

Chapter 4

The Main Companies in which the Five Major Banks Have a Holding

The five major banks' investments in consolidated and non-consolidated companies are extensive, in terms both of the actual size of the investments and their proportion to the banks' shareholders' equity. An in-depth analysis of these investments' contribution to a bank's income is therefore necessary. The main companies in which the banks have holdings (Table 4.1) engage in banking activity abroad (26 percent), mortgage loan activity (19 percent), commercial banking (11 percent), other financing activities (22 percent), non-financial holdings and insurance (6 percent), capital market activity (2 percent) and credit card activity (2 percent). During 2001, investments in consolidated and non-consolidated companies yielded income of NIS 1.35 billion or a return of 5.7 percent. This was below the average rate of 8 percent recorded during recent years (Table 4.1), and less than in 2000 (by NIS 471 million). Investments in local companies accounted for most of the decrease in income, while the contribution of companies abroad in which banks have a holding rose appreciably and totaled NIS 820 million¹ compared with NIS 265 million in 2000. Most of the increase in the sheqel contribution during 2001 can be attributed to the incomes deriving from exchange-rate differentials on investment in respect of the real depreciation of the sheqel against the dollar and the European currencies. The increased contribution also resulted from a slight rise in the companies' profitability and from a growth in their activity. These results highlight the importance of dispersing investments and in particular, the importance of dispersing investments between the local market and the foreign market. The contribution of banking subsidiaries abroad to

¹ The income presented above (NIS 820 million) includes subsidiaries' nominal dollar income and exchange-rate differentials on investments that were added to the income.

net income (after conversion to sheqels and accounting adjustments)² is volatile, and is largely dependent on a real depreciation or appreciation of the sheqel against the dollar and the European currencies. The nominal incomes of the companies abroad in which the banks have a holding totaled \$ 97.6 million in 2001 compared with \$ 96 million in 2000.

In 2001 as in previous years, the mortgage banks presented a favorable level of profitability (10 percent), although this was lower than the average for the past decade. The decline is apparent from the 9 percent decrease in net income that resulted from the increased credit risk involved in activity with home-buyers due to the recession in the economy.

1. INTRODUCTION

This chapter focuses on an analysis of the main investments in subsidiaries in Israel and abroad³ of the five major banks heading the groups. These investments account for 89 percent of the entire banking system's total investments in subsidiaries.

Most of the investment in subsidiaries in Israel is in commercial banks, mortgage banks, and other specialized banks. The banks also have holdings in companies that operate in areas similar or complementary to banking intermediation, such as financial leasing, credit card issuing and clearing companies, and capital market companies.⁴ The banks have additional holdings that are not connected with financial activities (henceforth, 'equity-basis investees'). These include non-financial companies, such as Koor, the Israel Corporation, Migdal Insurance Holdings, Africa Israel Investments and Clal Insurance. The banks also have holdings in companies that operate abroad, principally in local commercial banks and other financial companies.⁵

² The contribution of subsidiaries abroad to the banks' income in sheqels is comprised of net nominal income in dollar terms, translated into sheqels on the basis of the exchange rate for the end of the period in question, and from income or expenses in respect of exchange rate adjustments on investment that is presented in sheqels but that is recorded in the banks' books in foreign currency. The activity of subsidiaries' abroad contributes financing expenses or income against the hedging activity that the bank conducts with respect to its foreign currency investment.

³ The principal subsidiaries are companies that in the opinion of a bank's management have a material affect on its activity and financial results, or in which its investment accounts for at least one percent of shareholders' equity, or whose share in the bank's ordinary income exceeds 5 percent of its net income from these activities. These investments totaled NIS 23.1 billion on December 31, 2001. The banking system's total investments in subsidiaries amounted to NIS 26.2 billion on the same date.

⁴ Mutual fund management, underwriting, investment portfolio management and investment banking.

⁵ The analysis in this chapter is centered on the principal corporate holdings of the five largest banks alone. Data on the following items are taken from published financial statements and notes therein that relate to the details of the banks' principal holdings. The average coefficient of deviation and Sharp index take into account companies that were included in the banks' holdings in the past, in accordance with the size of the investment and the timing of the holding.

