CHAPTER 1

CHAPTER 1
DEVELOPMENTS IN THE ACTIVITY
OF THE ISRAELI BANKING SYSTEM

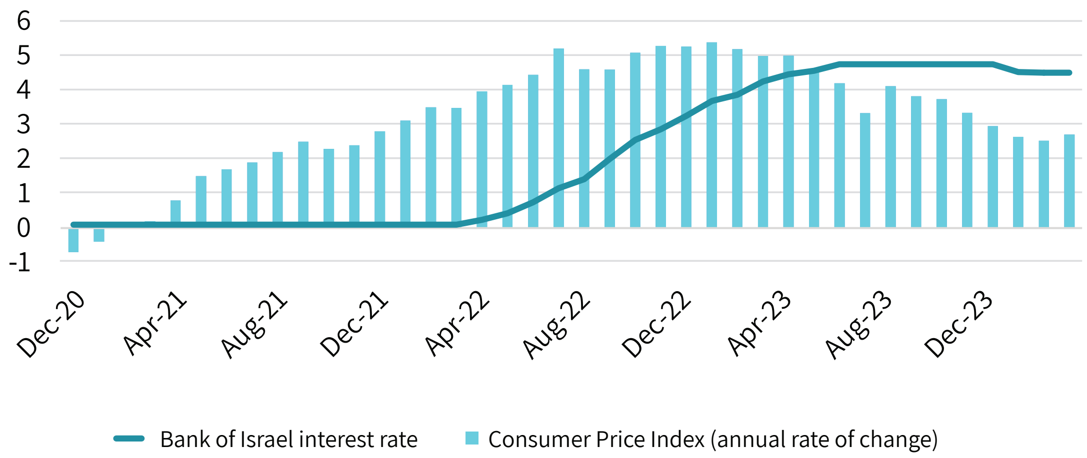
1. INTRODUCTION

The Israeli banking system continued to maintain its resilience and stability throughout 2023 despite the challenges it faced. Economic developments in 2023 were impacted by several key factors: high interest rates, legislative initiatives to change the judicial system, and the Swords of Iron War that erupted on October 7. At the beginning of 2023, the Israeli economy was in a strong position: high output levels, a government budget surplus, a tight labor market, and a stable financial system. Although inflation was above target, it was low relative to international levels. Throughout 2023, inflation moderated both in Israel and globally, alongside a slowdown in growth. The Bank of Israel continued its monetary policy, with interest rate hikes starting in April 2022, reaching a level of 4.75 percent in May 2023 (Figure 1.1). The high-interest environment increased the debt burden on households and businesses, as is expected.

Accordingly, the housing market slowdown continued in 2023, with a decrease in the number of transactions, an increase in housing supply, a slight decrease in home prices, and in line with these a marked reduction in new housing credit volume. A major development in 2023 was the government's proposed legislative changes to the judicial system, which sparked widespread public protest. The uncertainty surrounding the implications of this process and the public atmosphere were reflected in the financial markets: the shekel depreciated significantly, and the Israeli capital market underperformed compared to global markets. Major credit rating agencies were not indifferent to these developments. Early in 2023, they expressed concerns about the potential harm to the economy due to these processes (the legislative changes and related developments). Moody's even downgraded Israel's credit rating outlook from "positive" to "stable." Nevertheless, it is important to note that the rating agencies, as well as various international organizations, emphasized the resilience of the Israeli economy and its financial system.

An increase in the Bank of Israel interest rate in April 2022 led to a moderation of inflation during the year.

Figure 1.1 Bank of Israel Interest Rate and Consumer Price Index (annual rate of change), Montly Average, December 2020–April 2024 (percent)



SOURCE: Bank of Israel and Central Bureau of Statistics.

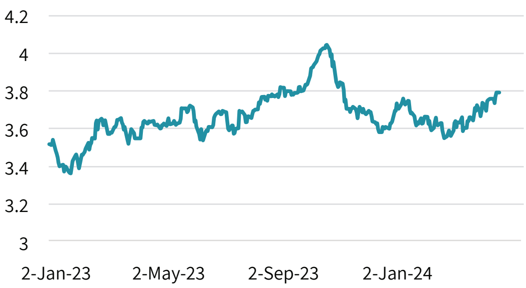
The Swords of Iron War, which erupted on October 7, 2023, marked a significant escalation in regional tensions, involving extensive military operations in the Gaza Strip, increased combat activities along the Lebanon border, and a high state of alert across Israel. The war has profound implications for various sectors of society and the economy. Immediate consequences included the evacuation of residents from areas close to the combat zones, extensive mobilization of reserve forces, and a reduction in the supply of non-Israeli workers. These factors disrupted the labor market and significantly impacted the supply and demand for workers.

Additionally, the onset of the war led to sharp declines in financial markets, rapid depreciation of the shekel, an increase in the country's risk premium, and a sharp increase in public expenditure. Policy actions taken by the Bank of Israel mitigated the depreciation in the foreign exchange market and contributed to the stabilization of other financial markets (see Figures 1.2 and 1.3). The construction and real estate industry, tourism (primarily incoming tourism), and agriculture were significantly affected by the war and continued to suffer long-term consequences even as other industries of the economy recovered and returned to relatively normal operations. In the early months of 2024, amid growing uncertainty about the war's duration, credit rating agencies downgraded Israel's credit rating and its outlook: Moody's in February 2024 and S&P in April 2024.

With the outbreak of the war, there was a rapid depreciation of the shekel and a rise in the economy's risk premium. Actions taken by the Bank of Israel moderated the depreciation.

Figure 1.2

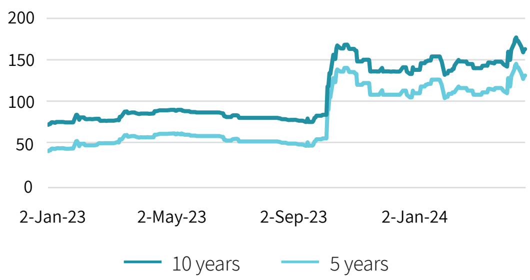
Shekel/Dollar Representative Exchange Rate, January 2023–April 2024



SOURCE: Bank of Israel.

Figure 1.3

Israel's 5-Year and 10-Year US Dollar CDS, January 2023–April 2024 (basis points)



SOURCE: Bloomberg.

In 2023, the banking system recorded high profitability, although the return on equity during the year was slightly lower than the peak observed in 2022. The system's profitability was driven by continued credit growth (albeit at a more moderate pace than previously) and the rise in monetary interest rates in Israel and worldwide from their near-zero level at the

beginning of 2022. The capital and liquidity ratios of the banking system remained high and above the minimum regulatory requirements, indicating the system's resilience and its ability to continue supporting the economy even during wartime.

