire Privée (Switzerland)

Foreign banks' growing interest in Israel resulting from the changes in Israel's geopolitical and economic environment has been referred to above. This interest is also reflected in the number of representative offices which have been opened: from 1994 to 1997 there was a slow trickle (on average one office a year), while in 1998 and 1999 the rate increased, and the Governor gave his consent to three and four a year, respectively. In 2000, only one representative office opened; nonetheless, there is continued interest from foreign banks. Since 2000, nine more financial institutions have been granted permission to open a representative office in Israel, of which three have already opened and operate a representative office.

In addition to the above, there has been a rise in activity in Israel by other foreign financial entities in the last few years, including banks in whose names the word "bank" does not appear. They engage in areas such as investment banking, including underwriting services and advising Israeli companies issuing shares or bonds abroad or prior to acquisitions or mergers as well as brokerage services.

2. *Activities via a branch*

When operating a branch in Israel a bank must meet the following criteria in addition to the requirements for setting up a subsidiary:

- Banking supervision in the home country must be performed on a consolidated basis, covering the branch to be opened in Israel, and in accordance with the international standards set by the Basel Committee.
- The bank must provide "endowment capital" to the branch to enable stability restrictions to be applied.

The permit granted to a foreign bank which meets the above criteria does not restrict the types of activities allowed in comparison with those allowed to domestic banks.

There are currently four branches of foreign banks operating in Israel: Citibank NA; HSBC Bank PLC; BNP Paribas SA; and the State Bank of India.

Citibank NA established a representative office in 1996 in Israel and in July 2000 became the first international bank with a full banking licence to offer a range of services to its clients in Israel. The branch offers large corporate finance, including underwriting and publicly distributing local corporate bonds, sales and trading, as well as cash management, import and export and trade finance solutions, and enjoys the advantage of Citigroup's wide international coverage. The global financial crisis and the changes in the group's management have not affected Citibank's business strategy in Israel thus far, and the branch has maintained its focus on capital market activities. The branch made a slight reduction in employee numbers as part of the group's policy to transfer some of the local activities to regional centres.

In 2009, two branches of the Citibank group decided to provide personal banking services in Israel, either through foreign bank branches or through representative offices.

In 2001, **HSBC Bank** opened a branch in Israel. HSBC operates in Israel in four areas: private banking, corporate banking, treasury services and investment banking services. The branch did not change its business strategy due to the global financial turmoil and, moreover, its scope of activity has extended in the last year. The branch is working to apply a new local risk management model – as required by the parent bank. No personnel changes have been made during that time. Outstanding loans have grown in the last three years and derivative activity is growing gradually, although it is not part of the branch risk, since it is recorded on London's books. In addition to the branch, the HSBC group also operates two private banking representative offices in Israel that cater to local customers wishing to open foreign accounts.

BNP Paribas group has operated in Israel since 1996, initially through a representative office (1998) and later through a banking branch (2006). The Israeli branch focuses on the following service activities: corporate and investment banking, as a trade centre and as a treasury platform. BNP Paribas Israel relies on the group's global network to support major Israeli corporations in developing their international business activities and to facilitate international clients' access to the local market.

Due to the global financial crisis, new instructions from the group to the Israeli branch changed its method for pricing transactions but, apart from this, no other adjustments were needed as a result of the crisis.

In 2009, one of the group's subsidiaries – BNP Paribas (Suisse) – opened a new representative office which is expected to promote private banking in Israel. In addition, the local branch is considering providing investment banking services to its local clients.

The State Bank of India's branch in Israel was opened in 2007. The branch focuses on: the firms operating in the diamond industry which are either affiliated to India or have economic relations with it; providing guarantees to Israeli industries working with the Indian Government; and providing discounted bills in export transactions by Israeli corporates to India.

3. Subsidiaries

Banking activities can be performed in Israel by a foreign bank through a subsidiary either by establishing a new bank in Israel or by acquiring control of a domestic bank.

The policy towards establishing a bank in Israel does not distinguish between holders of controlling interests who are non-residents, including foreign banks, and Israeli residents.