The (gross⁶) sheqel contribution of banking subsidiaries abroad increased greatly during 2001 due to a rise in profitability, a growth in activity and in particular, the real depreciation of the sheqel against the dollar and the European currencies in the course of the year (Figure 4.3). In 2001, this investment group was the largest in sheqel terms and in terms of the banks' shareholders' equity, and the investments in these companies increased by NIS 1.3 billion during the year. A large part of the increase derived from the sheqel revaluation of foreign currency denominated investments in respect of the depreciation, while part of the increase also derived from new investments, the most notable of which was the Hapoalim group's establishment of a new subsidiary for an investment of NIS 359 million.

The mortgage banking industry presented a high level of profitability in 2001 as in previous years, although the rate of profitability recorded was lower than the average for the past decade (Figure 4.12). This level of profitability is attributed to a growth in financing income and an increase in operational efficiency. However, the level of risk inherent in the business environment in which the mortgage banks operate has also increased, due to the continued recession in the economy and the stagnant level of activity that has been typical of the construction and real estate for several years now. In 2001, this situation was reflected by a rise in the proportion to outstanding credit of arrears in loan repayments by home-buyers and building contractors, and by an increase in current expenditure on loan losses in respect of the mortgage banks' activities.

The contribution of principal subsidiaries to the incomes of the five largest banks is presented in Section 2. A distinction is made between the subsidiaries' main areas of activity, and between consolidated companies and equity-basis investees. Section 3 analyzes the activity and profitability of the mortgage banks, which are a key profit center for their parent banking groups. Section 4 analyzes the business activity and financial results of overseas offices, including in this respect banking subsidiaries and overseas offices of local banks that operate abroad.

2. COMPANIES IN WHICH BANKS HAVE A HOLDING: GENERAL⁷

The five major banks' investments in subsidiaries totaled NIS 26 billion at the end of 2001, an increase of 10 percent compared with 2000. The net income deriving from

⁶ This income is after conversions and adjustments to sheqels, with the offset or addition of expenses for income in respect of the banks' coverage of investments against exposure to fluctuations in sheqel exchange rate differentials against the dollar and/or the principal European currencies. In 2001, the depreciation of the sheqel against the dollar and the other major currencies had the affect of offsetting this income to some extent, and is recorded and attributed in the banks' statement of income.

⁷ Accounting practice makes a distinction between consolidated companies and equity-basis investees. An equity-basis investee is defined as such because the holding ratio in it is less than the minimum required for consolidation in the financial statements, and the bank's investment in it is included in the banks' financial statements on the basis of adjusted equity.

Table 4.1
Investment in Companies in which the Five Major Banks Have a Holding, and in the Parent Bank,
and its Contribution to Net Income, 2000–2001

	Book value		Contribution to net income ^a (NIS mill.)				Return						
	(NIS mill., end year)		Year-on-year change(%)		Composition (%)		1994–2001(%)						
	2000	2001	1999	2000	2001	1999	2000	2001	Mean	S.D. ^b			
Main consolidated subsidiaries													
Commercial banks	1,719	1,812	5	128	153	120	7	10.2	11.2	7.0	9.3	1.49	6.2
Mortgage banks	4,411	5,037	14	398	446	438	19	11.5	11.9	9.9	12.6	1.98	6.4
Holdings, investments, and others ^c	5,121	5,106	-0.3	290	302	116	20	6.5	6.7	2.3	7.2	3.42	2.1
Subsidiaries and financial companies abroad	5,472	6,730	23	205	265	820	26	3.9	5.1	15.0	6.3	7.94	0.8
Capital market (underwriting and management)	604	607	0.5	17	64	-15	2	3.7	12.1	-2.5	3.5	4.57	0.8
Credit cards	474	476	0.4	-5	83	-39	2	-2.9	31.1	-8.2	15.3	14.14	1.0
Leasing	279	291	4	-11	78	10	1	2.3	1.5	3.6	8.8	8.24	1.1
Total	18,080	20,059	11	1,022	1,391	1,450	4	77	6.7	8.3	8.3	2.56	3.3
Main unconsolidated subsidiaries													
Commercial banks ^d	791	839	6	54	70	44	3	6.8	8.4	5.6	7.7	1.12	6.9
Nonfinancial and insurance companies ^e	1,733	1,636	-6	306	179	-161	6	16.8	10.0	-9.3	8.6	7.75	1.1
Holdings, investments, and others (including abroad) ^f	570	632	11	9	25	-12	2	1.6	4.2	-2.1	4.1	5.32	0.8
Total	3,094	3,107	0.4	369	274	-129	12	11.6	8.5	-4.2	7.6	4.87	1.6

