Chapter 1

Israel's Banking System – Activity, Financial Results and Risks in 2005 and for the Long Term

The performance and strength of Israel's banking system continued improving in 2005. This was reflected by a further growth in return on equity, which reached its highest level since 1989, together with the continued downward trend in the risks that banks are exposed to, most notably in credit risk (although these are still high).

The background factors that contributed to the improved profitability of the banking system and its expanded activity are apparently the upward trend in economic activities in Israel and abroad in the past three years, and the expanded activity of the capital market. Against the background of the improved profitability and fall in risk, it is important to stress the rise in capital adequacy, for despite the rise, Israel is among the countries with the lowest excess capital adequacy ratio (that is above the minimum required).

The central components of the rise in the banking system's profitability in 2005 were the rise in net interest income and a reduction in loan-loss provision. The sale of subsidiaries and holding companies also contributed to the rise in profits this year for the banking groups, and this is expected to strengthen in 2006, given the one-off profits that the banks will register by selling their holdings in management companies of provident and mutual funds, in the framework of the Bachar recommendations. Also as part of this framework, the banks will be allowed to operate in the fields of pension fund advice and life insurance products in the future, and this is expected to increase banks' interest and non-interest income. Financial results for the first half of 2006 point to an improved performance for the banks, expressed in the further rise in profitability and a fall in bank risks.

In 2005 the process of transferring control in the two last commercial banks still in state hands—the Discount and Leumi groups—to private parties that had bought the controlling shares, was completed. By 2006 all the commercial banks in the Israeli banking system were now privately owned.

During the year the dominance of the banking system in the field of financial intermediation continued to fall, following the increased threat of competition from non-bank financial intermediaries, in a process that began in 2003. An expansion of economic activity also contributed to this, seen in the growth in demand for financing by both the business and retail sectors. However unlike the business sector, which raised most of its funds through the issue of corporate bonds in the capital market, the retail sector has still little choice other than bank credit.

A further factor in the fall in the banks' dominance in the credit market was their policy not to expand bank credit (credit rationing); this was in light of their bad past experience when the banks expanded their credit while the economy was in a state of depression.

As the banks exercise stronger “market power” in the retail sector than on the business sector, the rise in competitive threat on business sector credit moved them to expand their credit to households.

The growth in banks' profits and profitability, alongside some reduction in bank risks, was reflected in the improved risk-adjusted return on capital (RAROC) for all five major banking groups. The improved performance of the banking system was also seen in investors' expectations regarding bank shares, as reflected in the sharp rise in the MV/BV ratio of the banks, that is the ratio of the market value, as assessed by investors, of those banks whose shares are traded on the Tel Aviv Stock Exchange, to their book value.

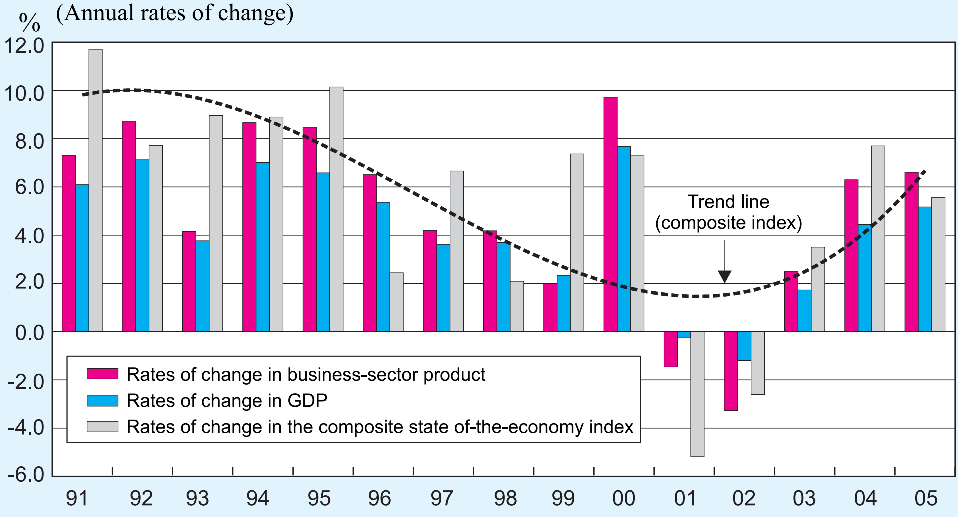
Overall the banks' improved performance was expressed in the further improvement of the robustness (“Hosen”) index of the banking system this year, further to its improvement in the previous two years, from when the economy began to extricate itself from the recession of 2001–02.

PART 1
DEVELOPMENTS IN ISRAEL'S BANKING SYSTEM

1. BACKGROUND – MACROECONOMIC DEVELOPMENTS

The economic growth trend that began in 2003 continued in 2005, as GDP, product of the business sector, and the composite state-of-the-economy index advanced by 5.2 percent, 6.6 percent, and 5.6 percent, respectively (Figure 1.1).

Figure 1.1
Annual Changes in GDP, Business-Sector Product and the Composite State-of-the-Economy Index, 1991-2005
(Annual rates of change)



SOURCE: Based on data from the Central Bureau of Statistics.

All industries except construction showed growth. The strong growth rates were reflected in the labor market, as the average unemployment rate fell from 10.4 percent in 2004 to 9 percent in 2005 and the real average wage per employee post rose by 1.8 percent (Figure 1.2).

The improvement in the banking system's economic environment was accompanied by a surging capital market. During the year, the leading share indices—the TA-25, the TA-100, and the General Share Index—advanced by 25–30 percent and the commercial bank shares gained conspicuously (by 52 percent, Figure 1.3). Share trading volumes averaged NIS 1 billion per day of trading—the highest level in the past decade—reflecting both the development and the liquidity level of the capital market (Figure 1.4). The trend was furthered by greater involvement on the part of nonresident investors[1]

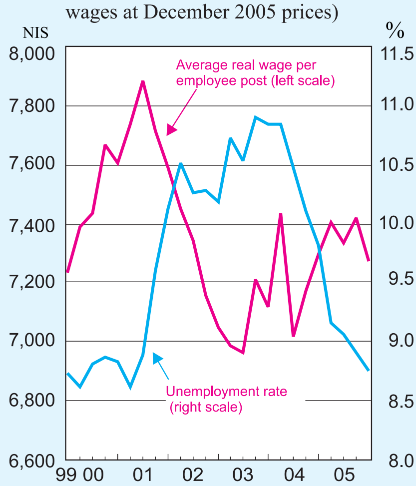
[1] Total nonresident financial investments were around $2 billion at the end of 2005.

and institutional players (pension funds, provident funds, and insurance companies) in the capital market.

Daily trading in government bonds, Treasury bills, and corporate bonds (of public companies) also expanded perceptibly (by 30 percent relative to 2004) and came to NIS 1.3 billion on daily average. Trading in corporate bonds was especially lively, at NIS 220 million on daily average—up 300 percent from 2004, due in part to large issues of such bonds. These developments in the issuance of and trading in corporate bonds in the secondary and primary markets reflect the rapid growth that is occurring in the market of bank-credit substitutes.

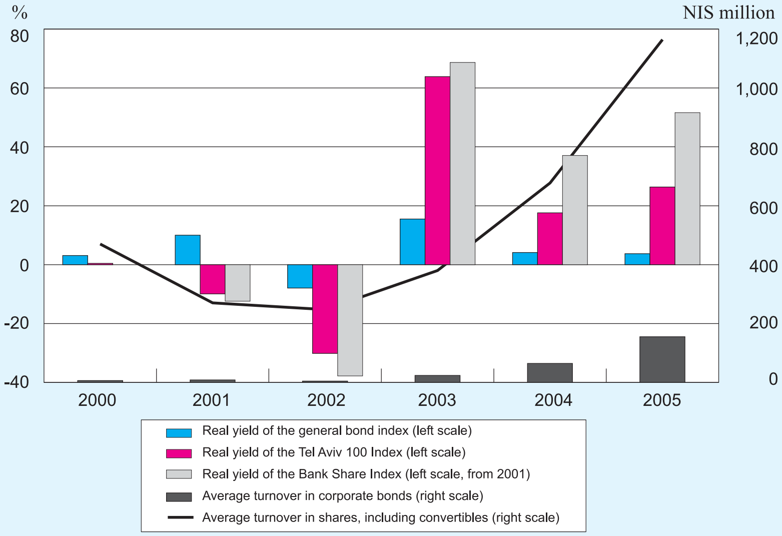
The favorable developments in the capital market had an indirect positive effect on banks' revenues in the senses of both operating income (a 20 percent increase in revenues from capital-market activity; Table 1.14) and profit, as derived from direct investments in the capital market (mainly in shares; Table 1.12).

Figure 1.2
Major Developments in the Labor Market - Unemployment and Average Real Wage per Employee Post, December 1999 to December 2005
(Quarterly data, seasonally adjusted, wages at December 2005 prices)



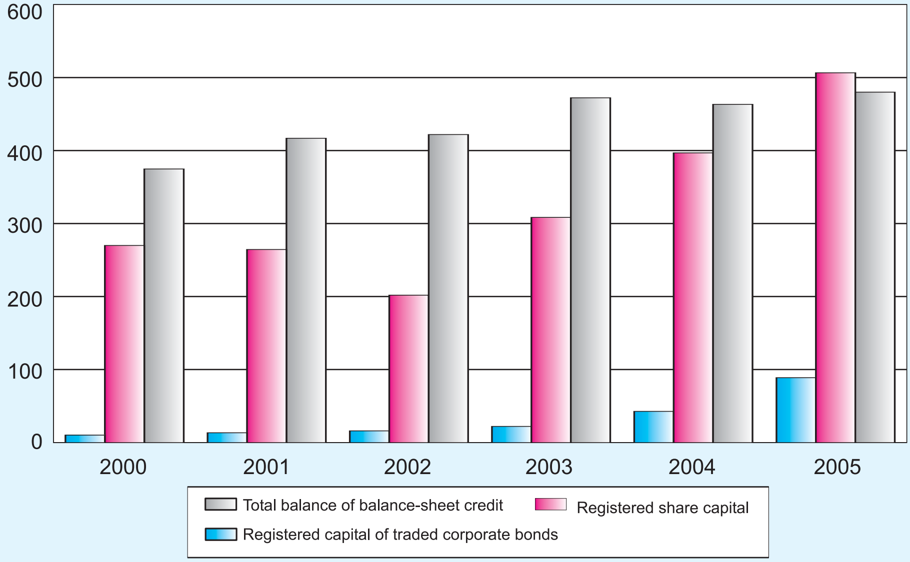
SOURCE: Based on data from the Central Bureau of Statistics.