There is one foreign-owned domestic bank currently operating in Israel – Dexia Israel Ltd bank. The bank is a subsidiary of the international Belgian–French Dexia group and began to operate in Israel by acquiring the local Israeli bank Otsar Hashilton Hamekomi through a privatisation process of the former which took place in 2001. The bank received a licence under the Israeli Banking (Licensing) Law in 2008, enabling it to provide a full range of banking activities in Israel; it has subsequently changed its name to Dexia-bank. One of the bank's core activities in Israel is to provide financial services to municipalities.

In October 2008, the branch's parent bank was nationalised by the French, Belgian and Luxembourg Governments, mostly due to the substantial losses of the group's subsidiary (FSA) in the United States. In November of that year, the new management conducted a transformation plan to minimise exposures to market risks, focusing on public sector financing, mainly in France, Italy, Luxembourg, Belgium and Spain, and shut down its activities in several other countries. As for Israel, the bank did not make any changes regarding the business strategy and policy of its Israeli subsidiary. Nonetheless, the bank has made clear to the local subsidiary that it must not lean on the parent bank for new funding and should finance itself independently. In addition, the criteria for granting indemnity for transactions greater than the single borrower limit have been tightened.

Two other subsidiaries operated in Israel until recently, both of which were acquired and merged into domestic banks: Bank Polska Kasa Opieki, a subsidiary of the Polish Bank Pekao (since 1999 the subsidiary has been part of the Italian bank UniCredito Italiano); and Investec Bank, controlled by the Investec group. Both banks were engaged in all types of banking activities.

B. Changes in bank lending

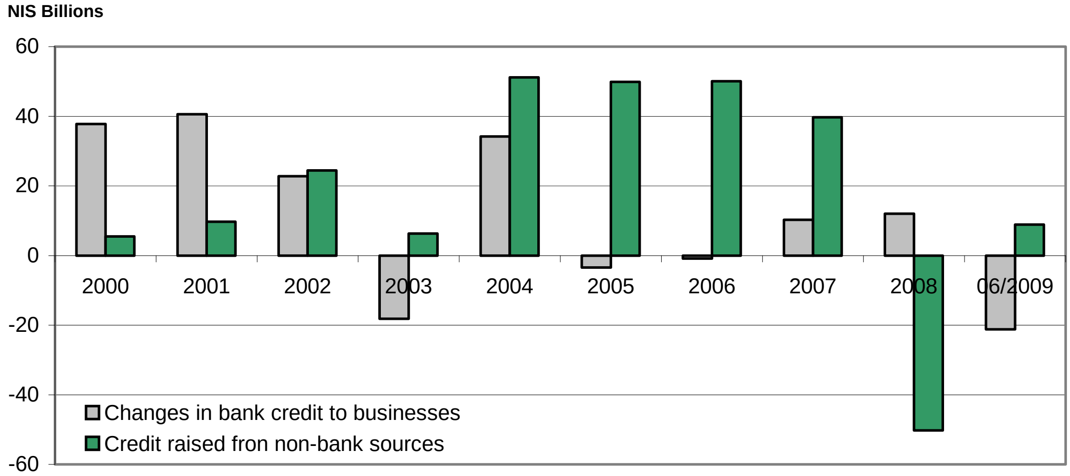
The total balance sheet of the Israel banking system continued to expand during 2008 at a rate similar to previous years (about 5%). At end-2008, it stood at around NIS 1.07 trillion (including foreign banks). However, there were some significant changes in the composition of the balance sheet during 2008, which reflected an increase in classic financial intermediation, ie an expansion of bank credit and growth in bank deposits to the public sector, accompanied by a sharp decline in securitsation activities. This represents a reversal of the prolonged trend of disintermediation in recent years.

In 2008, the banking system's degree of dominance in economic activity increased as a direct outcome of the global financial crisis and the recession in 2008. Israeli non-bank lenders, notably provident funds and insurance companies, suffered heavy losses in the final months of 2008, as the price of many bonds, which they had eagerly snapped up during the boom period, collapsed. Bond issuance fell sharply, with many issuers and some entire sectors (such as real estate and construction) effectively frozen out of the market; the market for new equity issues closed almost entirely. Israeli banks enhanced the scrutiny of credit risk and, when the level of risk exceeded their risk preferences, they abstained from lending to corporate borrowers (Figure 5).