The slight moderation in profitability was influenced by the public's shifting of funds from current accounts to interest-bearing deposits, which increased interest expenses, as well as leading to a significant increase in credit loss provisions due to worsening macroeconomic conditions and the effects of the war (for further details, see Chapter 3.1 of this survey). In contrast, conservative profit distribution rates at the onset of the war and the slowdown in credit contributed to capital strengthening (for further details, see Chapter 4 of this survey). Note that in view of the high budgetary needs in light of the war, a special payment law was passed in the Knesset in April 2024, requiring banks to pay up to NIS 2.5 billion in 2024–25. Despite the expected reduction in bank profitability during these years, mainly due to macroeconomic conditions and the effects of the war, the law's impact is not expected to adversely impact the banks' business operations. During the first half of 2023, three US banks collapsed after experiencing an unprecedented withdrawal of deposits within a brief period of time.

The collapse of these banks was the most significant failure event in the global system since the global financial crisis in 2008 (for more details, see Box 5.2 in this survey). The Banking Supervision Department studied the details of the events, the regulatory responses worldwide, and the lessons that might be relevant to the Israeli banking system and then began to apply those lessons.

During 2023, the growth rate of business credit and household credit moderated as a result of the high level of interest rates, with this trend intensifying after the outbreak of the Swords of Iron War in the fourth quarter of the year. Consumer credit (excluding housing) and credit to small and micro businesses contracted while credit to large businesses and for housing continued to grow, albeit at a moderate pace relative to recent years. The construction and real estate industry continued to lead the growth in the credit portfolio, particularly against the backdrop of a slowdown in sales that led to an increase in the financing needs of the companies in order to continue construction. It should be noted that the construction and real estate industry was experiencing a prolonged slowdown even before the war, which the war exacerbated due to a shortage of workers that led to delays at construction sites. Accordingly, the risk in the industry increased (for more details, see Box 5.1 in this survey). Immediately upon the outbreak of the war, the Bank of Israel and the Banking Supervision Department adopted several measures to support economic activity and assist customers (for more details on some of these measures, see Boxes 6.2 and 6.7, and Chapter 6 in this survey). **Credit risk increased during 2023, as reflected in various credit quality indices (for more details, see Chapter 5.2 in this survey). Looking ahead, this risk, and other risks faced by the banking system, may increase, especially given the high level of interest rates, which is expected to continue, the marked decline in growth, and the still high level of geopolitical uncertainty.**

The banking system is inherently exposed to a wide range of risks, the intensity and impact of which vary over time and as an outcome of various developments. **As mentioned, the risk level in the banking system's operations increased during 2023 and remains high, and it is expected**

to remain so throughout 2024. A risk survey conducted among senior banking officials at the beginning of 2024 reveals that cyber risk continues to be the most concerning risk faced by the banking system, with domestic political risk and geopolitical risk ranked second—an increase in rank compared to 2023, against the backdrop of the Swords of Iron War, its effects on the economy, and the fear of the war spreading to other arenas. This is in addition to concerns about significant legislative changes in the absence of a broad consensus (for more details, see Chapter 5.1 in this survey). **It should be noted that again this year, the Banking Supervision Department is conducting a macroeconomic stress test for the banking system, based on a uniform scenario—as is customary in other countries—in order to continue ensuring that even in the event of an extreme macroeconomic event, the banks will be able to absorb the resulting losses without endangering public deposits and their stability.** This year, in light of the war and its implications, the uniform scenario was modified and conveyed to the banking system; after completing the analysis, these results will be published, as they are every year.

Alongside these efforts, **the Banking Supervision Department continued this year to promote and enhance the level of fairness between the banking system and its customers. Fairness is a central goal of Banking Supervision Department, based on the perception that fairness in dealings with customers is a prerequisite for public trust in the financial system, which is closely tied to the system's stability.** In recent years, there has been a shift in the international supervisory approach to customer protection, and the Banking Supervision Department is also part of this trend (for more details, see Box 6.5 in this survey). **Additionally, the Banking Supervision Department continues to promote competition within the banking system. The banking system has been undergoing a revolution in recent years that has increased the level of competition.** Financial products and services are becoming unbundled and are being offered by additional players through various technological platforms. Financial information about the customer, which was previously the exclusive domain of the banks, is now openly accessible, allowing for the provision of services and value propositions tailored to the customer's type and activity (for more details, see Box 6.6 in this survey). The Banking Supervision Department has worked extensively to remove barriers, increase transparency, and promote competition in order to transfer power to the customer and strengthen the intensity of competition (for more details, see Box 6.4 in this survey). **In recent years, the Bank of Israel has worked to increase competition in the banking system and to encourage the entry of new entities. As a complementary step, the Banking Supervision Department has begun formulating a tiered licensing framework with three types of banking corporation licenses. This framework is expected to further reduce other barriers that have been identified and that constitute a challenge to new players in their efforts to enter the banking system** (for more details, see Box 1.1 in this survey). It should be noted that in 2023, the Competition Authority announced that it is considering the declaration of the five banking groups as a concentration group and accordingly to require them to take certain measures within this framework. The consultation process has not yet been concluded, and the Competition Authority has recently initiated hearings with the five banking groups.

During the rest of 2024, the banking system is expected to continue dealing with the uncertainty arising from the war and its effects, as well as with additional challenges and risks

that may arise. As mentioned, apart from increased financial risk, cyber risk and geopolitical risk have increased as well. The conflict has not yet come to an end and could even expand. **Despite these developments, the Israeli banking system remains robust and will continue to support its customers and the economy as a whole.** The Banking Supervision Department will continue, as always, to monitor the risks inherent in the activities of the banking system, oversee them, and act as needed, using the various supervisory tools at its disposal.