Figure 1.3
Real Annual Yield of the Tel Aviv 100 Index, the Bank Share Index, the General Bond Price Index and Average Daily Turnover in Shares and Corporate Bonds, 2000-05



SOURCE: Based on data from the Tel Aviv Stock Exchange.

Figure 1.4
Registered Capital for Trading of Bonds and Shares Traded on the Tel Aviv Stock Exchange, and Balance of Bank Credit,[a] 2000-05
(NIS billion)



[a] The balance of balance-sheet credit for 2003 and 2004 includes Mishkan and Tefahot banks.

SOURCE: Based on data of the Tel Aviv Stock Exchange and returns to the Supervisor of Banks.

2. ACTIVITY OF THE BANKING GROUPS

a. Introduction

The Israeli banking system is composed of five large banking groups, two independent banks, and two branches of foreign banks (Figure 1.5 and Table 1.1). In addition to classical banking intermediation that focuses on commercial banking (along with mortgage loans, most of which is provided today by commercial banks), the large banking corporations use subsidiaries to engage in additional fields of activity that complement commercial banking, thereby allowing them to provide what amount to universal banking services. The banking and financial services that the banking system delivers include credit cards[2] and overseas banking (via subsidiaries and branches), along with direct and indirect ownership of companies that operate in the capital market as consultants, trade in securities and financial assets, manage customers' portfolios, and engage in underwriting and issues.

[2] Even though the stake is limited to 20 percent of the banking corporation's capital and 20 percent of means of control in the acquired corporation.

Table 1.1
Israel's Banking System
Main Data from the Financial Statements of the Banking Institutions, December 2005

		Number of branches	Total assets	Share of total banking system assets	Balance of credit to the public[a]	Share of total banking system credit	Total deposits of the public	Share of total banking system deposits
			(NIS billion)	(%)	(NIS billion)	(%)	(NIS billion)	(%)
Hapoalim group[b]		**320**	**273.3**	**30.0**	**185.13**	**31.3**	**213.9**	**29.1**
Banking corporations	Bank Hapoalim	257	252.3		169.0		203.2	
	Otsar Hahayal Bank[d]	34	10.3		6.9		8.9	
	Bank Yahav	16	8.1		1.4		7.6	
	Bank Massad	13	2.8		1.3		2.5	
Bank Leumi group[c]		**232**	**272.8**	**29.9**	**177.3**	**29.9**	**221.8**	**30.2**
Banking corporations	Bank Leumi Le-Israel	199	222.4		122.2		187.7	
	Arab Israel Bank	24	3.4		1.9		2.7	
Mortgage banks	Leumi Mortgage Bank	9	33.1		32.8		8.9	
Discount Bank group[e]		**195**	**154.8**	**17.0**	**83.9**	**14.2**	**130.3**	**17.7**
Ordinary banking corporations	Israel Discount Bank	128	96.9		47.4		80.3	
	Mercantile Discount Bank	64	16.6		12.8		14.1	
Mortgage banks	Discount Mortgage Bank	3	10.4		10.0		1.6	
United Mizrahi-Tefahot Bank group[f]		**123**	**86.3**	**9.5**	**64.7**	**10.9**	**71.3**	**9.7**
Banking corporations	United Mizrahi Bank	113	84.6		61.1		69.8	
Mortgage banks	Adanim Mortgage Bank	10	3.3		3.2		2.0	
First International Bank group[g]		**103**	**71.9**	**7.9**	**43.3**	**7.3**	**61.6**	**8.4**
Banking corporations	The First International Bank of Israel	79	61.3		30.7		51.7	
	Poalei Agudat Israel Bank	13	2.8		0.9		2.3	
	UBank[h]	3	6.7		1.1		6.1	
Mortgage banks	The First International Mortgage Bank	1	6.8		8.9		0.7	
	Atzmauth Mortgage and Development Bank	7	2.3		2.3		0.2	

(cont'd)

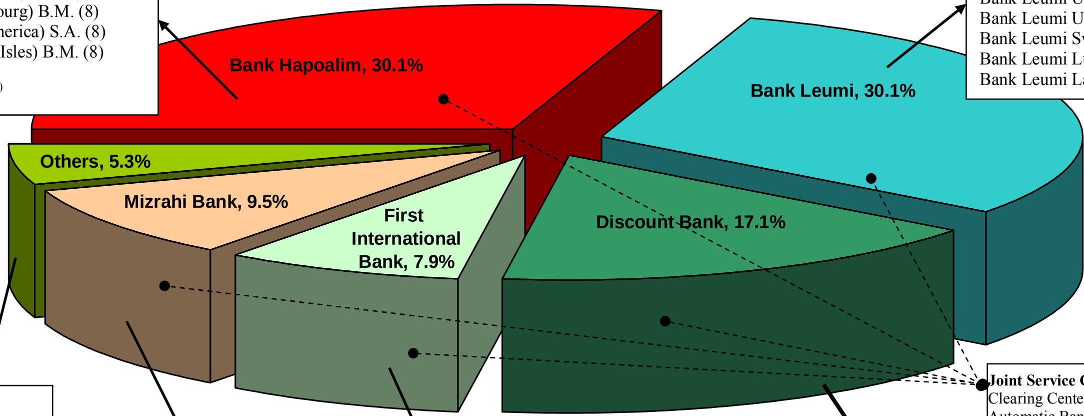
Table 1.1 (Cont'd)
Israel's Banking System
Main Data from the Financial Statements of the Banking Institutions, December 2005

		Number of branches	Total assets	Share of total banking system assets	Balance of credit to the publica	Share of total banking system credit	Total deposits of the public	Share of total banking system deposits
Union Bank		**31**	**25.7**	**2.8**	**16.1**	**2.7**	**21.9**	**3.0**
Industrial Development Bank[i]		**1**	**8.7**	**1.0**	**7.7**	**1.3**	**0.2**	**0.0**
				0.0		**0.0**		**0.0**
Bank of Jerusalem		**17**	**7.7**	**0.8**	**7.7**	**1.3**	**6.4**	**0.9**
Otzar Hashilton Hamkomi		**1**	**3.7**	**0.4**	**3.0**	**0.5**	**2.9**	**0.4**
Foreign banks		**2**	**6.2**	**0.7**	**3.3**	**0.6**	**4.4**	**0.6**
	Citibank	1	3.7		1.8		2.2	
	HSBC	1	2.5		1.5		2.2	
Total		**1,025**	**911.1**	**100.0**	**592.0**	**100.0**	**734.7**	**100.0**

[a] Credit given in Israel and abroad.
[b] This group also includes a banking subsidiary in Israel: Poalim Capital Markets and Investments (whose license was revoked in April 2005),
and banking subsidiaries abroad: Bank Hapoalim (Switzerland), Bank Hapoalim (Luxembourg), Hapoalim (Latin America), and Bank Hapoalim (Cayman Islands).
[c] Bank Leumi USA, Bank Leumi (UK), Bank Leumi Switzerland, Bank Leumi France (in March 2004 this bank returned its license to the authorities and ceased operating as a bank, and became a financial subsidiary named Bank Leumi France, and continued collecting the remaining outstanding debts), Bank Leumi Luxembourg, Bank Leumi Latin America, and Bank of New York−Inter Maritime Bank (the bank was bought in March 2005 and was merged with Bank Hapoalim Switzerland in January 2006).
[d] In January 2006 control of this bank was sold to the First International Bank of Israel.
[e] This group also includes banking subsidiaries abroad: Israel Disount Israel Bank of New York, USA; Discount Bank (Latin America); and Israel Discount Bank (Switzerland).
[f] This group also includes a banking subsidiary in Israel—"Tefahot" Israel Mortgage Bank (which was merged with Mizrahi-Tefahot Bank in January 2005, and its license revoked in April 2005);
and banking subsidiaries abroad: United Mizrahi Bank (Switzerland). In November 2005 the name of United Mizrahi Bank was changed to Mizrahi-Tefahot Bank.
[g] This group also includes banking subsidiaries abroad—FIBI Bank (UK) in London and FIBI Bank (Switzerland) in Zurich.
[h] In December 2004 control of this bank was bought by the First International Bank. Until March 2005 the bank was called Investec (Israel) Bank.
[i] Scheduled to be closed on 31 July 2008.
SOURCE: Published financial reports.

Figure 1.5

Total assets: NIS 907.2 billion
Herfindahl index: H = 0.228
CR_3 = 77.3%



Bank Hapoalim Group
Bank Hapoalim B.M. (1)
Bank 'Yahav' Le'Ovdei Hamdina Ltd (1)
Bank Massad Ltd (1)
Otzar Hahayal Bank Ltd (1) [b]
Poalim Capital Markets and Investments Ltd [g]
Isracard (7) [c]
Bank Hapoalim (Switzerland) B.M. (8)
Bank Hapoalim (Luxembourg) B.M. (8)
Bank Hapoalim (Latin America) S.A. (8)
Bank Hapoalim (Cayman Isles) B.M. (8)
Bank of New York –
Inter Maritime Bank (8) [d]

Bank Leumi Group
Bank Leumi Le-Israel (1)
Arab Israel Bank Ltd (1)
Leumi Mortgage Bank Ltd (3)
Leumicard (7)
Bank Leumi USA (8)
Bank Leumi UK (8)
Bank Leumi Switzerland (8)
Bank Leumi Luxembourg (8)
Bank Leumi Latin America (8)

Joint Service Companies Bank (5)
Clearing Center Ltd
Automatic Bank Services Ltd

Other
Commercial banks
Union Bank of Israel Ltd (1)
Bank of Jerusalem (1)
Otzar Hashilton Hamkomi Ltd (4)
Branches of foreign banks
Citibank N.A. (6)
HSBC BANK PLC (6)
Other institutions
Industrial Development Bank of Israel Ltd [a]
'Hesech' Kupat Hisachon Lehinuch Ltd, Haifa (4)

Mizrahi -Tefahot Bank Group [e]
Mizrahi Tefahot Bank Ltd (1)
Bank 'Adanim' Mortgage and Loans Ltd (3)
'Mashavim' United Mizrahi Bank Issuing Company Ltd (4)
'Tefahot' Issuing Company of the Bank Mizrahi Group (5)
United Mizrahi Bank (Switzerland) (8)

First International Bank Group
The First International Bank of Israel Ltd (1)
Poalei Agudat Israel Bank Ltd (1)
UBank (Israel) Ltd (1) [f]
The First international Mortgage Bank Ltd (3)
Atzmauth Mortgage and Development Bank Ltd (3)
FIBI Bank (UK), London (8)
FIBI Bank (Switzerland), Zurich (8)

Israel Discount Bank Group*
Israel Discount Bank Ltd (1)
Mercantile Discount Bank Ltd (1)
Discount Mortgage Bank Ltd (3)
Israel Discount Bank of New York Ltd, USA (8)
Discount Bank (Latin America) (8)
Israel Discount Bank (Switzerland) (8)
Visa Cal; 51 percent ownership and 63 percent voting rights

Definitions
(1) Commercial banks
(2) Merchant banks
(3) Mortgage banks
(4) Financial institutions
(5) Joint service companies
(6) Foreign banks
(7) Credit card companies
(8) Subsidiaries abroad

Statements
a In process of realizing assets and liabilities, and due to be closed by July 2008.
b Control of the group was sold to the First International Bank in January 2006.
c Incorporating Isracard, Eurpi (Eurocard Israel Ltd), Aminit and Poalim American Express
d This bank was bought in March 2005, and in January 2006 was merged with Bank Hapoalim (Switzerland).
e In November 2005 the name of the bank was changed to Mizrahi - Tefahot Bank Ltd.
f Bought by First International Bank in December 2004. Name changed to UBank in March 2005.
g The Merchant Bank license was revoked in April 2005.