Figure 5

Changes in credit to the business sector from non-bank and bank sources

(2000 to June 2009)

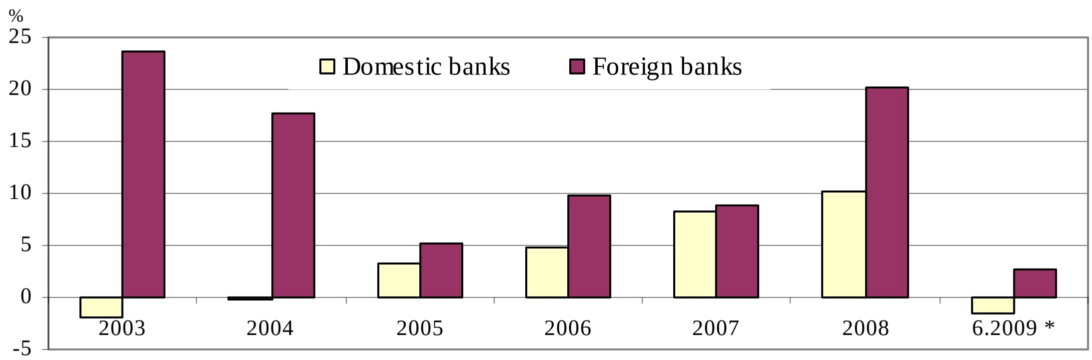


During 2008, banks' securities portfolio shrank in size, both in terms of absolute value and as a proportion of the balance sheet. The drop in value was a result of both the sharp decline in asset prices as well as of the sale of parts of the portfolio. Simultaneously to the decrease in size of the securities portfolio, which reflects a reduction in non-classical financial intermediation, there was a major increase in bank credit to the public sector, which is a reflection of increased classical financial intermediation. Thus, total balance sheet bank credit to the public sector rose by 10% in 2008, its highest rate of growth in recent years (Figure 6).

Figure 6

Rate of change in credit to the public sector: domestic banks vis-à-vis foreign banks in Israel

(2003 to June 2009)



* Six months' growth.

Both foreign and domestic banks' credit to the public sector grew substantially between 2003 and 2008 as a result of two factors: the enhancement of foreign banks' activity in Israel and the favourable macroeconomic conditions during those years (which were reflected in a growing demand for credit).

As a result of this development, the proportion of credit to the public sector in the balance sheet rose by a proportion similar to the drop in the securities portfolio. This rise in credit was also reflected in the provision of bank credit to industries which, in previous years, had not been major recipients of bank credit, such as the construction and real estate industry.

Outstanding bank and non-bank credit to the business sector remained practically unchanged in 2008. The slower pace of expansion in outstanding credit following three years of rapid growth – mainly in non-bank credit – was a consequence of the reduced supply of non-bank credit and the decline in bond prices caused by the increased assessment of risk in the financial market as a whole and in the corporate bond market in particular. The volume of business sector issues therefore fell heavily during 2008 overall. These issues ceased almost completely in the second half of 2008 and prices of CPI-indexed corporate bonds dipped significantly.

The growth in bank credit to the business sector differed between the various types of customers: while bank credit to large firms grew significantly in 2008, the growth in credit to small- and medium-sized businesses (SMEs) came to a standstill from the second quarter of the year.

The demand for credit during 2008 was affected by the downturn in the economy in two opposite directions: while the decline in investment reduced the demand for credit, the deterioration in firms' real position increased their working capital requirements. As a result, the number of companies financing constraints increased in the second half of 2008, particularly among smaller firms in the construction, transportation and commerce industries.

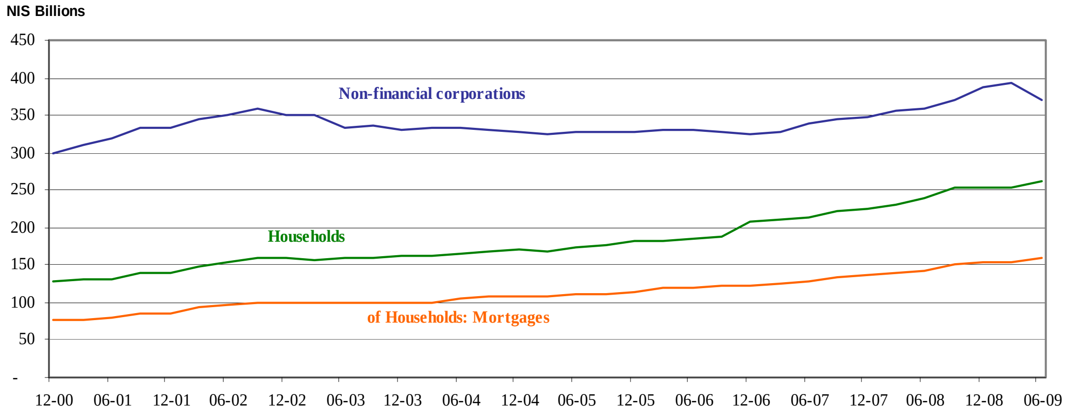
The rapid development of local non-bank credit during recent years (Figure 5) created an alternative channel to bank credit and led to a broader diversification of the credit risk in the economy, which could have contributed to the stability of the institutions extending credit as well as to the creation of a more competitive financial system. However, that was not the case, and the rapid growth actually led to an increase in the potential risk of the credit portfolio in the economy.