Table 4.1 (continued)

	Book value		Contribution to net income ^a (NIS mill.)				Return							
	(NIS mill., end year)		Year-on-year change(%)		Composition (%)		1994–2001(%)							
	2000	2001	1999	2000	2001	1999	2000	2001	Mean	S.D. ^b				
Total main companies in which banks have a holding	21,174	26,166	9	1,391	1,665	1,321	-21	89	8.0	8	6.2	8.0	1.98	4.1
Other companies ^g	2,528	2,927	16	138	162	35	-78	11	11.6	5.9	1.4	6.7	6.51	1.0
Total companies in which banks have a holding	23,702	26,093	10	1,529	1,827	1,356	-26	100	8.0	8	5.7	7.9	1.71	4.6
Parent bank^h	11,203	11,344	1	2,227	1,998	567	-72		32.5	14.3	4.5	26.5	13.07	2.0

^a Only ordinary income is included in income, while dividends and proceeds from the sale of excess holdings are not.

^b Average yield *divided by* the standard deviation measures the risk-adjusted yield on investment.

^c 'Holdings, investments, and others' comprises merchant banks and investment finance banks.

^d Holdings of Discount Bank and First International Bank have not been deducted from total investments or from contribution to net income.

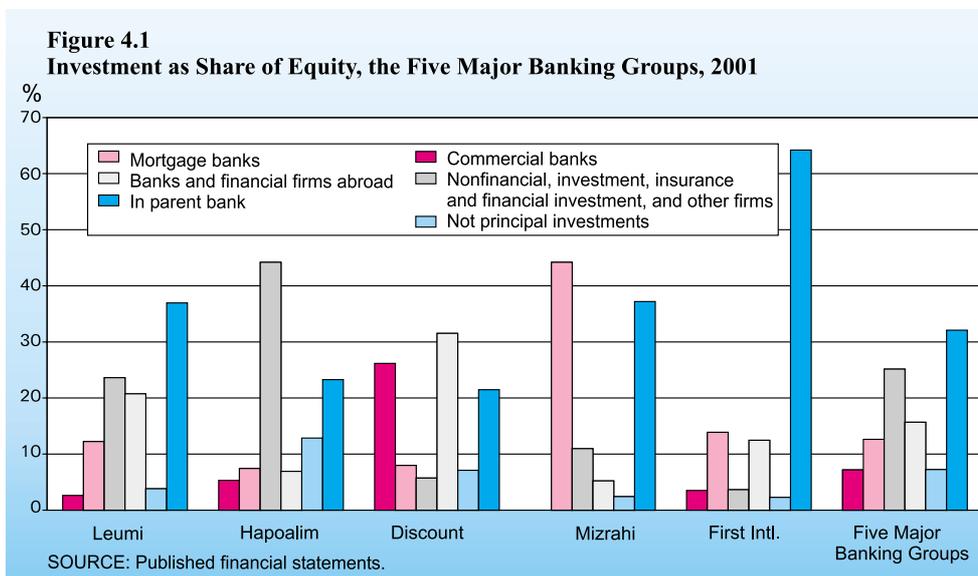
^e The yield on investments in these companies is biased downwards because the investment in nonbanking institutions does not require a minimum capital ratio, and hence all the capital invested in them may be used for profitable banking activity, which is not taken into account in the above return.

^f Holdings, investments, and others' include merchant banks and investment finance banks. It also includes the investments of United Mizrahi Bank and Bank Adanim, even though they are banks, as they have companies included on an equity basis. The net income from this investment in 2001 was NIS 6 million.