SOURCE: Banking Supervision Department

* Israel Discount Bank owns 26.4 percent of The First International Bank of Israel, but this investment is not consolidated in the financial statements.

The banks also maintain stakes in non-banking and insurance companies by holding their shares (in limited proportions and without management rights), mainly in order to diversify their groups' profit centers. The activities described above allow the banking groups to utilize economies of scale and diversity and to spread risks more effectively than small independent banks can.

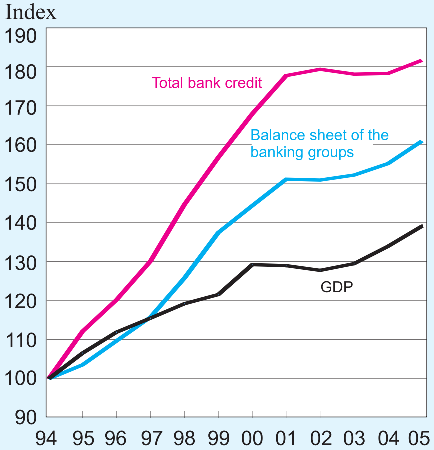
Until the review year 2005, the banks—by means of banking subsidiaries—also managed most of the mutual-fund industry and long-term savings by managing the provident-fund companies. However, their universal banking activities contracted in 2005 after the Bachar Commission recommendations were implemented in legislation.[3] In the foreseeable future, the banks will focus on financial and pension consulting and on underwriting—along with classical banking intermediation activity, of course. In the last-mentioned field, too, competition from non-banking financial intermediaries in the issue of credit to the public has been accelerating in recent years.

b. Main developments in balance-sheet activity

The total balance sheet of the five banking groups was NIS 859.2 billion, up 5.7 percent from 2004 (Table 1.2). Source-related changes in the five groups' consolidated balance sheets were most conspicuous in capital liabilities—bonds and deferred letters of liability—which increased by 29.1 percent (from NIS 39.6 billion at the end of 2004 to NIS 47.3 billion a year later) and deposits from the public, which grew by 4.9 percent (from NIS 653.8 billion at the end of 2004 to NIS 675.1 billion a year later).

The main changes on the assets side occurred in cash and bank deposits, which increased by 15.6 percent among the five groups; securities, up 9.4 percent; and outstanding balance-sheet credit to the public, up 3.4 percent—from NIS 536.3 billion at the end of 2004 to NIS 554.3 billion a year later (Figure 1.6 and Table 1.2).

Figure 1.6
Activity of the Five Major Banking Group vis-à-vis Total Economic Activity, 1994-2005
(100=1994)



SOURCE: Published financial statements and the Central Bureau of Statistics.

Credit to the public (on the balance sheet, net of non-monetary items) from the five large banking groups advanced by 3.3 percent in 2005 and came to NIS 553.8 billion (Table 1.3), after no change in 2004 and decreases of 0.3 percent and 1.2 percent in 2002 and 2003, respectively.

3 For further detail, see box in Part 2 of this chapter.

Table 1.2
The Consolidated Balance Sheet of the Five Major Banking Corporations, 2000-05

	Balance at the end of year								Average quarterly balance at current prices		Annual rate of change in the balance at the end of year from 2004 to 2005
	At December 2003 prices				At current prices[a]		Distribution				
	2000	2001	2002	2003	2004	2005	2004	2005	2004	2005	
	(NIS million)								(NIS million)		percent
Assets											
Cash and Deposits in banks	119,800	110,414	90,379	95,099	102,263	118,226	12.6	13.8	96,890	112,157	15.6
of which: Cash[b]	70,545	67,459	50,572	44,838	31,038	23,171	3.8	2.7			-25.3
Deposits in commercial banks	43,099	36,379	34,011	43,114	66,135	91,351	8.1	10.6			38.1
Securities	87,222	99,076	107,071	117,539	134,932	147,615	16.6	17.2	129,514	137,920	9.4
Credit to the public[c]	**485,639**	**533,192**	**541,760**	**535,202**	**536,298**	**554,298**	**66.0**	**64.5**	**536,045**	**542,519**	**3.4**
of which: Unindexed local currency	147,688	161,938	161,754	165,741	182,345	204,122	22.4	23.8	172,947	193,513	11.9
CPI-indexed local currency	176,371	184,513	183,658	174,945	167,403	174,494	20.6	20.3	171,442	170,394	4.2
In or indexed to foreign currency	161,676	186,742	196,347	188,047	186,290	175,186	22.9	20.4	191,386	178,013	-6.0
of which: In dollars	124,633	151,525	156,994	142,245	138,552	132,808	17.0	15.5	145,597	134,974	-4.1
Credit to the governmemt	13,244	8,300	6,768	4,684	3,301	2,441	0.4	0.3	3,845	2,791	-26.1
Investment in subsidiary and affiliated companies	4,222	4,176	3,560	3,561	4,000	4,364	0.5	0.5	3,788	4,223	9.1
Buildings and equipment	8,914	9,532	9,800	10,148	10,243	10,805	1.3	1.3	10,062	10,475	5.5
Other assets	11,860	15,741	19,088	22,872	21,647	21,406	2.7	2.5	19,803	21,122	-1.1
Total assets	**730,902**	**780,431**	**778,426**	**789,105**	**812,684**	**859,155**	**100.0**	**100.0**	**797,542**	**831,206**	**5.7**
Liabilities and capital											
Deposits of the public	613,581	654,615	651,032	649,274	666,353	698,951	82.0	81.4	653,769	675,134	4.9
Deposits from banks	20,410	19,622	18,923	21,522	21,834	21,014	2.7	2.4	23,240	22,811	-3.8
Government deposits	12,907	11,954	10,368	9,890	8,987	7,097	1.1	0.8	9,334	7,517	-21.0
Bonds and subordinated notes	29,114	34,424	35,655	37,718	39,957	51,595	4.9	6.0	39,626	47,370	29.1
Other liabilities	16,739	19,896	22,724	27,180	29,141	31,323	3.6	3.6	25,877	29,578	7.5
Total liabilities	**692,752**	**740,511**	**738,701**	**745,584**	**766,272**	**809,980**	**94.3**	**94.3**	**751,846**	**782,410**	**5.7**
Minority interests	1,963	1,816	1,767	1,711	2,027	1,322	0.2	0.2	2,043	1,382	-34.8
Equity	36,187	38,105	37,957	41,810	44,385	47,853	5.5	5.6	43,654	47,415	7.8
Total liabilities and capital	**730,902**	**780,431**	**778,426**	**789,105**	**812,684**	**859,155**	**100.0**	**100.0**	**797,542**	**831,206**	**5.7**

[a] In accordance with Accounting Standards 12 and 17 of the Israel Accounting Standards Board, inflation adjustment of the financial statement ceased on 1 January 2004; data for 2004 and thereafter are shown in current terms.
[b] Including deposits with the central bank.
[c] Excluding non-financial items (for further details see footnote d to Table 1.3).
SOURCE:Published financial statements.

Table 1.3
Distribution of Credit by Indexation Base, the Five Major Banking Groups, 2002-05

