Nadine Baudot-Trajtenberg: Brief overview of the changing landscape of the financial market in Israel

Remarks by Dr Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel, at the institutional investors conference, Eilat, 2 December 2015.

*   *   *

It is my pleasure to be here at the annual conference of the largest institutional investors in Israel. Today I'd like to give a brief overview of the changing landscape of the financial market in Israel, and particularly to highlight how recent legislation is expected to affect it.

Particularly I'd like to discuss three central issues that are always present in any discussion of financial intermediation: the size of the system, its competitiveness and its stability and credibility.

No one quite knows what the optimal size of the financial sector is for any country. What we do know is that if it is very large it is prone to crisis, and the past decade has seen a number of examples of overgrown financial markets that suddenly and often quite unexpectedly deflated rather violently and disastrously for the local economy.

If the sector is too small, it will stunt economic activity and will not play its central role of channeling savings to borrowers (both to investors and to consumers) in a way that sustains economic growth. In addition it will weaken monetary policy, as it is the main avenue for the transmission mechanism to work itself and impact on economic activity.

The second issue, and one which is at the forefront of public discourse in Israel, is the structure of the market, or how competitive the financial sector is. What we typically mean by competitiveness is not necessarily how concentrated that sector is, but rather whether the 3 essential characteristics of a competitive market are present:

To what extent is the supply appropriate – or in other words, is access to its services too restricted?

Is the pricing adequate – or in other words, do consumers get the best price for the service, the highest interest rate for savers and the lowest interest rate for borrowers of all kinds?

Is the sector dynamic in that it constantly innovates new and better services for its clients?

A market that is characterized by often complex products, not easily understood or compared by the consumers of those products, as well as by asymmetric information between the seller and the buyer, is a market that is unlikely to reach the "competitive market equilibrium" as delivered by the invisible hand.

Last but not least, stability is an issue that is intrinsically attached to financial markets, and not to other markets where the fall and rise of companies are part of the normal course of business, because there is something about the nature of financial services that make them particularly fragile: the seductive appeal of leverage. Anyone who has tasted it can be excessively charmed by it, and when things turn sour the impact on the rest of the economy can be large and long lasting – as we have seen again recently in so many countries, including developed countries that had presumably well developed and regulated markets.

The size of the financial sector relative to the economy in Israelis close to the OECD average. A few countries such as Switzerland, Ireland and the UK have become financial hubs and are exporting various financial services to other countries. In the case of Switzerland, the services exports are mostly asset management, Ireland's are mostly back office services, and in the UK it is mostly financial intermediation. The value added of financial intermediation in Israel was 5.1% of GDP in 2013, slightly less than the 5.4% average in OECD countries.

Total assets of the banking sector in Israel a share of GDP stood at 127% in 2014, well below the OECD median (243%) and average (247%). In fact, the total assets of the banking sector as a share of GDP has been contracting for the past decade from its peak of 147% in 2002.

At the same time, the assets that you, the institutional investors, manage have grown over the same period from 67% of GDP in 2002 to 117% in 2014.

We may not know whether the financial sector is of optimal size, but these figures show that Israel appears to be pretty much where one would expect it to be, neither very large nor very small – a reassuring figure overall.

Turning now to the trickier and thornier issue of the sector's competitiveness, we do not have all the indicators needed to make a perfect assessment of the situation, but we do note that the concentration in the banking sector is substantially higher than that of developed countries.

Perhaps even more striking is the area of consumer loans, which is entirely dominated by the banks, and in particularly by the large banks in Israel. This was always the case, but as banks have receded from granting credit to large corporations, they have increased credit to consumers.

Indeed during the past decade, retail credit, including mortgages, has grown much faster than any other type of credit.

Over the same period, institutional investors have broadened the allocation of their assets, particularly with respect to investments abroad which have grown from 8% to 19% of their assets between 2005 and 2015. However, they have so far not taken much part in the retail credit market, either in mortgages or in consumer credit. The truth is that it is not typical for large asset managers in developed countries to enter the retail lending market.

Institutional investors in Israel have entered the corporate debt market during the past decade, despite the fact that this sector shrunk as a share of GDP during that period.

So we know that retail lending has been growing, but it is dominated by the banks, while corporate lending has not been growing as a share of GDP and has been the subject of competition between institutional investors and banks.

What about small businesses? First, the importance of small businesses in the Israeli economy is similar to that in the other OECD countries, in fact a bit larger, constituting 42% of business sector GDP – a significant part of the economy that could be a source of economic growth.

The banks increased the volume of lending to small and medium businesses from 36% of banks' business sector credit to 44% between 2011 and 2014. An international comparison is difficult because the distribution is very wide.

What about pricing? Well, the smaller the business, the higher the interest rate it pays. Does this reflect the risk involved or market power?

What is clear is that profitability over the past 4 years has been much higher in the household and small business sector than for other types of credit. Even if we take into account that these years are upcycle years, and profitability is likely to be affected negatively in a downcycle, there are good reasons to believe that the higher pricing is in part due to market power.

Recent legislation and regulatory changes will tackle this problem and should bring the institutional investors, to that the small business and household credit market as well.

The establishment of a credit registry tackles the problem of asymmetric information, while the legislation enabling securitization will allow institutional investors to enter the retail market indirectly – as it is done in many other places in the world – by connecting institutional capital with the banks' ability to grant credit, which will lead to an expanded supply of credit and lower financing costs.