A significant part of the growth in total bank credit occurred in 2008 due to households, including both housing and consumer loans (Figure 7). This sector is considered to be less risky due to its high degree of diversification (indeed, the annual expenses due to the loan loss provision for this sector grew much less than for the business sector). The increase in demand for credit among households during the first three quarters of the year came to a halt during the fourth quarter – a trend parallel to that of private consumption, which is the main source of demand for credit.

Figure 7

Balance sheet bank lending: households vis-à-vis non-financial corporations

(December 2000 to June 2009)



The expansion of credit for housing in 2009 was a result of the public's desire to change the composition of its asset portfolio by moving away from financial assets to tangible assets. This trend appeared in 2008 as financial and capital market volatility intensified. A major portion of the funds withdrawn from provident funds was channelled into the housing market (which experienced a moderate rise in prices, primarily in areas of high demand).

Despite the increase in the credit risk of borrowers last year, the activity in housing loans is still considered to represent a low credit risk. Evidence of this is the stability (and even slight reduction) in total accumulated arrears among mortgage holders during the course of 2008, despite the economic slowdown.

An examination of the breakdown according to indexation segment shows that most of the expansion in bank credit in 2008 occurred in the unindexed segment, including both the business sector and the retail and household sector (Figure 7). This increase is the continuation of a trend which is partly explained by the continuous reductions in the short-term monetary interest rates, as set by the Bank of Israel, which are the key interest rates for transactions in that segment.

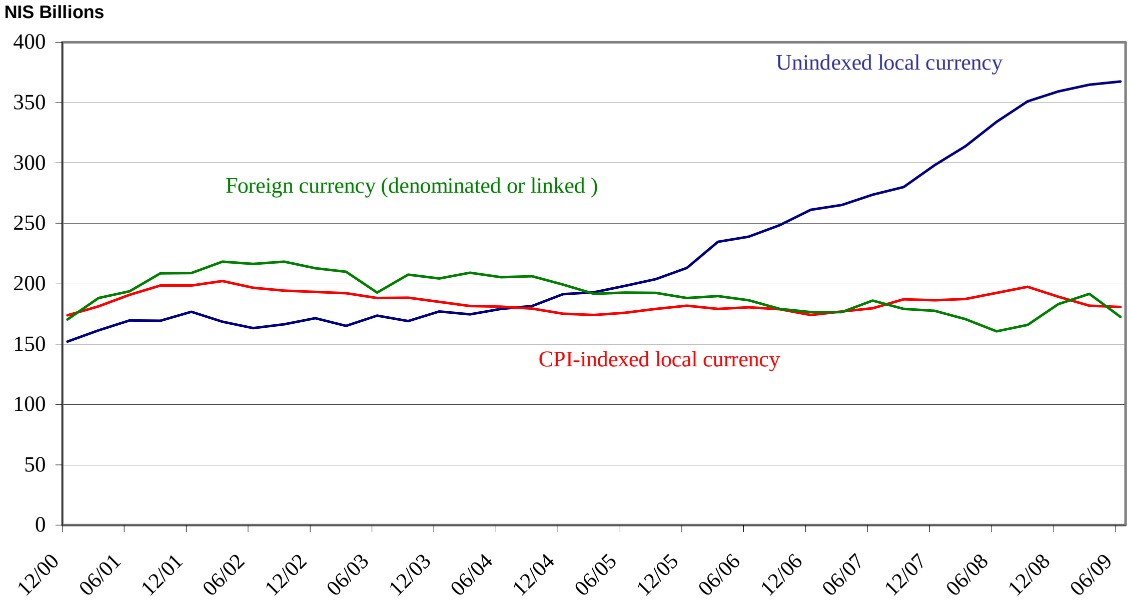
Vis-à-vis the increase in total bank credit to the public sector in 2008, as mentioned above, the scope of banks' activity in securities declined substantially in 2008 (from NIS 163 billion to NIS 130 billion); this decline occurred after several years (2006–07) during which the banks had increased, stabilised and diversified the composition of their securities portfolio. The proportion of government bonds, which are low-risk assets, declined, while the proportion of other debt securities increased, mainly as a result of the purchase of asset-backed securities (ABS) issued by financial institutions and firms.