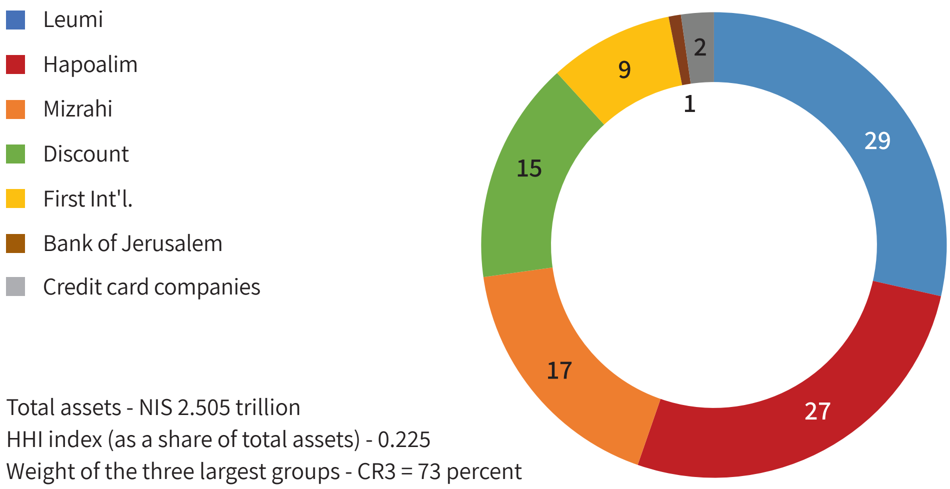
2. THE STRUCTURE OF THE BANKING SYSTEM

a. The structure of the banking system and the holdings of the banks

The Israeli banking system is primarily controlled by five large banking groups: Leumi, Hapoalim, Mizrahi-Tefahot, Discount, and First International, which include commercial banks in Israel and branches abroad. [1] As described in Figure 1.4, these groups together hold about 99 percent of the system's total assets, highlighting their significant impact on the financial landscape. The banking system also includes two independent banks, Jerusalem Bank and the new digital bank One Zero, which was launched in 2022, and four branches of foreign banks: Citibank, HSBC, Barclays, and State Bank of India, whose main activity is located in the credit market though their role in that market is minimal. At the end of 2022, a license was granted to the Esh Israel Bank, [2] another digital bank expected to start operations in the near future. The banking landscape is also complemented by three credit card companies: Isracard, which operates as an independent company; MAX, which operates under the ownership of Clal Insurance; and Cal (Israel Credit Cards), which is part of a banking group. [3], [4]

The two largest banking groups account for about 55 percent of the banking system's assets, according to the CR2 index.

Figure 1.4 Structure of the Israeli Banking System, December 2022
(groups on a consolidated basis, total assets, percent)



Total assets - NIS 2.505 trillion
HHI index (as a share of total assets) - 0.225
Weight of the three largest groups - CR3 = 73 percent

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

1 The proportion of these branches is very limited.
2 Click here for the press release on the Bank of Israel site (in Hebrew).
3 For further details on the requirement that the Discount group sell Cal company, see the press release on the Ministry of Finance site.
4 The Concentration Ratio (CR2) measures the weight (in percent) of the two largest players in the market. It is the convention to similarly measure the weight of the three—or five—largest banks in the market (CR3 and CR5, respectively).

Commercial banks in Israel offer a wide range of financial products and services, often specializing in different sectors or areas of activity. This specialization is typically managed through various divisions within each banking group, allowing these institutions to tailor their offerings to specific market needs. This strategic focus is a critical factor in determining the bank's market share and the distribution of its services across different sectors of the economy, as shown in Table 1.1. The shares of the banks in specific products or sectors significantly impacts the distribution of their market shares, as illustrated in Figure 1.4.

A closer look at the household credit market, which includes both housing and other types of consumer credit, reveals that Mizrahi-Tefahot Group is a prime example of how specialization can lead to a dominant market position. This group holds approximately 33 percent of the credit position in this sector, significantly higher than its share of total banking assets—about 17 percent (Figure 1.4, Table 1.1). This discrepancy highlights Mizrahi-Tefahot's strategic emphasis on household credit and its effectiveness in capturing a significant portion of this market. Similarly, the two largest banking groups, Leumi and Hapoalim, hold a combined market share of about 46 percent in the household credit sector. However, this figure is not proportional to their combined total assets, which account for about 55 percent of the banking system's assets. This indicates that while these groups are central players in the overall banking landscape, their influence in the household credit sector, though significant, does not match their overall asset dominance. This situation underscores the competitive dynamics in the Israeli banking sector, where strategic specialization by certain groups can lead to significant market influence in specific sectors, despite a smaller overall asset base.

Table 1 | In most of the retail activity sectors, the two largest banks control about half of the market.

Banks' Market Shares by supervisory activity segment, December 2023 | Percentages

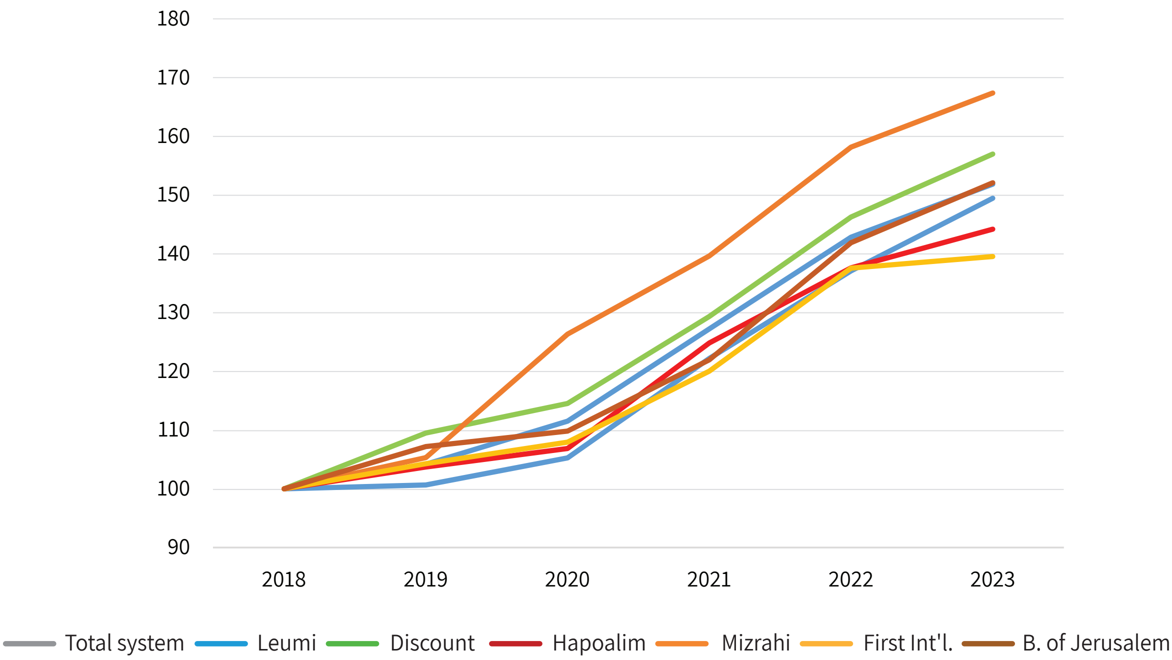
		Leumi	Discount	Hapoalim	Mizrahi-Tefahot	First Int'l	Bank of Jerusalem
Households	Deposits	22.1%	15.4%	27.8%	21.4%	11.6%	1.7%
	Housing credit	22.4%	11.9%	22.6%	35.4%	6.1%	1.7%
	Nonhousing credit	22.6%	12.7%	26.5%	20.4%	16.3%	1.4%
Small and micro businesses	Deposits	30.8%	14.1%	29.3%	16.9%	7.9%	0.3%
	Credit	30.1%	19.1%	25.5%	15.8%	8.2%	1.3%

SOURCE: Based on reports to the Banking Supervision Department.