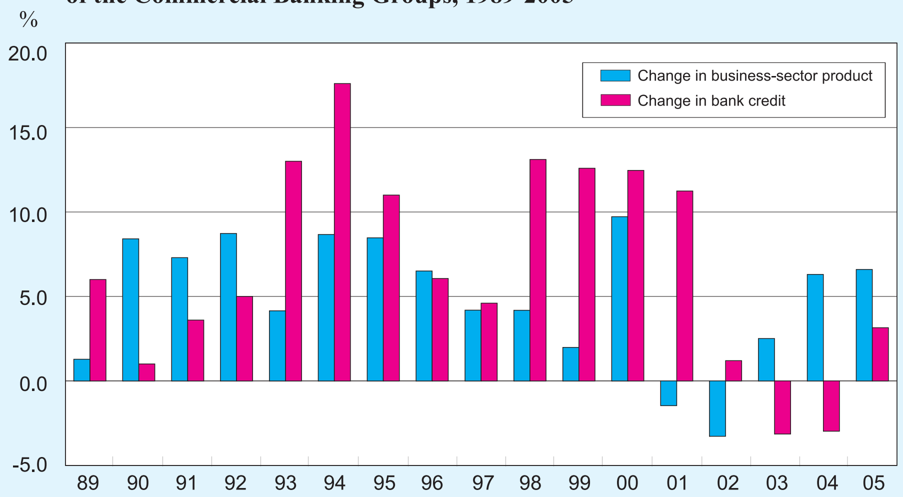
		End-year balances						Distribution			
Year	Bank	Unindexed	CPI indexed	US dollars	Other currencies	Total	Relative to equity[a]	Unindexed	CPI indexed	US dollars	Other currencies
		(NIS billion)						(percent)			
2003	**Hapoalim**	56.6	58.3	52.7	16.5	184.1	12.5	30.7	31.7	28.6	9.0
2004		64.8	52.8	47.7	17.2	182.5	11.2	35.5	28.9	26.1	9.4
2005		73.2	57.2	39.0	15.7	185.1[b]	11.0	39.6	30.9	21.1	8.5
2005 relative to 2004 (percent)		13.0	8.3	-18.3	-8.6	1.4					
2003	**Leumi**	51.9	54.8	46.8	15.6	169.2	11.7	30.7	32.4	27.7	9.2
2004		55.2	51.0	46.3	16.8	169.4	11.1	32.6	30.1	27.3	9.9
2005		62.3	52.6	47.6	14.8	177.2[c]	11.6	35.2	29.7	26.8	8.3
2005 relative to 2004 (percent)		12.8	3.0	2.7	-12.3	4.6					
2003	**Discount**	26.8	18.8	25.5	5.3	76.5	11.8	35.1	24.6	33.3	7.0
2004		27.5	18.8	25.8	5.5	77.5	11.3	35.4	24.2	33.3	7.1
2005		31.8	19.2	27.6	5.3	83.9	12.3	37.9	22.9	32.9	6.3
2005 relative to 2004 (percent)		15.8	2.3	7.1	-4.2	8.2					
2003	**Mizrahi-Tefahot**	15.8	31.0	9.0	4.4	60.1	14.5	26.2	51.6	14.9	7.2
2004		17.7	32.5	9.1	4.4	63.6	15.4	27.8	51.0	14.4	6.8
2005		18.4	33.4	9.3	3.6	64.7	15.6	28.5	51.7	14.3	5.6
2005 relative to 2004 (percent)		4.1	3.0	1.4	-17.2	1.7					
2003	**First**	16.6	14.1	10.0	4.8	45.5[d]	12.4	36.6	31.0	22.0	10.5
2004	**International**	17.2	12.3	9.6	3.9	43.0[e]	11.0	39.9	28.7	22.4	9.0
2005		18.4	12.1	9.4	3.1	42.9[f]	11.0	42.9	28.2	21.8	7.1
2005 relative to 2004 (percent)		7.0	-2.0	-2.8	-21.4	-0.3					
2003	**Five groups**	167.7	177.1	144.0	46.6	535.3	12.3	31.3	33.1	26.9	8.7
2004		182.3	167.4	138.6	47.7	536.0	11.5	34.0	31.2	25.8	8.9
2005		204.1	174.5	132.8	42.4	553.8	11.3	36.9	31.5	24.0	7.7
2005 relative to 2004 (percent)		11.9	4.2	-4.1	-11.2	3.3					

[a] With the addition of the rights of external sharehoders.
[b] Not including non-financial items of NIS 20 million.
[c] Not including non-financial items of NIS 74 million.
[d] Not including non-financial items of NIS 86 million.
[e] Not including non-financial items of NIS 198 million.
[f] Not including non-financial items of NIS 402 million.
SOURCE: Published financial statements.

Two factors had contrasting effects on the level of credit in the review year. The continuing growth trend (5.2 percent in 2005 as against 4.4 percent in 2004; Figure 1.1) whet demand for bank credit (the income effect) while the increase in non-banking alternatives to bank credit dampened this demand (the substitutability effect; Figure 1.7). The main beneficiaries of the growth in non-bank credit were publicly traded companies and large private firms that are typified by low credit risk. Two factors—an increase in capital adequacy (resulting in a larger excess of capital adequacy) and a decrease in borrower risk—had an expansionary effect on the supply of banking credit.

In the resulting re-equilibration of banking credit, outstanding credit to the public rose slightly and interest rates on unindexed and indexed credit edged downward. (In the foreign-currency segment, interest climbed slightly due to an upturn in the LIBOR rate during the past year—Table 1.4, Figure 1.12).

Figure 1.7
Annual Changes in Business-Sector Product and Total Bank Credit of the Commercial Banking Groups, 1989-2005



SOURCE: Based on returns to the Supervisor of Banks.

Several major developments allowed Israel's financial markets to become more efficient and gradually induced institutional investors—pension funds, provident funds, and insurance companies—and foreign banks to become large-scale participants in the domestic capital market: an increase in the unrestricted and tradable portion of long-term savings vehicles (pension funds, provident funds, and insurance plans), a steep decrease in the extent and mix of government bond issues (due to the sharp contraction of government debt and the government's preference of issuing bonds abroad[4]), and the equalization of tax rates on capital gains from securities investments. Concurrently, the

4 The government raised only NIS 5 billion on the domestic capital market in 2005 (total issues less redemptions), about one-fourth of the sum raised in each of the two previous years.

Table 1.4
Average Annual Yields on Selected Assets and Liabilities in the Various Segments, 2004 and 2005

	Annual average		2005				Annual average		2005			
	2004	2005	I	II	III	IV	2004	2005	I	II	III	IV
	(Nominal rates of return)						(Expected real rates of return)					
Unindexed local-currency segment[a]												
Demand deposits	1.2	1.1	1.1	1.1	1.1	1.1	-0.2	-1.0	-0.9	-1.1	-1.1	-0.9
SRO deposits	3.1	2.8	2.7	2.7	2.7	3.2	1.7	0.7	0.7	0.5	0.4	1.1
Resident time deposits	3.7	3.3	3.3	3.2	3.2	3.5	2.2	1.1	1.3	0.9	0.9	1.4
Total unindexed deposits	**3.4**	**3.0**	**3.0**	**2.9**	**2.9**	**3.2**	**2.0**	**0.9**	**1.0**	**0.7**	**0.6**	**1.1**
Term credit[a]	6.5	6.0	5.9	5.8	5.8	6.3	5.0	3.8	3.9	3.5	3.5	4.2
Overdraft accounts and facilities[a]	10.2	9.6	9.4	9.4	9.5	10.0	8.6	7.3	7.2	7.0	7.1	7.8
Total unindexed credit	7.4	6.8	6.7	6.6	6.6	7.1	5.9	4.5	4.6	4.3	4.2	5.0
Makam[b]	5.2	3.8	4.3	4.0	3.4	3.3	3.7	1.6	2.3	1.8	1.1	1.2
Banks' deposits with Bank of Israel[c]	4.3	3.8	3.7	3.7	3.6	4.1	2.9	1.6	1.7	1.4	1.2	2.0
Total unindexed assets	**6.6**	**6.1**	**6.1**	**5.9**	**5.9**	**6.4**	**5.1**	**3.9**	**4.0**	**3.7**	**3.5**	**4.2**
CPI-indexed local-currency segment												
Savings plans[d]	2.9	1.9	.	.	.	.	2.9	1.9	2.2	1.8	1.7	2.0
Indexed bonds[e]	.	.	.	.	.	.	3.8	3.0	3.1	3.0	2.7	3.1
CPI-indexed credit[f]	.	.	.	.	.	.	5.4	4.7	4.9	4.4	4.5	5.1
Mortgages[g]	.	.	.	.	.	.	.	.	.	.	.	.

(cont'd)

Table 1.4 (Cont'd)

Average Annual Yields on Selected Assets and Liabilities in the Various Segments, 2004 and 2005

	Annual average		2005				Annual average		2005			
	2004	2005	I	II	III	IV	2004	2005	I	II	III	IV
	(In dollar terms[h])						(Expected real rates of return[i])					
Foreign-currency-denominated and indexed credit												
Time deposits	0.2	0.5	0.2	0.3	0.6	0.8	1.9	0.2	0.9	-3.9	-0.6	4.5
Foreign-currency-denominated deposits[j]	1.0	2.8	2.1	2.5	2.9	3.5	2.8	2.5	2.7	-1.7	1.7	7.4
Foreign-currency-indexed credit	3.7	5.6	4.9	5.4	5.9	6.2	5.5	5.4	5.6	1.0	4.6	10.2
Foreign-currency credit to residents	3.2	5.0	4.4	4.7	5.2	5.7	5.0	4.8	5.1	0.4	3.9	9.6
Deposits abroad[k]	1.5	3.4	2.7	3.2	3.6	4.2	3.3	3.2	3.4	-1.1	2.4	8.1
	(Nominal rates of return)						(Expected real rates of return)					
Annual rates of change												
CPI	1.2	2.4	-2.4	4.5	5.7	2.0	.	.	.	.	.	.
NIS/$ exchange rate	4.9	6.8	2.7	21.0	2.1	0.4	.	.	.	.	.	.
Tel Aviv 100 index	19.0	29.4	4.5	-1.2	14.8	9.2	17.6	26.4	5.1	-1.7	12.7	6.7
General bonds index	5.3	5.9	2.3	1.8	3.0	-1.2	4.1	3.5	2.9	0.7	1.6	-1.7
General corporate bonds index	5.4	6.2	2.7	2.3	3.3	-2.1	4.1	3.7	3.3	1.2	1.9	-2.6

[a] Effective annual yields/costs, as reported by the seven major banking groups.

[b] The market yield for two months on unindexed bonds.

[c] Calculated as the effective annual rate of return received on depositing with the Bank of Israel. Balances used in the calculation are average balances in the period.

[d] Average rate of interest on savings deposits.

[e] Average gross yield to maturity of all CPI-indexed bonds (market rate).

[f] Based on reports of cost of credit extended during the month.

[g] Weighted average interest on mortgage loans from non-earmarked sources.

[h] The data refer to dollar denominated credit and deposit items.

[i] Real interest calculated on the basis of the public's inflation expectations, derived from the capital market, and the expected exchange rate, calculated from the rate of actual depreciation over the previous twelve months.

[j] Including nonresidents' and residents' restitutions deposits.

[k] 3-month Libor interest rate.

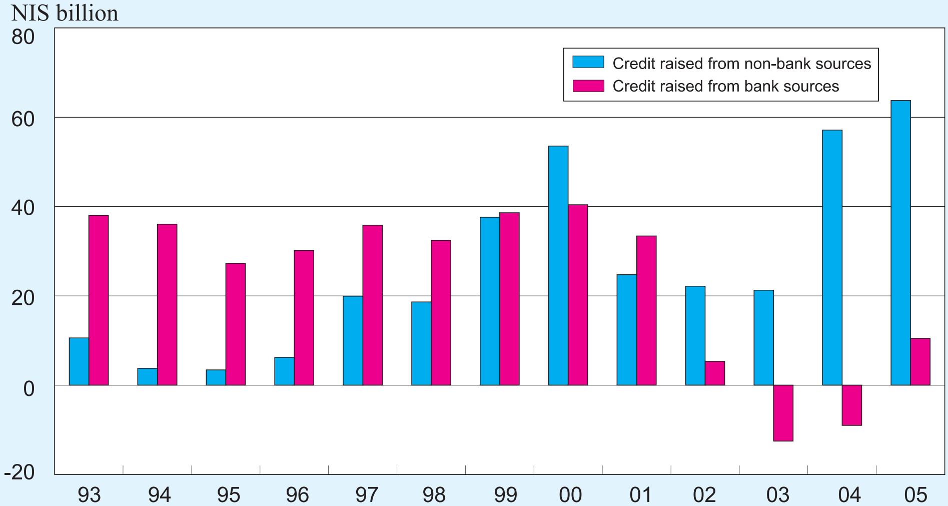
SOURCE: Based on reports to the Supervisor of the Banks and Bank of Israel data.

supply of corporate bonds increased (as firms preferred to raise capital from the public than to take bank credit—Table 1.5).