The sharp rise in bond spreads in Israel also led to a decline in the value of corporate bonds issued in Israel; however, thanks to the relatively small magnitude of this exposure (about NIS 6.6 billion), the effect on the risk of the securities portfolio was fairly minor. Unlike corporate bonds issued abroad, most of which are issued by the financial sector, investment in domestic bonds is characterised by a high level of diversification among the various business sectors.

Figure 8

Balance of credit to the public by indexation segment

(June 2000 to June 2009)



C. Changes in bank funding

Banks operating in Israel raise most of their funds through offering short- and medium-term deposits and savings schemes to their household customers as well as through the issuance of bonds and notes on the domestic market or directly to institutions. The funds thus raised can be either unlinked or CPI-linked, and their composition will vary in line with current and expected inflation rates and the influence they have on both household and business demand for various types of funds and on banks' internal funding structure and needs.

At the end of June 2009, total interest bearing liabilities of banks operating in Israel amounted to NIS 1.02 trillion, a 10% increase compared to the corresponding period in 2008, of which about 2% came from foreign banks and the rest from domestic banks. Deposits, which are the primary source of bank funding, constituted around 82.4% of interest bearing liabilities among domestic banks and a smaller share of 66.5% among foreign banks. While bonds and subordinated debt constituted around 7.2% among domestic banks, that figure was much lower among foreign banks and their share amounted to less than 1% of banks' interest bearing liabilities (among foreign banks, the only bank involved in raising funds through bonds and subordinated debt notes is Dexia-Israel). During the first six months of 2009, bond issuance and subordinated debt increased by NIS 5 .6 billion (8%) among domestic banks, reflecting the direct continuation of the trend prevailing in recent years that had helped banks to increase their capital adequacy, as they were expected to reach a total risk-based capital ratio of 12% by year-end 2009. As required by the Basel Accord, the Supervisor of Banks in Israel limits the use of such notes to a maximum of 50% of the Tier 1 capital as eligible capital for the calculation of the risk-based capital ratio – a limit exploited by three of the five major banking groups in Israel (due to year-end 2008).

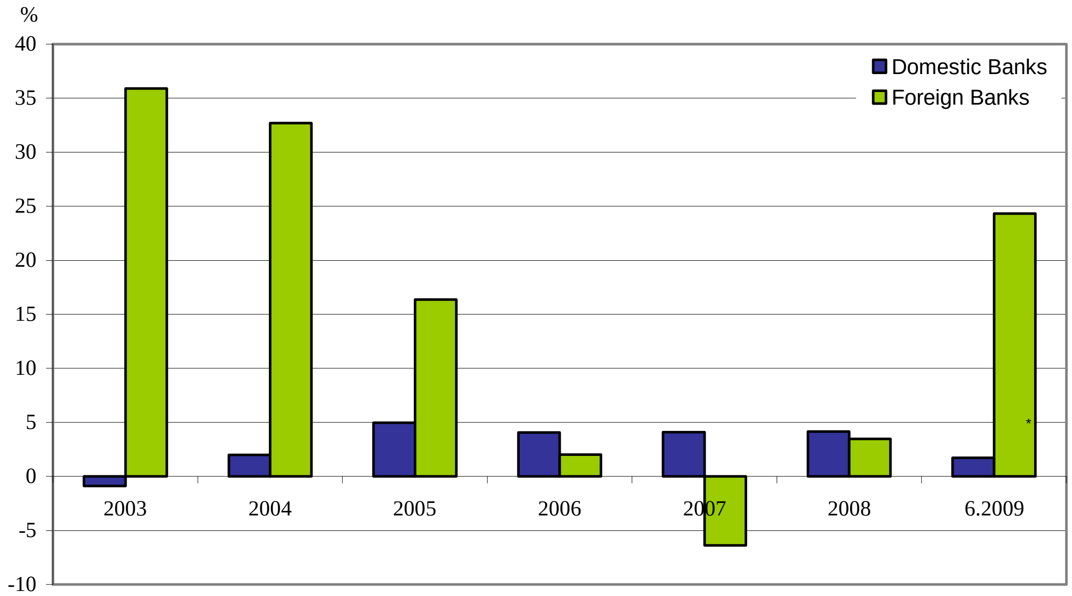
Total public sector deposits rose by 4.2% during 2008. After falling by 3% in the first six months of 2008, total public sector deposits increased sharply from June 2008 to June 2009 (9.3%), mostly during the last six months of 2008 (7.2%). This increase might be explained by the rise of risk assessments in the financial markets in the wake of the crisis, as volatility increased and risk margins expanded. These assessments led to higher rates of withdrawals from provident funds during the year, which prompted the public to seek lower-risk forms of investment. In periods of uncertainty, investors have a diminished risk appetite and therefore prefer to minimise exposure through bank deposits, which are considered a “safe haven”, at least in the medium term.