^g Subsidiaries not specified as main in note number 6 of the financial statement.

^h The investment in the parent bank is derived by deducting investment in subsidiaries, at its balance-sheet value, from total equity, and differs from the definition of equity for the purposes of calculating section 23a in the Banking (Licensing) Law. The contribution to the parent bank's net income is calculated as net ordinary after-tax income, on a bank basis. This constitutes a bank's ordinary after-tax income *less* its net share in the total income of all its subsidiaries.

SOURCE: Published financial statements.



these investments totaled NIS 1.35 billion, a decrease of 26 percent compared with 2000 (Table 4.1). The decrease in income encompassed all areas of the (local) subsidiaries' activity, and was particularly apparent among companies engaged in a non-financial activity, which recorded large losses. Non-financial companies' losses offset to a considerable extent the incomes of subsidiaries abroad.

Investments in principal subsidiaries yielded an average return of 6.2 percent, a large decrease in comparison with the average for recent years. Despite their reduced contribution to the five largest banks' total income, these investments accounted for 69 percent of income in 2001, while their proportion to the banks' shareholders' equity was only 62 percent. This was actually due to the fact that at those overseas offices where the volume of investment was relatively large, the incomes and returns on this investment surged to a record level of 15 percent. At the same time however, the incomes from regular commercial activity of the banks heading the groups fell considerably. (Table 4.2 presents the banks' direct income from commercial banking activity, which is derived from the banks' total income minus income from all companies in which they have holdings.)

The range of holdings in non-banking financial companies enables the large banks to engage in universal banking, which encompasses the majority of financial activities, and to utilize economies of scope: Alongside financial intermediation activities, the banks engage in capital market activities, brokerage, securities custodianship, portfolio management, mutual fund management, underwriting, and investment banking via subsidiaries. These investments, principally in North America and Europe, also enable the banks to diversify their sources of income in times of local crises.

As part of their advisory services for large customers, the banks offer a wide range of financial tools.⁸ In order to diversify their sources of income from non-financial activities, the banks invest in large non-financial companies, including insurance companies.⁹ However, holdings of this type are subject to investment restrictions (investment up to the rate of 25 percent of the bank's shareholders' equity and 20 percent of the equity of the purchased company).

Presented below is a brief analysis of the return on investment in the main subsidiaries, beginning with the return on investment in consolidated companies, followed by the return on investment in equity-basis investees (based on Table 4.1).

a. Main consolidated companies

The investment in consolidated companies totaled NIS 20 billion in 2001, an increase of 11 percent compared with 2000. The net income from these holdings rose by 4 percent and totaled NIS 1.45 billion—a return of 8.0 percent, slightly less than the multi-year average of 8.3 percent. Investments in banking companies in Israel, including those relating to both commercial and mortgage loan activity, which in the past yielded high average returns, produced a lower income and return in 2001. The higher ratio of average return to standard deviation¹⁰ and the Sharpe index (which adjusts the yield to that obtained from a risk-free asset, Figure 4.4) are indicative of a high rate of risk-adjusted return on equity over time. Developments in 2001 may have been an exception to the long-term trend.

In 2001 as stated, income from holdings in subsidiary and affiliated companies in all industries fell, while investments in banking subsidiaries abroad yielded very high returns. The gradual increase in overseas banking subsidiaries' sheqel income during the years 1994-2001 prompted the banks to increase their investments in these subsidiaries. Today, this investment group accounts for 26 percent of the banks' total capital. The balance of investment in this group rose from NIS 5.4 billion at the beginning of 2001 to NIS 6.7 billion at the end of the year.

Investments in mortgage banks also produced a high yield considering the recession in the real estate market, which had continued for the fifth consecutive year.

⁸ Joint consortiums with foreign banks, financial and operational leasing, underwriting consultancy and the issue of securities etc.

⁹ To date, the banks have only been able to utilize their economies of scope from these two areas by means of their holdings in insurance companies within the framework of non-financial holdings, and the permitted rates of holding in these companies are restricted. The banks would like to engage in this area of activity directly via their branches (principally by selling life insurance policies), but have not yet received a permit for such activity.