In recent years, most medium-sized banks have increased their net public credit position at a faster rate than the large banks (average annual growth rates of approximately 10 percent and 9 percent respectively between 2019 and 2023; Figure 1.5). Nonetheless, the credit extended by the two largest banking groups constitutes more than half of the banking credit to the public.

The rate of growth in credit to the public among most of the medium-sized banking groups has been faster than among the large banking groups.

Figure 1.5 Index of Development of Credit to the Public, 2018–2023
(groups on a consolidated basis, total banking system, index: 2018=100)



SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

In recent years, the Bank of Israel has been at the forefront of initiatives to enhance the competitive landscape of the banking system. By removing regulatory barriers, it has paved the way for new players to enter the market. This successful removal of barriers has contributed to the creation of market conditions that led to the issuance of banking licenses to two new banks [5] for the first time in 40 years, marking a significant milestone in the development of the banking sector.

One Zero Bank, [6] a prominent new entrant, completed its first full year of operation, focusing on the local market. This bank has a clear focus on households and small and micro businesses, offering a range of services such as credit provision, deposit management, and advanced payment services. Its services are tailored to the unique needs of these sectors, reflecting a shift towards more specialized and accessible banking solutions. In late 2022, a license was granted to another digital bank, Esh Israel, which is also expected to begin operations in the local market in the near future. [7] It is too early to predict the long-term impact of these digital banks on the overall banking

[5] During 2020, a license was granted to the first digital bank: One Zero.
[6] Since it began operations during 2023, the bank's aggregate data have not yet been included.
[7] Click here for the press release.

system. However, their focus on leveraging innovative technologies may lead to changes in the interactions between market players.

In addition to these developments, the Bank of Israel has also created a tiered licensing framework that has the potential to be a game changer in the banking sector. This new framework includes three separate types of licenses for banking corporations and is designed to streamline the process of new banks entering the market and to reduce the barriers that previously hindered the entry of new players.

Further details about this new licensing framework can be found in Box 1.1 of this survey, where the specifics of each type of license are described. This step is a crucial part of the broader strategy to ensure a vibrant, competitive, and flexible banking system that can adapt to the evolving needs of the Israeli economy. [8]

b. The banks as part of the financial system

Alongside the commercial banks, which form a central pillar of the financial system, other significant players contribute to the financing of the economy. These include institutional entities such as pension funds, provident funds, insurance companies, nonbank entities [9], and credit card companies. They provide various services, some similar to those offered by the banks, such as providing credit to the public, managing investment portfolios, and offering insurance products. Their involvement shapes the structure of the business sector and its sources of debt.

In 2023, there was continued growth in the debt of the business sector (which accounts for most of the economy's debt) to the financial system, although at a slower rate than in previous years, and in particular, relative to 2022 which was a peak year.

This moderation in debt expansion can be attributed to several factors. By the end of 2023, the total debt of the business sector to the financial system stood at approximately NIS 1315 billion, reflecting a growth rate of about 4.4 percent since the end of 2022, or an increase of about NIS 55 billion. The majority of this increase is attributed to the business sector's debt to the banks, which accounts for about 55 percent of the business sector's total debt. [10] It should be noted that in response to the rise in interest rates in the economy, the growth in the debt moderated during the year, especially among small to medium-sized businesses. **This trend of moderation was also observed among large businesses starting from the last quarter of the year** (for more details, see Chapter 5.2 of this survey and Chapter 4 of the Bank of Israel Annual Report for 2023).

The increase in business sector debt this year was primarily funded by the banking system, with institutional entities contributing to a lesser extent (Figure 1.6). Conversely, the overall increase in the debt position was offset by a decrease in the business sector debt held by nonresidents, even after adjusting for exchange rate effects.

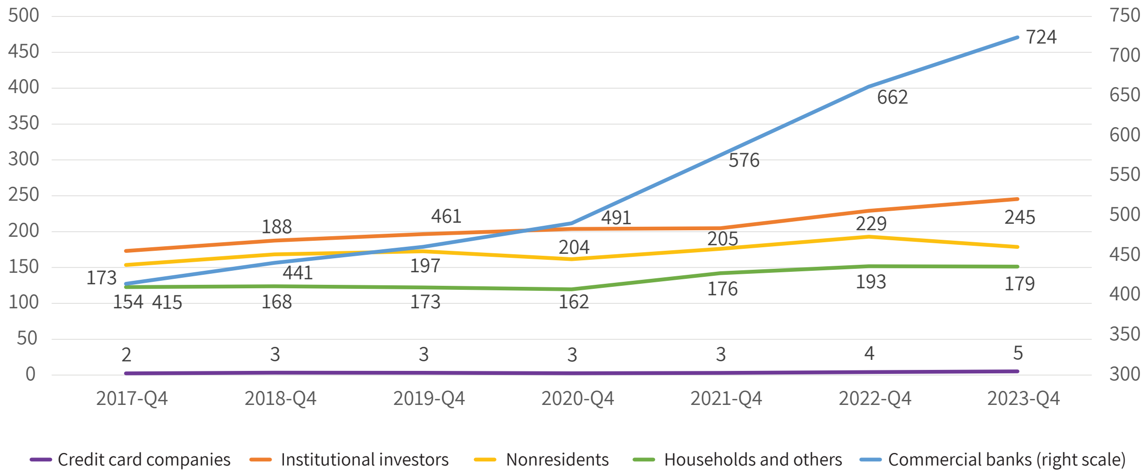
[8] For further details, see the press release on February 14, 2024 on the Bank of Israel site.

[9] Such as Mimun Yashir, Peninsula, Albar, etc.

[10] For further details on the trend in the private nonfinancial sector's debt, see the Statistical Bulletin published by the Information and Statistics Department at the Bank of Israel, March 2024.

The banking system and the institutional entities are the business sector's main sources of financing.