Compared with domestic Israeli banks, which maintain a steady growth rate in total public sector deposits, the rate of change among foreign banks is more volatile. The high growth rate of the early years (2003–05) stemmed from the enhancement of their activity in Israel, and the low and negative rates of 2007–08 stemmed from the financial crisis, as foreign banks were perceived as less sound than domestic banks. In 2009, that trend changed with an increase of over 20% in deposits to the public sector among foreign banks (Figure 9).

Figure 9

Rate of change in public sector deposits: domestic banks vis-à-vis foreign banks in Israel

(2003 to June 2009)



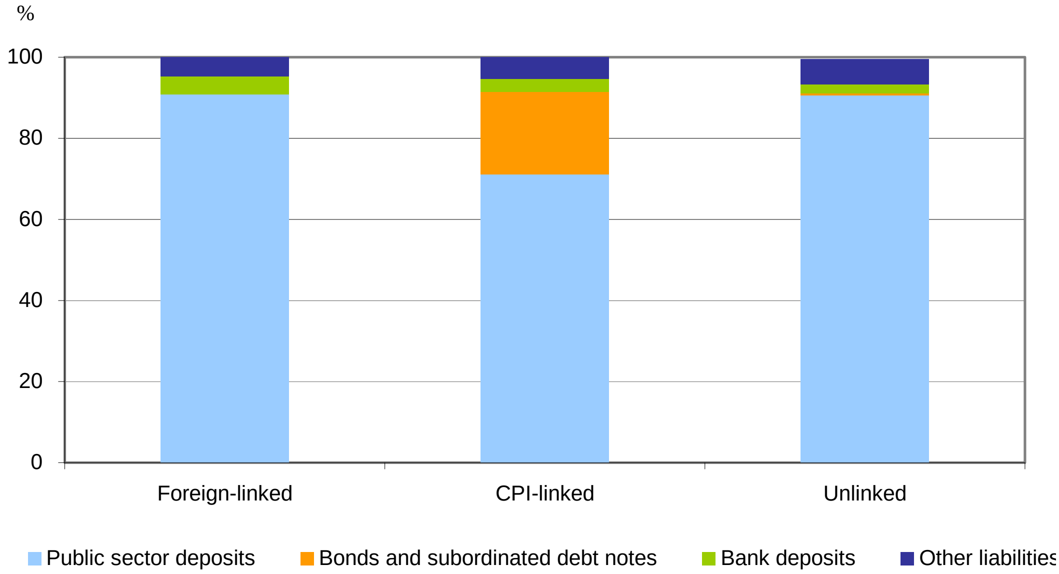
* Six months’ growth.

As with loans, deposits can be transacted in unlinked Israeli shekels, in CPI-linked Israeli shekels or in a foreign currency (including a foreign currency-linked clause), and each sector is influenced by different competitive and pricing forces. Unlinked shekel intermediation activity is a short-term activity, mostly up to a year. The primary fund sources in this sector are either the unlinked public sector deposits or the monetary loans provided by the Bank of Israel. Since December 2008, due to a liquidity surplus in the banking system, no monetary loans have been granted by the Bank of Israel and the share of unlinked deposits among total unlinked interest bearing liabilities was, as of June 2009, around 90% (Figure 10), an increase of 2 percentage points compared to June 2008.