¹⁰ This ratio, which is a pure number independent of a reference point, is obtained by dividing the average standard of deviation. A high ratio implies a good investment at a low level of risk.

Table 4.2 (continued)

	First International				Total			
	NIS million		Percent		NIS million		Percent	
	Book value of investment	Contribution to net income	Yield on investment	Investment/ equity	Book value of investment	Contribution to net income	Yield on investment	Investment/ equity
In commercial banks	106	13	12.3	3.5	2,510	164	6.5	7.2
In mortgage banks	419	36	8.6	13.9	4,411	438	9.9	12.6
In nonfinancial and insurance companies, holdings, investments, and others ^c	110	0	0.0	3.6	8,781	-101	-1	25.2
In banking and financial companies abroad	376	44	11.7	12.5	5,472	820	15.0	15.7
Total in main subsidiaries and affiliates	1,011	93	9.2	33.5	21,174	1,321	6.2	60.7
Not in main investments ^g	69	1.0	-	2.3	2,528	35	1	7.2
In parent bank (solo) ^f	1,937	71	3.7	64.2	11,203	567	5.1	32.1
Balance of equity;								
total net income ^e	3,017	165	5.5	100	34,906	1,923	5.5	100

^a See footnotes to Table 4.1.

SOURCE: Published financial statements.

Another investment group in the banks' holdings is investments in financial companies. These are dispersed between companies operating in the capital market, credit card companies, mutual fund management companies, and provident fund management companies. Investments in these companies yielded low returns in 2001, in a deviation from the long-term trend. This development partly resulted from the weak state of the capital market,¹¹ changes that occurred during the year in the public's preferences for the different forms of investment in the market, and the banks' increased competition with other stock exchange members.¹² These two phenomena have had the effect of reducing the income of companies operating in the capital market. The fall in income resulted partly from the continued impact of the recession in the high-tech industries, which has led to a decrease in the usage of leasing companies services (mainly vehicle leasing companies) and partly from the establishment of a new credit card company that has not yet presented a income. It should be noted however, that some of these companies provide an indirect contribution to the banks' income, via the commissions that they charge on their activities in the capital market, commissions on credit card activity, and income from credit granted for financing credit-card purchases.¹³

b. Main equity-basis investees

Investments in equity-basis investees, which are principally investments in non-financial companies, totaled NIS 3.1 billion in 2001, similar to the level in the previous year. For the first time in a long period, the banks recorded heavy losses on their investments in equity-basis investees in 2001. These losses totaled NIS 129 million compared with a income of NIS 274 million in 2000. The sharp change from income to a loss is mainly attributed to the crisis in the high-tech industries, which began in the last quarter of 2000 and continued for all of 2001. This crisis reduced by NIS 289 million the income of Bank Hapoalim, which holds 22 percent of the equity of Koor.¹⁴ The other non-financial companies (except for the insurance companies) recorded a fall in income due to the

¹¹ A weak situation in the capital market adversely affects commission income from trading in securities on behalf of customers, underwriting commissions, securities distribution fees and at certain companies, net income as well, due to losses from direct investment in tradable securities

¹² The change in the public's preferences was reflected by a shift in demand from equity investment to the fixed-income market. Concurrently, a trend noted during recent years became increasingly apparent, namely a gradual shift to trading in the capital market via stock exchange members who do not belong to the large banking groups. Similar trends were observed in the primary equity market, where the volume of issues has decreased and the proportion of underwriters not belonging to the banking groups has increased.

¹³ As an example, Bank Leumi recorded interest of NIS 76 million from this activity.