Figure 1.6 **Development of Business Debt by Financing Source, 2017–2023** (NIS billion)



1) The nonbank companies included in the calculation starting from 2019 are: Opal Balance Investments Ltd., Or Shay G.S. Ltd., S.R. Accord Ltd., Bull Trading and Investments Ltd., Barkat Capital Ltd., Gibui Holdings Ltd., Gama Management and Clearing Ltd., Gamla - Harel Residential Real Estate Ltd., Unit Credit Financial Services Ltd., Michman B.S.D. Ltd., Mikhlol Financing Ltd., M.L.R.N. Projects and Trade Ltd., Manif - Financial Services Ltd., Nawi Brothers Group Ltd., Erech Financing Cahalacha Ltd., Psagot Group, Peninsula Group Ltd., E.N. Shoham Business Ltd., Jacob Finance and Investments Ltd.

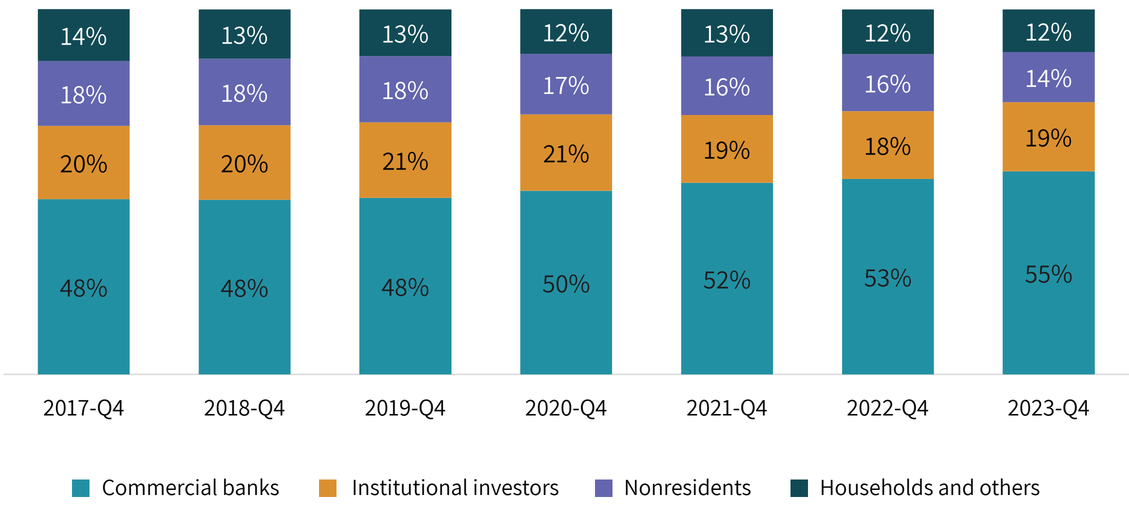
2) A nonresident: Anyone who is not defined as a resident of Israel. The debt to nonresidents includes bonds held by nonresidents (in Israel and abroad) and loans provided by them. The loan mix includes financial loans (foreign banks, institutional entities, etc.), supplier credit, and shareholder loans.

SOURCE: Based on reports to the Bank of Israel and the Tel Aviv Stock Exchange.

In light of these developments, the proportion of debt originating from the banking system increased to approximately 62 percent by the end of 2023, compared to around 60 percent at the end of 2022. This shift occurred at the expense of the debt held by institutional entities and nonresidents, indicating a change in the dynamics of debt distribution in the economy (as can be seen in Figure 1.7).

During 2023, the banking system expanded its share of total financing of the business sector at the expense of nonresidents.

FIGURE 1.7 Distribution of Business Sector Debt by Financial System Lender, 2017–2023 (percent)



1) The nonbank companies included in the calculation starting from 2019 are: Opal Balance Investments Ltd., Or Shay G.S. Ltd., S.R. Accord Ltd., Bull Trading and Investments Ltd., Barkat Capital Ltd., Gibui Holdings Ltd., Gama Management and Clearing Ltd., Gamla - Harel Residential Real Estate Ltd., Unit Credit Financial Services Ltd., Michman B.S.D. Ltd., Mikhlol Financing Ltd., M.L.R.N. Projects and Trade Ltd., Manif - Financial Services Ltd., Nawi Brothers Group Ltd., Erech Financing Cahalacha Ltd., Psagot Group, Peninsula Group Ltd., E.N. Shoham Business Ltd., Jacob Finance and Investments Ltd.
2) The business credit provided by credit card companies is negligible (less than 0.5 percent of total business credit) and therefore they were not included in the graph.

SOURCE: Based on reports to the Bank of Israel and the Tel Aviv Stock Exchange.

c. Credit Card Companies

In recent years, the operating environment of the credit card companies and nonbank credit providers has undergone a number of changes, with notable developments occurring in 2023. In January 2023, the Knesset Finance Committee approved the separation of the credit card company Cal from its parent company, Discount Bank, following the recommendations of the committee for the implementation of the Strum Law.[11] This separation requires that Cal be sold within three years from the date the regulations are published in the official record, or up to four years, under certain circumstances, should a public offering route be decided on. In March 2023, the sale of the MAX credit card company by Warburg Pincus to Clal Insurance Group was completed for approximately NIS 2.5 billion. Another transaction in 2023 involved the Isracard credit card company, which entered into a merger agreement with Harel Insurance Investments and Financial Services Ltd. (hereinafter: Harel). Harel sought to purchase all the shares of Isracard. The transaction received approval from the Supervisor of Banks, partly based on the understanding that such a deal

[11] Recently, Discount Bank was granted an extension in light of the Swords of Iron War. For more details about the Finance Committee's approval, click here.

is expected to strengthen competition in retail and small business credit. The transaction also received approval from the Capital Market Authority. However, in January 2024, the Competition Authority announced its opposition to the merger, citing significant concerns about potential harm to competition, particularly in the health insurance sector, where Harel is a leading player. [12]

Additionally, and as part of the Bank of Israel's ongoing efforts to increase competition in the banking sector and facilitate the entry of new players by removing regulatory barriers, the Banking Supervision Department announced its intention in February 2024 to promote a tiered framework for granting banking corporation licenses to nonbank entities, including credit card companies. [13] This initiative aims not only to enhance competition in the banking system, in terms of both credit and deposits, thereby reducing the costs of banking products, but also to provide strategic planning opportunities for companies (for further details, see Box 1.1 in this survey). This regulatory progress is expected to eliminate some of the uncertainty in the business environment and assist companies in their long-term strategic planning.