These factors are subjecting the banking system to true contestability in credit for the domestic market. The non-banking sources serve the business sector, in the main, as an alternative to domestic banking intermediation in raising capital. (Importantly, the expansion of the market of bank-credit alternatives has made this market accessible not only to large borrowers but to medium borrowers as well.) Venture-capital companies are also raising more money due to the high-tech recovery. Thus, the non-bank intermediaries are presenting the domestic banking sector with a contestability threat in the issue of business credit.

Businesses[5] raised NIS 63.7 billion in 2005 from alternative sources[6] in 2005 as against NIS 57.1 billion in 2004 (pursuant to a trend that began three years ago). Concurrently, the banking system issued only NIS 10.4 billion in business credit (Table 1.5, Figure 1.8).

Figure 1.8
Funds from Non-Bank Substitutes Compared to Bank Sources,[a] 1993-2005



[a] Business credit given throughout the year excluding credit to individuals.

SOURCE: Based on returns to the Supervisor of Banks; Annual Report of the Supervisor of Capital Markets Insurance and Savings in the Ministry of Finance; the Bank of Israel; and data from the Tel Aviv Stock Exchange.

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5 Non-bank credit is available largely to relatively strong business customers—mostly publicly traded companies or private companies that operate extensively in Israel and abroad and have rather easy access to the alternative-credit market—unlike households, which have no adequate alternative to bank credit in financing their outlays.

6 The capital market, insurance companies, provident funds, credit from foreign banks, and issues in foreign capital markets.

Table 1.5

Changes in Bank Credit to the Business Sector and its Principal Non-bank Substitutes, 1997-2005

(NIS million, at current prices)[a]

	Overall changes in bank credit and its substitutes	*of which*		Funds from non-bank substitutes						Difference between changes in bank credit and its substitutes
		Changes in bank credit[b]	Overall funds from non-bank substitutes	Bond issues in Israel[c]	Share issues in Israel	Capital raised abroad[d]	Changes in direct credit from abroad[e]	Venture capital funds	Changes in credit from institutional investors[f]	
1997	13,954	-6,663	20,617	1,546	8,256	6,895	5,619	1,730	-3,430	-27,280
1998	51,031	32,400	18,631	2,549	7,895	4,562	3,554	2,448	-2,377	13,769
1999	76,204	38,591	37,613	1,681	5,659	17,802	4,883	4,462	3,126	979
2000	93,939	40,384	53,555	292	14,212	19,267	2,131	13,351	4,301	-13,171
2001	58,129	33,400	24,729	90	5,833	7,322	648	8,708	2,129	8,671
2002	27,518	5,325	22,193	2,969	5,555	1,061	6,763	5,289	555	-16,867
2003	8,755	-12,522	21,277	2,793	3,148	3,855	992	4,427	6,062	-33,799
2004	48,117	-8,987	57,104	12,551	8,251	11,341	7,866	6,268	10,826	-66,091
2005	74,209	10,458	63,751	14,169	13,079	4,876	11,068	6,154	14,404	-53,294

[a] In accordance with Accounting Standards 12 and 17 of the Israel Accounting Standards Board, inflation adjustment of the financial statement ceased on 1 January 2004; data for 2004 and thereafter are shown in current terms.

[b] Credit to the public from the commercial banks (on a consolidated basis). Does not include credit to individuals and credit to borrowers for activity abroad. It is assumed that the change in credit balances reflects the flow of new credit granted.

[c] Corporate bond issues and allocations by Tel Aviv Stock Exchange companies. From 2001 all bond issues that are not credit substitutes (financial issues, banking corporations' Tier 2 capital, financial exchange traded funds (ETFs), etc.), so that this refers to real issues.

[d] Including issues of bonds and shares abroad, after offsetting early redemption of bonds and share buy-backs.

[e] Defined as credit to the public or to the government given by banks abroad, and which is non-tradable (excluding commercial credit).

[f] From 2005 this item includes non-negotiable bonds issued to institutional investors.

SOURCE: Reports to the Supervisor of Banks.

The banking system used its surplus sources (generated by stiffer competition from non-bank entities) to build up its domestic securities from NIS 135.2 billion to NIS 147.6 billion (a 9.4 percent increase—Table 1.6) and to increase its bank deposits and holdings of securities abroad (by 24 percent and 30 percent, respectively, in real terms—Tables A.1.1– A.1.3).

Also due to the intensification of contestability in business credit from non-banking sources, the banks began this year to reroute sources to the retail segment. The blossoming of non-banking alternatives for business borrowers seems to have prompted the banks to increase their lending to households and small businesses, because these groups have lower credit risk and deliver higher profits. (See Part 2 of this chapter for further details.) The implementation of Proper Conduct of Banking Business Directive 325, concerning credit-facility management,[7] also speeded up the development of non-banking sources of consumer credit. As they prepared to meet the requirements of Directive 325 during the year, the banks made more time credit available to their customers so that credit facilities would not be overrun when the directive went into effect.[8]

The credit-card companies (Isracard, ICC, and Leumi Card)—all of which are banking subsidiaries—expanded their activities in 2005 by issuing revolving credit cards.[9] RCCs give customers flexibility by allowing them to determine the amounts and times to be charged during the month in accordance with their changing needs and abilities.[10] Furthermore, the number of cards issued by the credit-card companies increased in 2005 by 22.3 percent over 2004, after a 15 percent increase in 2004 relative to 2003 (Table 1.7).[11]

These two developments—the increase in issue of credit cards at card companies' liability and the use of revolving-credit cards—were main factors behind the growth in outstanding credit, most of which accrued to the consumer segment at the liability of the credit-card companies. Outstanding credit of this type was NIS 841.2 million at the end of December 2005 as against NIS 466.8 million at the end of December 2004—an 80.1 percent increase (Figure 1.9). Outstanding bank credit to private individuals for nonhousing purposes was NIS 146.7 billion at the end of 2005 as against NIS 134.9 billion a year earlier (Table 1.20.)

The contestability threat to bank credit (both business and retail) has presumably begun to heat up and will gain further momentum as soon as trading in short-term commercial paper (an alternative non-bank source of business credit) begins, repo

7 The directive requires banks to establish a credit facility for each customer, tailored to h/her needs, repayment ability, and collateral, on the basis of documented analysis. Due to concern that the banks would not be able to make timely preparations for the conclusion of facility agreements with all customers, the original deadline for implementation was postponed from January 1, 2006, to July 1, 2006.

8 The seven commercial banks issue 78 percent of outstanding unindexed credit to business customers.

9 The principle behind an RCC is the provision of a credit facility that is separate from and independent of the bank account, thereby allowing the customer to maintain an account for expenses that is alternative to his current account. Thus, Leumi Card offers the "Multi," ICC the "Aktiv," and Isracard the "More."

10 The de facto result is a short-term loan.

11 The credit provider in this case is the credit-card company, not the bank.

Table 1.6
The Securities Portfolios of the Major Banking Groups, 2004-05

		Hapoalim				Leumi				Discount			
		2005		2004		2005		2004		2005		2004	
		Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)
Bonds held to maturity	Government bonds	56	0.2	130	0.4	3,577	0.1	4,435	10.1	5,761	13.7	5,524	13.8
	Other bonds	349	1.0	1,765	4.9	120	0.3	116	0.3	23	0.1	35	0.1
	Total bonds held to maturity	**405**	**1.2**	**1,895**	**5.3**	**3,697**	**7.7**	**4,551**	**10.4**	**5,784**	**13.7**	**5,559**	**13.9**
Securities available for sale	Government bonds	13,385	39.6	12,930	35.9	20,117	42.0	19,721	45.1	27,856	66.1	26,354	65.8
	Other bonds	15,265	45.1	16,836	46.8	15,308	32.0	11,744	26.9	4,761	11.3	4,537	11.3
	Total bonds available for sale	28,650	84.7	29,766	82.7	35,425	74.0	31,465	72.0	32,617	77.4	30,891	77.1
	Total shares available for sale	1,381	4.1	1,053	2.9	1,660	3.5	1,423	3.3	1,060	2.5	894	2.2
	Total securities available for sale	**30,031**	**88.8**	**30,819**	**85.6**	**37,085**	**77.4**	**32,888**	**75.2**	**33,677**	**79.9**	**31,785**	**79.3**
Tradable securities	Government bonds	3,069	9.1	2,417	6.7	4,977	10.4	4,382	10.0	2,166	5.1	1,934	4.8
	Other bonds	221	0.7	57	0.2	1,828	3.8	1,212	2.8	509	1.2	772	1.9
	Total tradable bonds	3,290	9.7	2,474	6.9	6,805	14.2	5,594	12.8	2,675	6.3	2,706	6.8
	Total tradable shares	86	0.3	805	2.2	300	0.6	672	1.5	3	0.01	11	0.0
	Total tradable securities	**3,376**	**10.0**	**3,279**	**9.1**	**7,105**	**14.8**	**6,266**	**14.3**	**2,678**	**6.4**	**2,717**	**6.8**
	Total government bonds	**16,510**	**49**	**15,477**	**43**	**28,671**	**52**	**28,538**	**65**	**35,783**	**85**	**33,812**	**84**
	Total other bonds	**17,302**	**51**	**20,516**	**57**	**19,216**	**40**	**15,167**	**35**	**6,356**	**15**	**6,249**	**16**
	Total securities	**33,812**	**100**	**35,993**	**100**	**47,887**	**100**	**43,705**	**100**	**42,139**	**100**	**40,061**	**100**

(cont'd)

Table 1.6 (Cont'd)