¹⁴ Although under the Banking (Licensing) Law, investment in non-financial companies is restricted to a maximum rate of 20 percent, the Bank Hapoalim group holds 22 percent of Koor's equity due to the amortization of that company's capital. Bank Hapoalim's investment in Koor totaled NIS 420 million at the end of 2001 compared with NIS 912 million at the end of 2000.

recession in the economy.¹⁵ Despite the fall in the non-financial companies' incomes and the low, negative return from them (9.3 percent), from the long-term aspect these investments still constituted stable sources of income that yielded high rates of return (Figure 4.2). The Sharp index, which weights return per unit of risk, shows a change in investment dispersal policy in non-financial activity between the two largest banks (Figure 4.4): Bank Leumi invests in non-financial companies in two main areas—via a wholly owned subsidiary (Leumi Real Holdings), and directly. These (direct and indirect) investments are distributed among a range of activities: insurance, real estate, energy,

Figure 4.2
Average Yield vis-à-vis Standard Deviation in Main Companies Held by Banks, 1994–2001

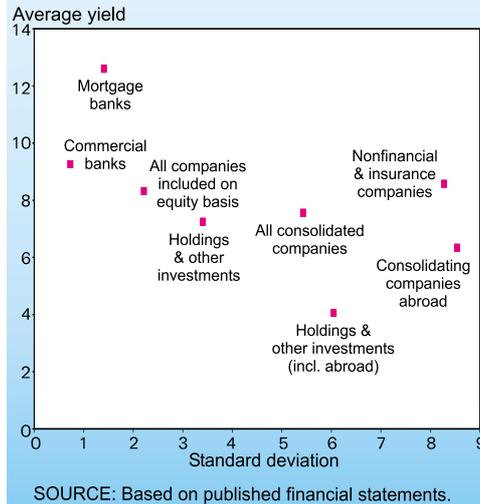
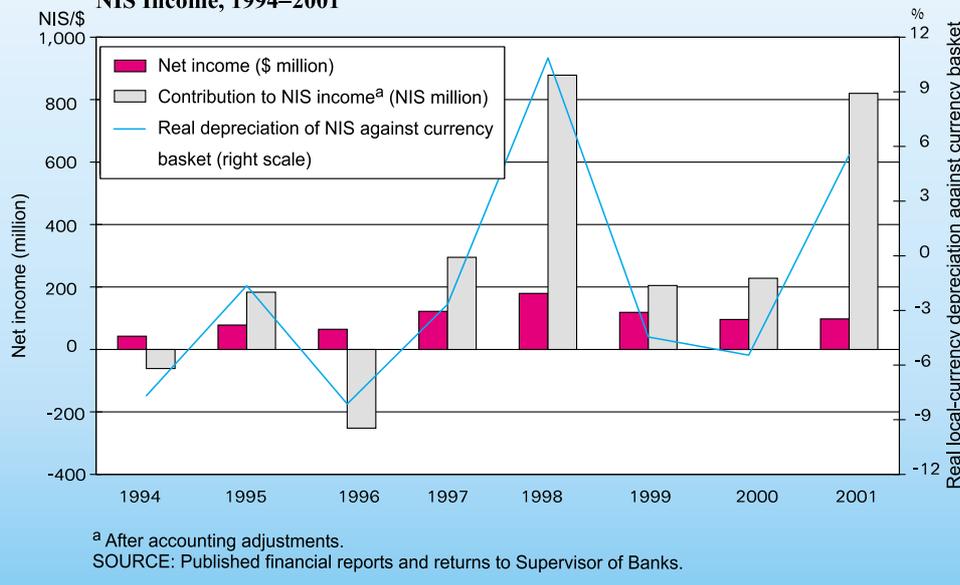


Figure 4.3
Net Dollar Income of Overseas Subsidiaries, and their Contribution to Groups' NIS Income, 1994–2001



¹⁵ The fall in profitability during 2001 encompassed most of the companies that are traded on the Tel Aviv Stock Exchange.

telecommunications, sports stores and the Keshet TV broadcasting company. Bank Hapoalim invests directly in only two companies—Koor and Clal Insurance Holdings. An examination of return-versus-risks shows that investments in these non-financial companies are notable not only for higher average rates of return, but also for relatively high variability (Figure 4.2). However, Bank Hapoalim incurred a loss of NIS 289 million in 2001 on its principal investment (in Koor).