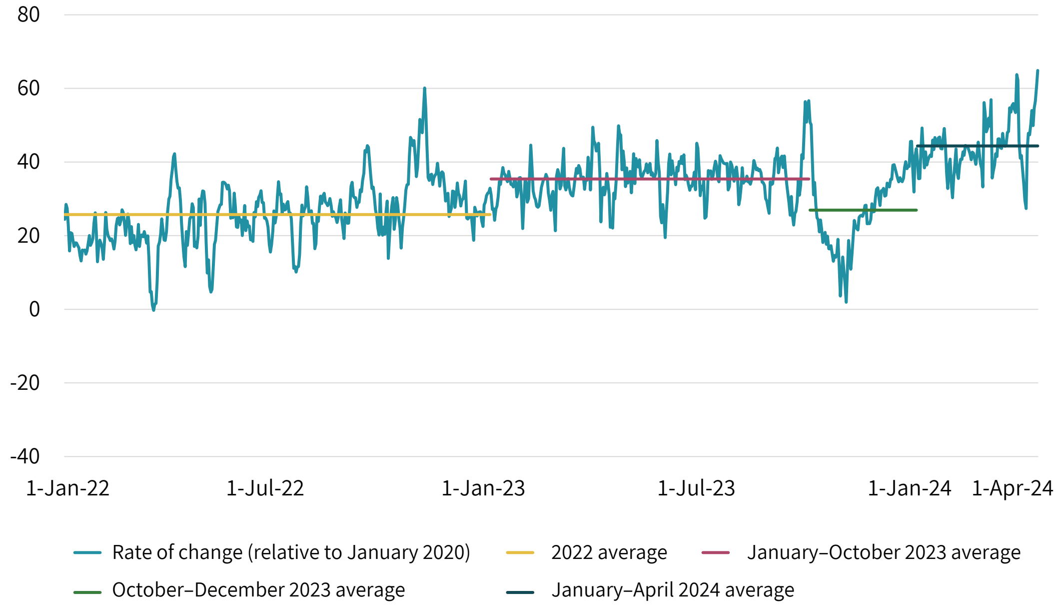
The outbreak of the Swords of Iron War significantly impacted the economy, especially the activity of credit card companies, which recorded a notable slowdown. However, there was a rapid recovery starting in mid-November 2023, with credit card usage surpassing pre-war levels in February 2024. Despite this recovery, it is important to recognize the challenges faced by credit card companies. Due to their increased exposure to the rise in credit card usage in the economy (Figure 1.8), these companies are more susceptible to the consequences of such shocks. Accordingly, the profitability of credit card companies declined in the last quarter of the year. This was in addition to the slowdown, mainly during the first half of the year, in private credit extended by the companies, which was affected by the high interest rates prevailing in the economy.

[12] The main concern was that Harel might misuse the information about its customers and the financial data held by Isracard to create a pricing model that estimates customers' sensitivity to paying for insurance products, thereby implementing price discrimination. This step would reduce the consumer surplus and harm the competitive environment in the insurance sector. For more details, click here.

[13] The Bank of Israel publishes a public consultation document for promotion of a gradual framework for granting banking corporation licenses to nonbank entities.

Following the increase in credit card usage in recent years, the Iron Sword war led to a significant decline. This was followed at the beginning of 2024 by an increase in credit card usage that exceeded pre-war levels.

Figure 1.8 Change in Credit Card Expenditures, Equavalized to Business Days, January 2022–April 2024 (percent)



SOURCE: Based on SHVA.

3. THE BANKING SYSTEM'S CHANNELS OF ACTIVITY

Banking services are increasingly being provided through a mix of physical and digital channels, reflecting significant changes in the distribution of these services. These shifts include a reduction in the number of physical branches, driven by changes in consumer preferences and banking service consumption patterns. This development highlights the adaptability of the banking system and it is accompanied by improvements in the quality and variety of services offered through digital communication channels, even as the number of service branches has decreased in recent years. [14]

In 2023, the total number of transactions carried out across various channels grew by approximately 7.5 percent, reaching around 154 million transactions (Figure 1.9). This

[14] The closing of bank branch requires the approval of the Supervisor of Banks, who carries out a comprehensive examination based on a variety of considerations, and in particular the welfare of the consumer. In most of the cases that the Banking Supervision Department approves the closure of a branch, it is conditional on the creation of an alternative infrastructure nearby. For further details on the examination of a request to close a branch, see Proper Banking Conduct Directive 400 and Chapter 6 of Israel's Banking System 2022.

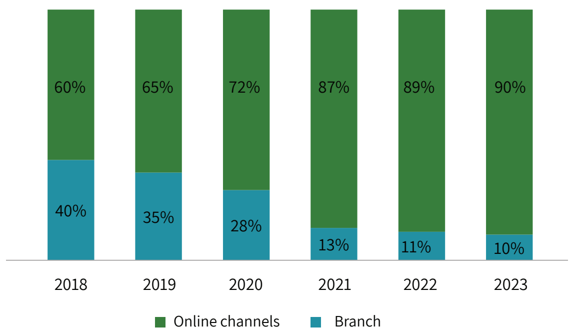
growth was mainly driven by an increase in transactions conducted through digital channels, while transactions through physical branches declined slightly. [15] **By December 2023, about 90 percent of banking activities were conducted through digital channels, underscoring the effectiveness and widespread acceptance of the banking sector's digital transformation.**

During the course of the year, there was variability in the level of activity across different channels. In the first half of the year, there was an increase in the number of transactions in all channels, including both physical and direct (digital) channels. However, in the second half of the year, in parallel to the outbreak of the war, a notable shift occurred, whereby activity through digital channels increased, while the number of teller-executed transactions conducted in person at branches declined. [16] This change further illustrates how external factors, such as geopolitical events, can accelerate trends towards greater use of digital banking and can influence how and where consumers choose to conduct their banking business.

The number of transactions carried out by households during 2023 was double the number in 2019, the year prior to the outbreak of the COVID-19 pandemic.

Figure 1.9

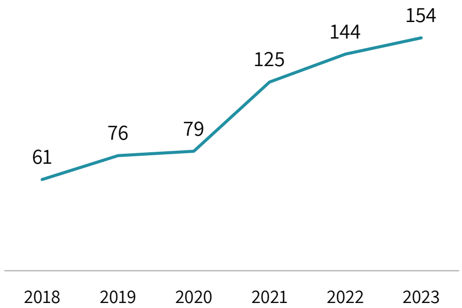
Rate of Transactions Using Various Channels Relative to Branch Activity, The Five Large Banking Groups, December 2018–December 2023 (percent)



SOURCE: Reports to the Banking Supervision Department.

Figure 1.10

Total Transactions Made, The Five Large Banking Groups, December 2018–December 2023 (million)



SOURCE: Reports to the Banking Supervision Department.

15 In addition, there was a change in the definition of a transaction carried out in direct channels, which led to an increase in the number of transactions carried out in that year; however, the change in classification had a negligible effect and does not explain the entire increase.