The Securities Portfolios of the Major Banking Groups, 2004-05

		Mizrahi-Tefahot				First International				Total of Five Banking Groups			
		2005		2004		2005		2004		2005		2004	
		Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)	Fair value (NIS million)	Distribution (percent)
Bonds held to maturity	Government bonds	0	0	48	0.83	0	0	0	0.0	9,394	6.4	10,137	7.5
	Other bonds	151	2.3	314	5.46	1,012	5.9	160	1.7	1,655	1.1	2,390	1.8
	Total bonds held to maturity	**151**	**2.3**	**362**	**6.29**	**1,012**	**5.9**	**160**	**1.7**	**11,049**	**7.5**	**12,527**	**9.3**
Securities available for sale	Government bonds	4,560	69.4	3,952	68.66	7,809	45.4	5,387	55.9	73,727	49.9	68,344	50.6
	Other bonds	1,492	22.7	1,083	18.82	5,462	31.7	2,413	25.0	42,288	28.6	36,613	27.1
	Total bonds available for sale	6,052	92.1	5,035	87.47	13,271	77.1	7,800	80.9	116,015	78.6	104,957	77.7
	Total shares available for sale	367	5.6	341	5.92	636	3.7	491	5.1	5,104	3.5	4,202	3.1
	Total securities available for sale	**6,419**	**97.7**	**5,376**	**93.40**	**13,907**	**80.8**	**8,291**	**86.0**	**121,119**	**82.0**	**109,159**	**80.8**
Tradable securities	Government bonds	0	0	17	0.30	2,216	12.9	1,115	11.6	12,428	8.4	9,865	7.3
	Other bonds	1	0.02	0	0.00	58	0.3	70	0.7	2,617	1.8	2,111	1.6
	Total tradable bonds	1	0.02	17	0.30	2,274	13.2	1,185	12.3	15,045	10.2	11,976	8.9
	Total tradable shares	0	0	1	0.02	21	0.1	6	0.1	410	0.3	1,495	1.1
	Total tradable securities	**1**	**0.02**	**18**	**0.31**	**2,295**	**13.3**	**1,191**	**12.4**	**15,455**	**10.5**	**13,471**	**10.0**
	Total government bonds	**4,560**	**69**	**4,017**	**70**	**10,025**	**58**	**6,502**	**67**	**95,549**	**65**	**88,346**	**65**
	Total other bonds	**2,011**	**31**	**1,739**	**30**	**7,189**	**42**	**3,140**	**33**	**52,074**	**35**	**46,811**	**35**
	Total securities	**6,571**	**100**	**5,756**	**100**	**17,214**	**100**	**9,642**	**100**	**147,623**	**100**	**135,157**	**100**

SOURCE: Published financial reports.

Table 1.7
Credit Card Activity, 2002-05

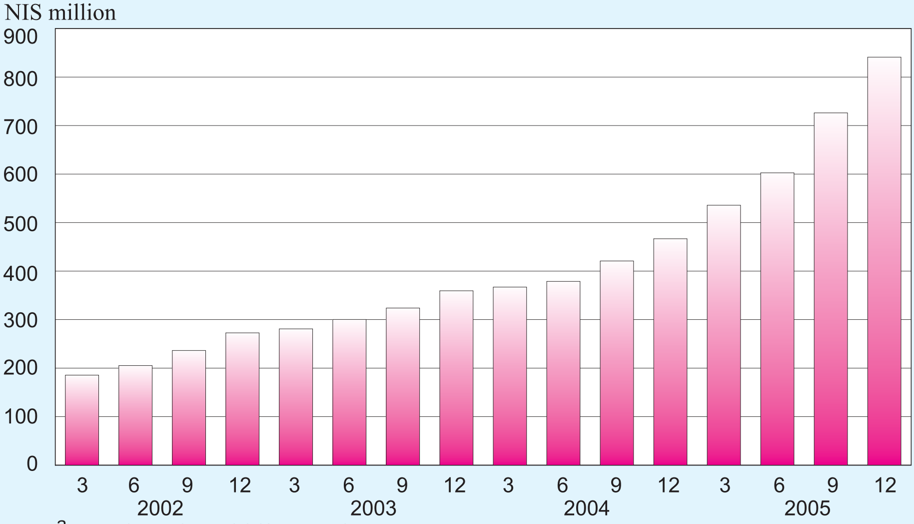
	2002	2003	2004	2005	Rate of change from 2003 to 2004	Rate of change from 2004 to 2005
		(million)			(percent)	
Number of cards active at the end of the year	3.5	3.6	3.8	4.2	6.2	10.3
of which: Cards at the sole responsibility of the credit card company	0.33	0.34	0.39	0.48	15.0	22.3
		(million)				
Number of transactions	385.5	411.8	449.9	490.4	9.3	9.0
of which: in Israel	376.3	404.5	442.5	482.5	9.4	9.0
		(NIS billion)				
Amount of transactions	91.3	97.4	107.5	118.1	10.4	9.9
of which: in Israel	86.1	92.7	102.4	113.1	10.5	10.4
		Indicators of activity				
Average credit card transaction (NIS)	236.8	236.5	238.8	240.8	1.00	0.83
Average monthly expenditure per credit card (NIS)	2,149	2,260	2,350	2,342	3.96	-0.33
Average number of transactions per card per year	108.9	114.7	118.1	116.7	2.93	-1.15

SOURCE: Reports to the Supervisor of the Banks.

transactions are introduced, and securitization transactions on various types of credit (retail and business) are allowed, as is conventionally done around the world.

The changes in outstanding credit were uneven among the system's activity segments.

Figure 1.9
Outstanding Credit to the Public through the Credit Card Companies,[a] 2002-05



[a] Israel Credit Cards (ICC), Leumi Card, Isracard and American Express.

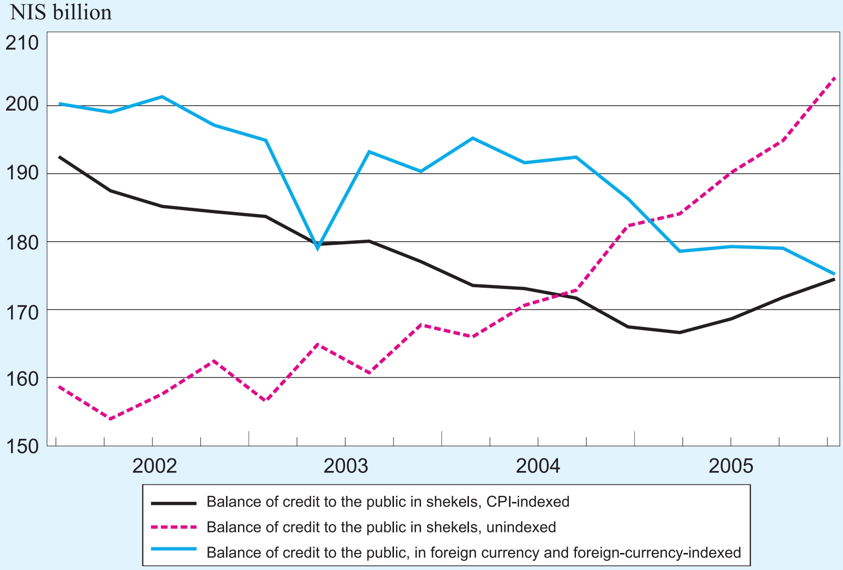
SOURCE: Returns to the Supervisor of Banks.

Unindexed shekel activity, which accounts for 37 percent of outstanding credit to the public, increased by 12 percent while indexed shekel activity advanced by only 4 percent (Figure 1.10 and Table 1.3). The redirection of credit from indexed to unindexed vehicles evidently traces to the decline in inflation uncertainty, as reflected in a decrease in the standard deviation of inflation expectations to one year ahead (Figure 1.11) and the continued increase in raising of capital by means of corporate bonds, nearly all of which are indexed (Table 1.5).[12]

Foreign-currency credit declined by 6 percent due to a change occasioned by the price effect, as an increase in the LIBOR dollar interest rate depressed demand for this form of credit (Figure 1.12). This led to a change in the mix of borrowers in the indexed segment, as large business borrowers repaid CPI-indexed bank credit and raising indexed sources from non-bank entities.

[12] Most corporate bonds in Israel are indexed to the CPI; therefore, they serve as an alternative to indexed credit.

Figure 1.10
Quarterly Development of Balance of Credit to the Public of the Five Major Banking Groups by Indexation, 2002-05



SOURCE: Published financial reports.

Examination of the distribution of indexed credit by corporation size shows that large and medium firms account for only 55 percent of outstanding indexed bank credit[13] as against 71 percent of unindexed credit, a field that is noted for a paucity of non-bank credit alternatives. Thus, the effect of substitutability on the indexed segment has become more conspicuous in recent years,[14] illustrating the unavailability of credit alternatives to credit consumers. It also points to the strong dominance of the banking system in unindexed activity, since almost all credit alternatives are available in medium and long terms and there are hardly any short-term alternatives in unindexed shekel credit. This dominance gives the banking system market power that it brings to bear against retail clients. (See Israel's Banking System, 2004).

Outstanding housing credit increased during 2005 at a moderate 4.1 percent pace and came to NIS 125.5 billion. The growth traces to several factors: an upturn in personal disposable income and financial wealth, occasioned, among other things, by rising prices in the capital markets; the continued decline in unemployment rates (9 percent on average in 2005 as against 10.4 percent in 2004); and a low interest environment during most of the year (in the unindexed segment, in both short and long terms—Figure 1.13). These

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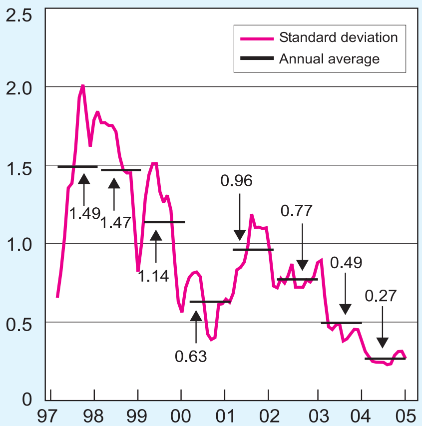
[13] In the past, nearly all unindexed activity took place vis-a-vis the business sector and, especially, large corporations, whereas indexed credit was used to finance long-term real investments.

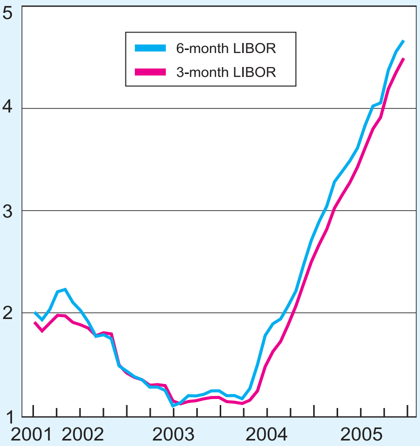
[14] It should be borne in mind, however, that a low inflation environment has a negative effect on the public's demand for indexed credit. Israel's low level of inflation in the past two years redirected demand for CPI-indexed credit to unindexed credit.