Figure 10

Distribution of funds by indexation sector, Israeli banking system

(Unconsolidated data, June 2009)



* Other liabilities include, among others: government deposits; creditors in respect of credit card activities; and credit balances due to derivative financial instruments (except for embedded derivatives).

The CPI-linked sector is characterised as a medium- to long-term activity. The primary fund sources are medium- to long-term linked public sector deposits or deposits in savings accounts, bonds and subordinated debt notes. Whereas the share of linked deposits and deposits in savings accounts in total linked interest bearing liabilities has not changed significantly since June 2008 (approximately 65%), the share of bonds and subordinated debt notes issued by banks has increased by 2 percentage points to 20.5%, amounting to NIS 34.4 billion in June 2009. Although banks have increased the funds raised through this channel, they have not used it to grant credit to the public sector, even though the purpose was to use these funds to increase capital adequacy, as mentioned above. Among foreign banks, all of the CPI-linked funds are raised by Dexia-Israel bank through institutional investors, deposits of municipalities and local authorities, public sector deposits (both corporate and retail) and bond issuance.

When referring to public sector deposits in Israeli banks, two unique features of the Israeli banking system should be highlighted: the first is its large non-resident foreign currency deposits, which are considered to be solid and firm and more than matched by assets. These non-resident deposits come from the large Jewish diaspora and have been stable for many years. The second unique feature is the absence of a formal deposit insurance scheme in Israel. However, the law specifies that the Governor of the Bank of Israel may decide to guarantee in whole or in part bank deposits in which it has intervened or other classes of bank liabilities. The guarantee may be for a limited or unlimited time, either subject to conditions or unconditional. The implicit government guarantee is a result of the precedent established in 1983 when the government saved the major Israeli banks by nationalising them. The authorities strengthened this precedent by guaranteeing the deposits of two small banks which failed in 1985 and 2002. The Governor of the Bank of Israel is empowered to guarantee deposits upon receiving the government’s approval. In fact, the authorities have never permitted bank depositors to lose money and market participants believe that the government has an implicit guarantee for all bank deposits. Except for the cases specified, no bank in Israel has required government intervention – including foreign banks operating in Israel (whether through subsidiaries or branches). In a recent pronouncement on this subject, the authorities indicated that there would be no discrimination between local and foreign banks if a formal deposit insurance scheme were to be established.

D. Banks' balance sheet liquidity

Liquidity risk is measured and managed in the Israeli banking system through internal models that monitor the liquidity situation using various indices and scenarios.[2] The internal models developed by the banks are differentiated by their working assumptions and methods of calculation and are derived from the characteristics of each bank's customer base. These models also take into account other factors, such as the dependence of the bank on large depositors, ie the degree of concentration among depositors, the bank's ability to obtain a credit line abroad and from the parent bank, and the bank's reputation, etc.

The banks use their internal models, based in general on statistical tests, to derive the rates at which to recycle their deposits (according to various segmentations: size, type and period of deposit, type of indexation, etc) and their ability to liquefy various assets. The models are also used to calculate the following liquidity indices on a daily basis: the liquidity gap according to the period to maturity (a day, up to a week, up to a month, up to three months, up to six months, up to 12 months and longer than 12 months) and the ratio of liquid assets to liabilities with a time to maturity of up to one month. In addition, liquidity indices are analysed for various scenarios, such as stress tests, that are related to a crisis at the bank or a general crisis (war, political upheaval, shocks to the financial markets, etc), and which demonstrate how the bank would continue to operate in a crisis at a reasonable cost for a one-month period. Since the crisis began in September 2008, most of the banking system has been operating according to extreme scenarios, which require the holding of larger reserves of liquid assets.

Although Israeli banks did not experience a liquidity crisis, liquidity risk has risen. In September 2008, in an effort to monitor the stability of the banking system and to enhance the transparency of financial reporting, banking corporations were asked to provide the Supervisor of Banks with newly formatted reports on liquidity risk. In addition, and as mentioned above, an ad hoc task force team was established by the Supervisor of Banks to scrutinise banks' risk exposures and to monitor their operations and liquidity positions.