16 Click here for the announcement of the Banking Supervision Department on the reduction in activity of branches in certain areas at the beginning of the war.

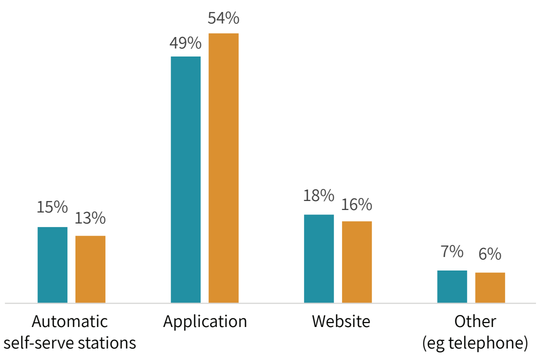
Transactions conducted through direct channels are primarily carried out via mobile apps, accounting for 54 percent of all transactions, as shown in Figure 1.11. Over the past year, there has been a significant increase in the use of this channel, with a 17 percent rise relative to the previous year. This increase reflects a broad shift in customer behavior toward more frequent use of digital banking tools.

However, this shift varies with the age of the customer. Data shows that reliance on transactions via mobile apps declines with a customer's age, with a corresponding increase in the use of alternative channels. Older customers prefer to use websites or conduct transactions directly with a teller at the bank branch, as illustrated in Figure 1.12. This difference underscores the need for banks to understand and adapt their operations to the varying needs and behaviors of different age groups, ensuring that appropriate and accessible banking solutions are provided to every customer segment.

A large proportion of the transactions are carried out on mobile apps. For all age groups combined, most of the consumption of banking services is carried out on the bank's website or app.

Figure 1.11

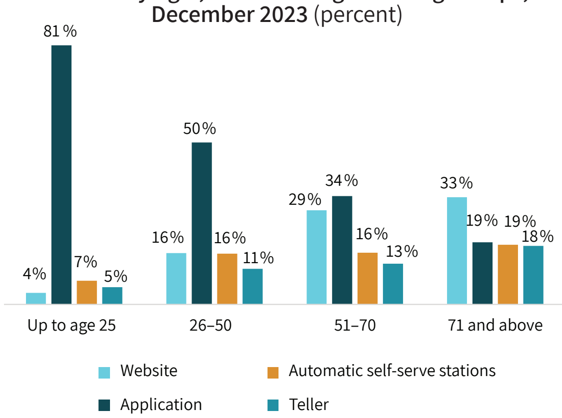
Rate of Household Transactions Using Various Channels, The Five Large Banking Groups, December 2022 and December 2023 (percent)



SOURCE: Reports to the Banking Supervision Department.

Figure 1.12

Rate of Household Transactions Using Various Channels by Age[a], The Five Large Banking Groups, December 2023 (percent)



a The remaining portion of transations are those made via direct channels (such as telephone or correspondence).

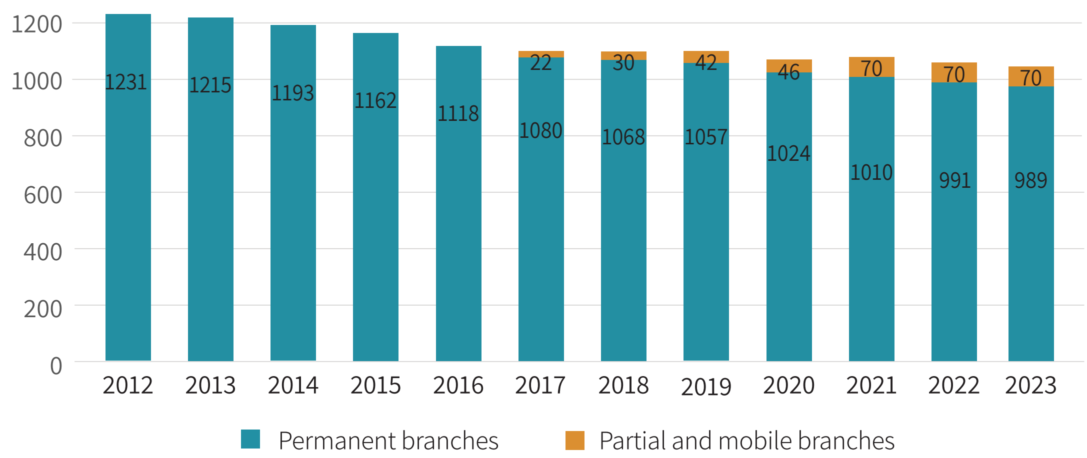
SOURCE: Reports to the Banking Supervision Department.

The infrastructure through which banking services are provided to the public is a hybrid system that includes both physical and digital components. As indicated by the data presented above, the change in the distribution of banking services aligns with changes in the way these services are consumed. The changes are particularly evident in the increased reliance on direct channels, which include digital databases and services offered directly by banks. This shift is supported by improvements in the quality and variety of services available through digital channels.

Despite the growing preference for digital banking, the number of physical branches remained almost unchanged in 2023. This stabilization follows a decade during which banks consistently reduced the number of their branches, as illustrated in Figure 1.13. This recent stability indicates a balancing act where banks maintain a physical presence to complement their expanding digital offerings, paying attention to the preferences of all customers, including those who still value face-to-face interactions.

During 2023, there was almost no change in the number of total branches (fixed and partial and mobile).

Figure 1.13 Number of Bank Branches[a], Total Banking System, 2012–2023



a Permanent branches operating in Israel, excluding performance divisions and units.

SOURCE: Based on reports to the Banking Supervision Department.

BOX 1.1: A tiered framework for granting banking corporation licenses to nonbank entities

- The Bank of Israel's standing is that entities seeking to accept deposits from the public and to provide credit from these deposits must have a banking corporation license and be subject to prudential supervision. Accepting deposits from the public and providing credit from these deposits without a banking corporation license and appropriate supervisory framework could create significant risks to the financial system and endanger public funds during a crisis. This standing is consistent with existing legislation in OECD countries and international banking supervision standards.
- In recent years, the Bank of Israel has worked to increase competition in the banking system and to encourage the entry of new participants by removing regulatory barriers, resulting in the issuance of licenses to two new banks.
- Granting a banking corporation license to nonbank entities could increase competition in the banking system, benefiting customers in terms of both credit supply and pricing, and deposit interest rates.
- As a complementary step to the actions taken so far to increase competition, the Bank of Israel is formulating a tiered framework with three types of banking corporation licenses. This framework is expected to reduce additional barriers that have been identified and that are challenging new participants in their efforts to enter the banking system.