Figure 1.11
Standard Deviation of Inflation Expectations for the Year, December 1997 to December 2005



SOURCE: Based on Bank of Israel data.

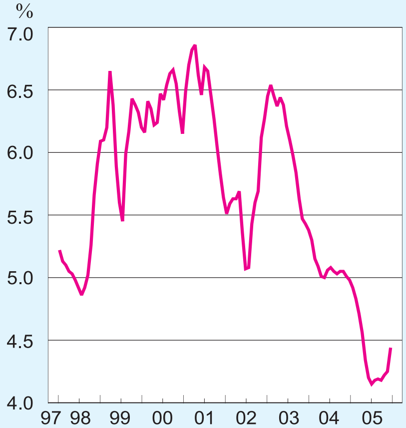
Figure 1.12
LIBOR Dollar 3- and 6-Month (Average Monthly) Interest,[a] December 2001 to December 2005



[a] LIBOR - London Interbank Offered Rate; the average rate of interest that banks pay on deposits from other banks. Rates available for the five largest banks in the world (UK, Japan, Germany, France and US).

SOURCE: Based on Bank of Israel data.

Figure 1.13
Average Rates of Interest on Housing Loans, 1997-2005[a]



[a] From September 2002 the interest rate on housing loans was redefined according to the new Banking Order (Fees for Early Repayment), 5762-2002.

SOURCE: Returns to the Supervisor of Banks.

factors stimulated private customers' demand for housing credit and nonresidents' demand for dwellings in Israel as investments.[15] Much of the banks' performance in housing credit originates in payback of loans previously taken. The trend of rollover of housing loans continued this year, as in 2004 (an increase of 66.1 percent—Table 1.8), mainly due to the decline in interest rates on indexed loans.

The banks encouraged this process because rollover activity enhances their operating and financial revenues. As for the distribution of housing credit, the transition to unindexed credit continued in 2005 due to the settling of inflation at a low level, the decline in inflation uncertainty in recent years, and greater availability of long-term unindexed sources amid the continuing contraction of indexed

[15] Nonresident real-estate investments (mostly in prestige dwellings) burgeoned from $0.2 billion two years ago to $1 billion in 2005.

sources. Consequently, the share of CPI-indexed housing loans has been declining in recent years, at 75 percent of total housing loans at the end of 2005 as against much higher rates until recently.[16] Concurrently, the share of foreign-currency-denominated and -indexed loans increased, as did the share of unindexed loans (11 percent at the end of 2005).

Table 1.8
Cumulative New Mortgages from and Repayments to Mortgage-Granting Banks[a]

(NIS million)

	2002	2003	2004	2005	Rate of change 2005 relative to 2004
					(percent)
Total loans from non-earmarked sources granted to home buyers	15,502	11,899	15,886	20,661	30.1
Total early repayments (housing)	7,085	6,092	9,216	15,306	66.1
Total accumulated arrears among home buyers	1,382	1,737	2,006	2,134	6.4
Total balance of outstanding mortgages	116,139	115,263	120,436	125,430	4.1

a “Adanim” Mortgage Bank, Bank Hapoalim (since 2004), Union Bank (since 2004), Otsar Hahayal Bank (since 2004), Mercantile Discount Bank (since 2004), Bank of Jerusalem, Leumi Mortgage Bank, “Tefahot” Israel Mortgage Bank until 31 December 2004 (since 2005, Mizrahi-Tefahot), Discount Mortgage Bank, and the First International Bank.

SOURCE: Reports to the Supervisor of the Banks.

c. Off-Balance-Sheet activity

Bank-guarantee and bank-liability transactions[17]—Three consecutive years of rosy economic trends have reduced the risk and uncertainty that accompanies the issue of guarantees and the assumption of liabilities by banks. Accordingly, the balance of off-balance-sheet activity increased by 12 percent in 2005, much as in 2004, and is estimated at NIS 301 billion. This is the result of economic growth, among other things (Table A.1.4).[18] Increases were observed on all lines except “Documentary Credit” and “Liabilities on Account of Open Credit-Card Transactions,” which account for 8 percent of total transactions. The strongest upturn occurred in “Balance of Irrevocable Liabilities for Issue of Credit Approved and Not Yet Taken,” which constitutes 24 percent of the total—due to impressive increases in these balances among the three large banking groups. Another line, “Unused Overdraft Facilities and Other Credit Facilities to the Public,” increased by 10 percent. This upturn was evidently brought on by the unilateral

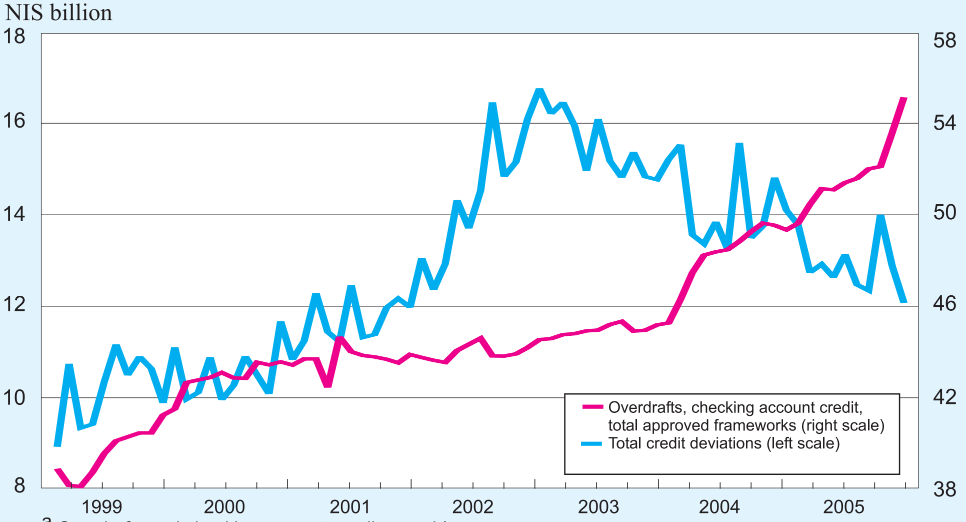
[16] 93 percent at the end of 2000, 90 percent of the end of 2001, 87 percent of the end of 2002, 83 percent of the end of 2003, and 77 percent of the end of 2004.

[17] Transactions in which the balance represents a credit risk.

[18] There is a 68 percent correlation between the rate of economic growth and the share of off-balance-sheet activity that is attributed to bank guarantee and liability transactions.

expansion of credit facilities by the banks, since the rate of credit utilization within facilities did not change significantly (Figures 1.14 and A.1.1).

Figure 1.14
Total Approved Credit Frameworks Compared to Total Credit Deviations,[a] Seven Largest Commercial Banks in Israel, December 1999 to December 2005



a Overdrafts and checking account credit, monthly average.

SOURCE: Published financial reports.

Activity in derivatives[19] expanded by 30 percent in 2005 and came to NIS 1,035 billion.[20] All banking groups reported an increase in derivatives activity; the largest contribution was that of the Hapoalim group—a 58 percent upturn (Table 1.5) that brought the share of this group in derivatives activity to 34 percent of the total. Trading in interest contracts[21] expanded by NIS 76 billion—up 35 percent after 20 percent growth in 2004. Outstanding currency contracts, which account for 60 percent of the total outstanding balance, increased by NIS 123 billion, up 26 percent after no change in 2004. Other contracts[22] climbed by NIS 34 billion pursuant to a trend that began in 2004, occasioned by steep increases in the General Share Index, the TA-100 index, and the Maof index, and lively trading volumes on the stock exchange that had to be hedged (Figure A.1.2).

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19 Transactions expressed in gross nominal sums before conversion into balance-sheet equivalents.

20 This figure relates to total forward transactions as reported to the public. The balance-sheet value of this sum is around NIS 60 million.

21 Banks use interest contracts to hedge against interest risk. About 7 percent of interest contracts are NIS–CPI; the others are classified as “Other Contracts.”

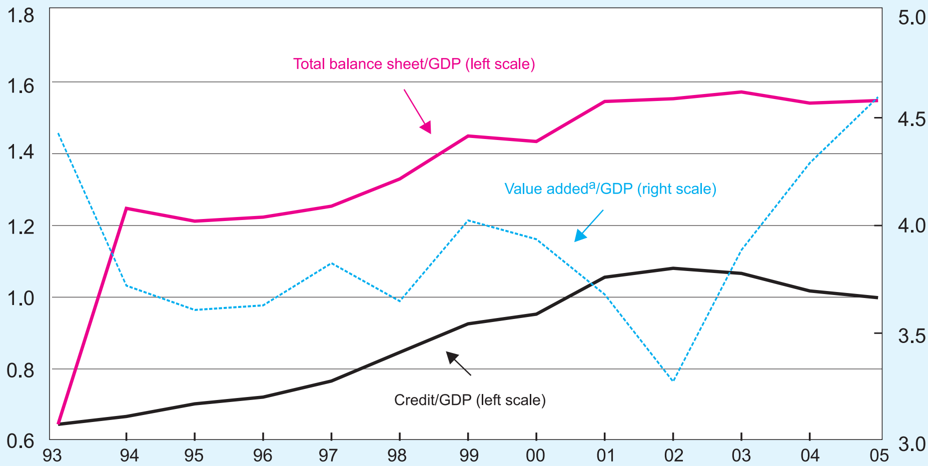
22 On shares, share indices, *makam* forwards, and goods.

d. Main developments in banking activity indices

The Banking Activity Index—expressed as the ratio of Added Value[23] to Gross Domestic Product—continued to climb in 2005, pursuant to a trend that began in 2002 (Figure 1.15). Israel's ratio resembles the average in the developed countries (Figure 1.16). The mild increase in outstanding credit to the public in 2005, coupled with a steep (and protracted) decline in loan-loss provisions and an upturn in operating revenues, had an upward effect on bank earnings, thereby abetting continued improvement in the Added Value/GDP ratio. See also the Business Results chapter in this survey.

The bank credit/GDP ratio, in contrast, has been declining for the past three years because the development of bank-credit substitutes has caused bank credit to grow more slowly than GDP. The credit/GDP ratio gives an indication of the extent of banking-system dominance and centrality in financial intermediation and of the quality of bank credit, because GDP is the principal source for the repayment of credit. Furthermore, businesses' independent capital issues, using non-banking sources of finance, also have an indirect positive effect on the quality of bank credit.