The liquidity crisis led the Bank of Israel (BoI) to adopt a series of monetary measures:

a. In April 2009, the BoI reduced the absorption of liquidity surpluses through the issuance of makam (1-year nominal T-bills). Since that time, excess liquidity has been absorbed primarily by allowing commercial banks to increase their deposits at the BoI (which are not considered part of the money base). This means that the public's portfolio has shifted from foreign currency and/or bonds to currency or deposits. Public sector deposits provide most of the liquidity to commercial banks, and banks do not use all the additional liquidity to offer loans – this liquidity, excluding a small fraction which they are required to hold as reserves, is absorbed by the BoI as commercial banks' deposits at the prevailing rate (0.5%). Consequently, the base expands only by a small amount while M1 expands considerably due to the very low interest rates.

[2] Liquidity risk is measured and managed in the Israeli banking system using internal models and, therefore, banks are not obligated to achieve a ratio of 1, as required by the standard model in Directive no 342 of the Proper Conduct of Banking Business.

b. Monetary loans of a longer maturity were added to those currently issued by tender to the banking system for durations of one day and one week.

c. The spread around the BoI interest rate at the credit window (the "corridor") and at the deposit window for commercial banks was lowered from ±1% to ±0.5%, and at the beginning of 2009 there was a further reduction to ±0.25%.

d. Repo tenders to commercial banks and financial institutions were offered for longer than the previous term of one week.

e. The purchase of government bonds by the BoI has helped to reduce the yields on long-term government bonds. Additionally, the purchase of bonds has helped the capital markets to return to more normal functioning, particularly with regard to the renewal of issuances and the raising of capital by the business sector; the BoI ceased buying bonds in August 2009.

Other changes in BoI policy during 2008 which increased liquidity (although that was not their primary goal) included:

a. The intervention by the BoI in the foreign currency market for the first time in 11 years, which involved the purchase of foreign currency (in the amount of NIS 55 billion thus far) and the corresponding injection of shekels.[3]

b. The lowering of the interest rate five times during the last quarter of 2008 (two of which were inter-meeting decisions, ie not taken on the regular interest rate announcement dates), from 4.25% to 1.75%. Since the beginning of 2009, the BoI has continued to lower the interest rate to record low levels and in April it was lowered to a level of only 0.5%.[4] In September 2009, the interest rate was raised by 0.25 percentage points only, to 0.75%, a rise that stemmed from the need to bring inflation back to the target set by the government while at the same supporting the recovery of economic activity.

Since December 2008 and throughout 2009 there was a noticeable upward trend in the liquidity of the banking system, characterised by a basic liquidity surplus, and banks began placing deposits with the BoI. This is in contrast to the basic liquidity deficit prevailing until December 2008, during which the BoI offered banks loans by tender.[5]

As a result of the worsening of the crisis in September 2008, Israeli banks as well as foreign banks also took a number of steps aimed at maintaining a level of liquidity that was appropriate to the level of uncertainty. These included an increase in their deposits, both at local banks and at the BoI, as well as in their holdings of government bonds, which was carried out simultaneously with a reduction in deposits at foreign financial institutions and the shortening of their duration. Consequently, the ratio of liquid assets to liabilities with up to one month to redemption increased steadily from September 2008 to June 2009, both in Israeli and foreign banks and, as can be seen in Table 2, the increase among Israeli banks was more moderate compared to foreign banks.

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3 The goal of the purchases was to halt the appreciation and to adjust foreign exchange reserves to the levels generally accepted in other countries.

4 The main goal of lowering the interest rate was to keep to the inflation target and support real economic activity.

5 Another development in 2008 that worked to reduce the liquidity risk implicit in the settlement process was the addition of the shekel as a currency cleared through CLS (Continuous Linked Settlement), an international interbank settlement system, in May 2008.

Table 2

Local currency and foreign currency liquidity indices, the standard model[a] (September 2008 to September 2009)

(Ratio of liquid assets to liabilities with up to one month to redemption)

	09/2008	12/2008	03/2009	06/2009
Domestic banks	0.19	0.26	0.28	0.32
Foreign banks	0.31	0.39	0.49	0.61
Banking system	0.19	0.27	0.29	0.33

[a] The standard model as described in Directive no 342 of the Proper Conduct of Banking Business.