Background

In recent years, the Bank of Israel has worked to increase competition in the banking system and to encourage the entry of new participants, including the establishment of a technological service bureau, the establishment of a credit data register for retail customers, adapting banking regulation for new banks, simplifying the process of establishing a new bank, and providing support to entrepreneurs. Removing barriers has led, among other things, to the establishment of two new banks for the first time in over 40 years: One Zero Digital Bank Ltd. and Bank Esh Israel (in formation) Ltd.

Granting a banking corporation license to nonbank entities will allow them to accept deposits and reduce the costs of their funding sources, thereby benefiting customers and increasing competition in terms of credit supply and pricing, as well as deposit interest rates, particularly for households and SMEs.

The Bank of Israel's standing is that nonbank entities seeking to accept deposits from the public and to provide credit from these deposits must have a banking corporation license and be subject to prudential supervision, similar to international standards. Accepting deposits from the public and providing credit from these deposits without

a banking corporation license and appropriate supervisory framework could create significant risks and expose the corporation to stability, interconnectedness, and contagion risks, endangering public funds during a crisis. Therefore, the corporation must manage liquidity, interest rate, and capital adequacy risks.

International Review

International organizations that set banking supervision standards, particularly the BIS and FSB [1], state that an entity accepting deposits from the public and providing credit from these deposits must be subject to banking prudential supervision to protect depositors' interests and reduce risks to the financial system's stability.

In line with the approach of international organizations, legislation in all OECD countries requires an entity accepting public deposits and providing credit from these deposits to obtain a license anchored in banking legislation and be subject to banking regulation and supervision. It should be noted that legislation in the European Union and the United Kingdom excludes payment account management activities by payment companies (e-money) from the definition of deposit acceptance requiring a banking license, but prohibits such license holders from providing credit from customer funds received in the managed payment account.

In most OECD countries, all banking corporations are required to have an extended banking license, and there is no basic banking license allowing narrow activities compared to an extended banking license. However, within the banking license, some countries define a list of permitted activities, which may be limited for certain entities compared to all banking activities permitted in the legislation.

In countries with several types of banking licenses, these licenses allow more limited activities than those permitted under an extended banking license, but do not impose quantitative restrictions on the volume of deposits or assets. Additionally, in countries with explicit references to digital banks, their licensing requirements are similar to those for traditional banks, with certain adjustments.

In all OECD countries, the banking supervisory authority oversees entities with a license allowing both deposit acceptance and credit provision. In most OECD countries, the banking supervisory authority also oversees quasibanking institutions (credit unions, etc.) and nonbank financing and payment entities that do not engage in both deposit acceptance and credit provision.

As part of implementing the Basel Committee's proportionality principle, some supervisory authorities impose regulatory requirements tailored to the size and complexity of small deposit-taking entities' activities, without compromising stability requirements.

1 Bank for International Settlements and Financial Stability Board (respectively).

Main points of the proposed framework and challenges

According to the proposed framework, a hierarchy of banking corporation licenses will be established, in line with the Governor of the Bank of Israel's existing authority to grant licenses.

The main points of the proposed framework are as follows:

a) **Banking corporation accepting deposits and providing credit from these deposits without current account management** [2] – A banking corporation that accepts deposits, provides credit from these deposits, and does not manage current accounts will be exempt from banking legislation and regulation that is relevant for managing such accounts.

b) **Banking corporation with a basic banking license** – This tier will include a banking corporation limited in its scope and complexity of activities. In addition to accepting deposits and providing credit from these deposits, such a banking corporation will be allowed to manage current accounts and provide credit from them.

c) **Banking corporation with an extended banking license** – This tier will include a banking corporation with a banking license that does not meet the definitions specified in Sections (a) or (b).

The Bank of Israel published a call for public comments on the proposed framework, receiving feedback from nonbank entities, including credit card companies, the banking system, and various social organizations. The framework is currently being reviewed in light of the received comments.

Challenges

The experience gained in establishing new banks and discussions with various stakeholders have led to the identification of the following challenges that may pose barriers to the entry of additional participants into the banking system, and which the framework is expected to address:

Adapting legislation and regulation – Legislation imposes identical costs on all banking corporations, regardless of the scope and complexity of their activities. These costs, along with the technological complexity and resource investment required for several projects simultaneously, extend the preparation time for new banking corporations.

[2] This tier already exists in the Banking (Licensing) Law, 5741–1981, as a financial institution permitted to accept monetary deposits and provide credit from them, but that is not permitted to accept monetary deposits in current accounts in order to pay by check on demand from those deposits.

According to the Basel Committee's proportionality principle, the burden of banking legislation and regulation should be aligned with the scope and complexity of activities, without compromising stability requirements. The framework will examine the implementation of this principle.

It should be noted that regarding banking regulation, the Banking Supervision Department adapted the Proper Conduct of Banking Business directives for new banking corporations as part of this principle. This included easing requirements in the areas of: capital ratios, liquidity calculation model, board size and composition, possibility of consolidating functions, and outsourcing certain central functions. All this, while maintaining the banking corporation's stability and protecting its customers. The framework will examine additional leniencies according to the type of license.

Managing a current account imposes various obligations on the banking corporation, such as fee rules, opening a current account, and issuing bank checks in NIS and foreign currency. The framework will examine these obligations concerning the types of banking corporations.

Permitted activities – The Banking (Licensing) Law, 1981, provides a closed list of activities permitted for banking corporations. The list aims to prevent exposure to risks related to nonbanking activities and avoid potential conflicts of interest between banking and other activities. In line with global practices, it is proposed to allow the regulatory body flexibility in determining permitted activities based on the nature of the banking corporation's activities and potential conflicts of interest with other activities, instead of a blanket prohibition. Such flexibility is also required due to the differences between the list of permitted activities for banking corporations and those allowed for nonbank entities, including credit card companies, so that their current activities are not adversely impacted.

Parallel control of an institutional investor and a banking corporation – Legislation prohibits parallel control of an institutional investor and a banking corporation, but does not prohibit parallel control of an institutional investor and a nonbank entity, including a credit card company.

The framework will also examine this prohibition, considering the size and scope of the banking corporation's activities. On the one hand, allowing parallel control of nonbank entities that receive a banking corporation license will enable those entities to benefit from business support, strategic promotion, and to some extent, capital support, which are expected to contribute to competition. On the other hand, parallel control of nonbank entities with a banking corporation license is expected to increase interconnectedness and interrelationships among institutional investors themselves and between institutional investors and the banking system. The interconnectedness and interrelationships are influenced by the same market parameters, linked to the same companies, and may therefore increase systemic risk in the financial system.