Figure 1.15
Indices of Banking Activity of the Five Major Banking Groups Relative to GDP, 1993-2005
(Percent)

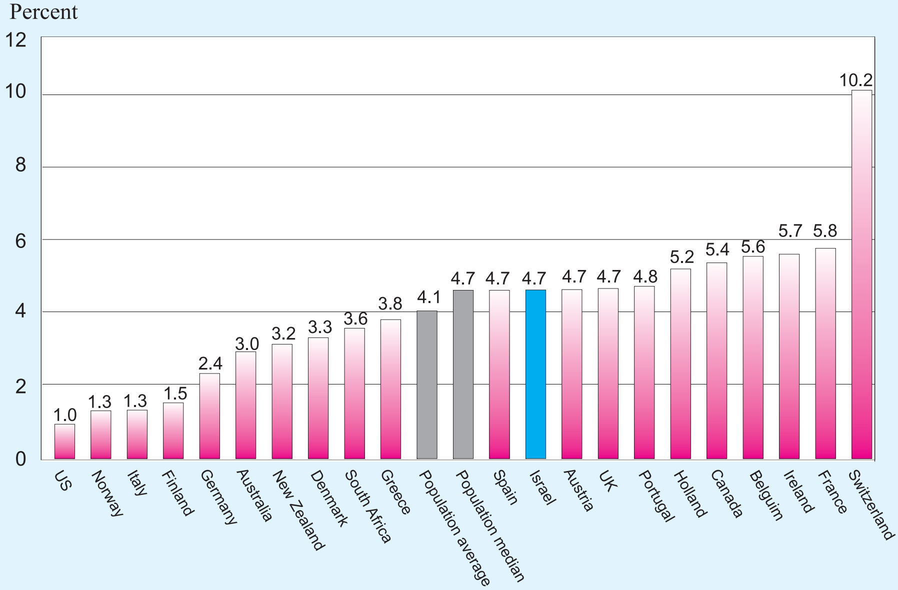


[a] Value added is the sum of net ordinary before-tax income, salaries and related expenses, general expenses, maintenance and depreciation on buildings and equipment.

SOURCE: Based on published financial reports and data from the Central Bureau of Statistics.

[23] Added Value is the sum of ordinary pre-tax operating earnings and three types of expenses: payroll, operating, and other.

Figure 1.16
Value Added[a] as Share of GDP 2005, International Comparison



[a] Value added is the sum of net ordinary before-tax income, salaries and related expenses, general expenses, maintenance and depreciation on buildings and equipment.

SOURCE: Based on data from Bankscope, the IFS database of the International Monetary Fund; Israel's GDP from the Central Bureau of Statistics.

3. SUPPLY OF DEPOSITS TO THE BANKING SYSTEM AND THE PUBLIC'S ASSET PORTFOLIO

The public's asset portfolio grew at twice the 2004 pace and came to NIS 1,813 billion, 20 percent greater than in the previous year (Table 1.9). The change in value was influenced both by a price effect (change in asset prices) and a quantity effect (increase in asset inventory). The price effect was reflected in an increase in the value of investment vehicles in the capital market, including the prices of government and corporate bonds.[24] Additional influences were monetary and fiscal policies during the first three-fourths of the year[25] that were supportive of the decline in the domestic interest environment, and the depreciation of the shekel against the dollar (by 6.85 percent) due to appreciation of the dollar around the world. The quantity effect was reflected in an increase in the prices of shares in the domestic and foreign capital markets, occasioned by the continuing

[24] This happened even though the supply of government bonds contracted; the upturn is due to a steep increase in private bond issues.

[25] The Bank of Israel rate edged down during the year from 3.9 percent in December 2004 to 3.5 percent in September 2005; afterwards, it trended upward to 4.5 percent in December 2005.

growth trend, the easing of security tension, and expectations of further growth. These factors, acting in concert, allowed the value of the public's portfolio of assets to rise smartly.

Analysis of the public's asset portfolio on the basis of investment vehicles shows a perceptible increase (43.9 percent) in the component of shares, due to the price effect and an increase in registered capital for trading. (Figure 1.4) This component of the portfolio accounted for 23.1 percent of the total portfolio at the end of 2005 (Table 1.9). The proportion of shares in the portfolio grew because the "bull market" led to a sizable increase in the quantity of shares and registered capital for trading—to NIS 506 billion as against NIS 396 billion at the end of 2004. The growth in trading volumes and the increase in the number of issuing companies helped the market to improve its efficiency more quickly and to assimilate new investment instruments such as basket certificates on international indices (such as the S&P 100, the Nasdaq 100, FTSE, Dow Jones, and the issue of short certificates on international indices of Israeli shares).[26] The advent of these instruments allowed the public to invest in leading global share indices via the Tel Aviv Stock Exchange,[27] resulting in the redirection of structured deposits[28] from the banking system to the exchange. Resident investments abroad increased at a vigorous 16.6 percent pace and accounted for 7.3 percent of the public's total portfolio at the end of 2005. Most investment abroad is carried out by institutional players (pension funds, insurance companies, and provident funds) and a large portion takes place by means of mutual funds. The change in the extent of investment abroad seems to have been influenced by several factors: the equalization of tax rates on capital gains from investments in foreign and domestic securities, including a full exemption for provident funds on overseas investments from 2005 onward, investors' wish to diversify risks, and the narrowing of the interest-rate spread. Due to these developments, the share of assets deposited with the banking system continued to contract and settled at 30.6 percent at the end of 2005, much lower than in previous years (Table 1.9 and Figure 1.17).

The supply of public sources to the banks during the review year was affected by two main contrasting developments. The income effect abetted an increase in the public's asset portfolio, mainly due to the recovery of activity as reflected, among other things, in larger personal household disposable income. The substitutability effect, in contrast, steered sources from the banking system to the capital and money markets, which continued to advance strongly compared to the relatively low effective yields offered by

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26 At the end of 2005, thirty-nine basket certificates were being traded. The trading volume in these certificates was 9 percent of total turnover in the stock market and the value of the public's holdings in basket certificates was NIS 6.1 billion in September 2005 as against NIS 5 billion at the end of 2004.

27 These issues were affected mainly by tax discrimination between investments in domestic securities and investments in foreign securities. This discrimination was abolished at the beginning of 2005.

28 Structured products are financial products that offer customers an investment vehicle that assures all or part of the principal but also allows the possibility of a higher return than that provided by a risk-free investment. By foregoing risk-free interest, one may purchase financial derivatives on various underlying assets such as interest rate options, share and share-index options, exchange-rate options, credit derivatives, etc., which constitute the components of the structured product.

Table 1.9
The Public's[a] Assets Portfolio in Banks and not in Banks, 2001-05

	Balances					Composition					Rate of change	
Financial Assets	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005	2004 relative to 2003	2005 relative to 2004
	NIS billion (December 2003 prices)			(current prices)		(percent)					(percent)	
1. The public's assets in banks[b]	536.3	519.4	523.6	526.2	554.4	42.9	43.5	38.3	34.7	30.6	0.5	5.4
Unindexed local-currency deposits[c]	289.9	261.2	278.0	291.0	305.8	23.2	21.9	20.3	19.2	16.9	4.7	5.1
Deposits in and indexed to foreign currency[d]	80.9	86.9	91.9	100.7	119.0	6.5	7.3	6.7	6.6	6.6	9.5	18.2
Indexed deposits[e]	165.5	171.3	153.7	134.5	129.6	13.3	14.4	11.2	8.9	7.1	-12.5	-3.7
of which Bank deposits of provident and pension funds and insurance companies	72.6	66.8	60.8	62.7	57.3	5.8f	5.6f	4.4f	4.1f	3.2[f]	3.1	-8.6
2. The public's tradable assets	383.3	346.4	464.4	576.4	755.2	30.7	29.0	34.0	38.0	41.6	24.1	31.0
Shares[g]	204.5	143.6	224.9	291.0	418.8	16.4	12.0	16.4	19.2	23.1	29.4	43.9
Traded bonds and makam[h]	88.2	101.2	138.1	171.3	203.5	7.1	8.5	10.1	11.3	11.2	24.1	18.8
Residents' investments abroad	90.5	101.5	101.4	114.0	132.9	7.3	8.5	7.4	7.5	7.3	12.5	16.6
3. Cash held by the public	15.2	15.3	16.2	17.8	20.9	1.2	1.3	1.2	1.2	1.2	9.8	17.8
4. Assets of provident and pension funds and insurance companies (excluding bank deposits)[i]	313.9	312.6	363.6	395.8	483.3	25.1	26.2	26.6	26.1	26.6	8.9	22.1
Total assets of the public: 1+2+3+4	**1,248.7**	**1,193.7**	**1,367.7**	**1,516.2**	**1,813.9**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**10.9**	**19.6**

[a] The public does not include the government, the Bank of Israel, the commercial banks or the mortagage banks.
[b] Including commercial and mortgage banks.
[c] Including unindexed earmarked deposits.
[d] Including time deposits, unrestricted resident deposits, unrestricted resident restitution deposits, residents' foreign currency deposits and non-resident deposits of residents of Israel.
[e] Including deposits approved for the granting of loans of affiliated companies and others.
[f] Of total bank deposits.
[g] Shares held by the public and provident funds, not including the holdings of nonresidents and the government.
[h] Including government bonds (indexed and unindexed) and private bonds.
[i] Includes provident and compensation funds, advanced study funds, pensions and life insurance funds in the "guaranteed return" and "participating in profits" programs.
SOURCE: Based on reports to the Bank of Israel.

the banks (Table 1.4). Consequently, deposits from the public with the banking system increased at a gentle pace of 5.4 percent while the flow of public assets to non-banking destinations expanded by 31.0 percent.[29]

Figure 1.17
Proportion of Public Assets in the Banking System Compared to Public Assets outside the Banking System, 1990-2005[a]

[a] Due to structural changes in the capital market, in 2005 assets held in and outside of the banking system were reclassified.

SOURCE: Reports to the Supervisor of Banks; Annual Report of the Supervisor of Capital Markets, Insurance and Savings in the Ministry of Finance; the Bank of Israel; and data from the Tel Aviv Stock Exchange.

[29] Not forgetting that any decision by the public to divert sources from the banking system to the capital and money markets would also be affected by the difference in risks between these investment channels.