3. MORTGAGE BANKS

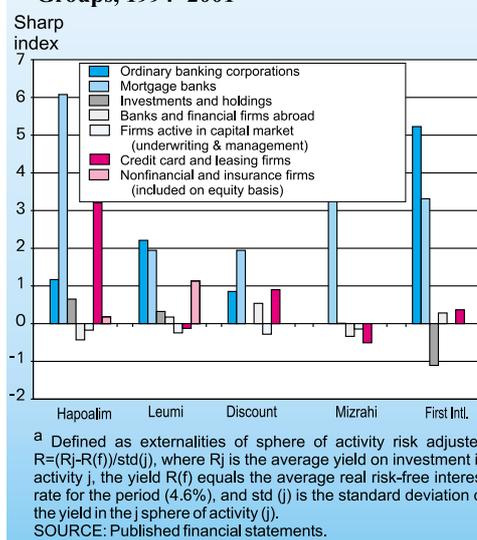
a. Activity of the mortgage banks¹⁶

(i) Uses

Total performance: The extent of activity (new credit extended) during the year under review, financial results and the risk exposure of the mortgage banks were affected by the situation in the economy as a whole and by the level of activity in the construction industry and the real estate market in particular. The slowdown in the construction industry activity intensified during 2001 (Figure 4.5 and Table 4.5), a development that was reflected by home-buyers' demand for credit, principally for credit at the banks' responsibility. New credit granted in the course of the year rose by the minor rate of 0.7 percent compared with 2000, and totaled NIS 23 billion—a stability that encompassed most types of current activity (Table 4.5). The level of activity during the year under review was considerably lower than during the peak years of 1994 to 1996. But in the course of the year, mainly in the second half, a moderate growth in directed credit was recorded due to point government encouragement for those with Housing Ministry eligibility. Despite this development however, the long-term trend of a decrease in the proportion of directed credit to the mortgage banks' outstanding (balance-sheet and off-balance-sheet) credit did not change. The distribution of year-end balances shows a slight one percentage point decrease in the proportion of directed credit (which yields commission income only, and is risk-free) to 28.5 percent, concurrent with an increase at a similar rate in the proportion of credit at the banks' responsibility to 59.4 percent. The

¹⁶ The analysis covers of the activity and profitability of the seven mortgage banks and Bank Jerusalem which is a commercial bank but most of whose activity is centered in the mortgage industry. The analysis excluded Bank Carmel, which was included in the Union Bank's financial statements with effect from the fourth quarter of 2001. The Union Bank's outstanding housing loans totaled NIS 1,983 million at the end of 2001 compared with NIS 983 million at the end of 2000. The Union Bank's net income from housing loan activity totaled NIS 8 million.

Figure 4.4
Sharpe Index^a in the Five Major Banking Groups, 1994–2001



proportions of outstanding credit to contractors and credit for other purposes (mortgage against real estate assets) remained stable at 2.5 percent and 9.7 percent respectively. As for the distribution of uses of new credit (the extension of new loans) for non-housing purposes—credit to contractors grew by 6.7 percent (NIS 1.5 billion)—a high rate that is partly attributed to the reduced ability to raise capital on the stock exchange.¹⁷ The recession in the industry (the slowdown in apartment sales is presented in Table 4.3) is making it difficult for construction companies to raise capital in the primary capital market, with the result that these companies are relying increasingly on bank finance. The mortgage banks for their part are interested in supplying credit to contractors in order to diversify uses from the aspect of timing and indexation bases.¹⁸ Project finance provides the mortgage banks with direct access to apartment buyers for the purpose of granting additional mortgage loans. (Box 4.1 discusses this profit center.)

The increase in housing prices (Figure 4.6) led to a 2 percent increase in the average loan size (in current loan extensions) to NIS 233 thousand.¹⁹ This appears to have resulted from the government's point encouragement ('location assistance'), which increased the directed credit component of the loans.

¹⁷ Issues by the construction industry on the Tel Aviv Stock Exchange averaged NIS 600 million a year during recent years, compared with NIS 60 million (only four issues) in 2002.

¹⁸ Most of the credit granted to contractors is short-term. In 2001, the average terms of CPI-indexed credit was extended to six years compared with three years in 2001. This change was a direct result of the recession in the industry.

¹⁹ The average size of loan to borrowers purchasing an apartment without government financial assistance was NIS 258 thousand.

Figure 4.5
The Construction Industry

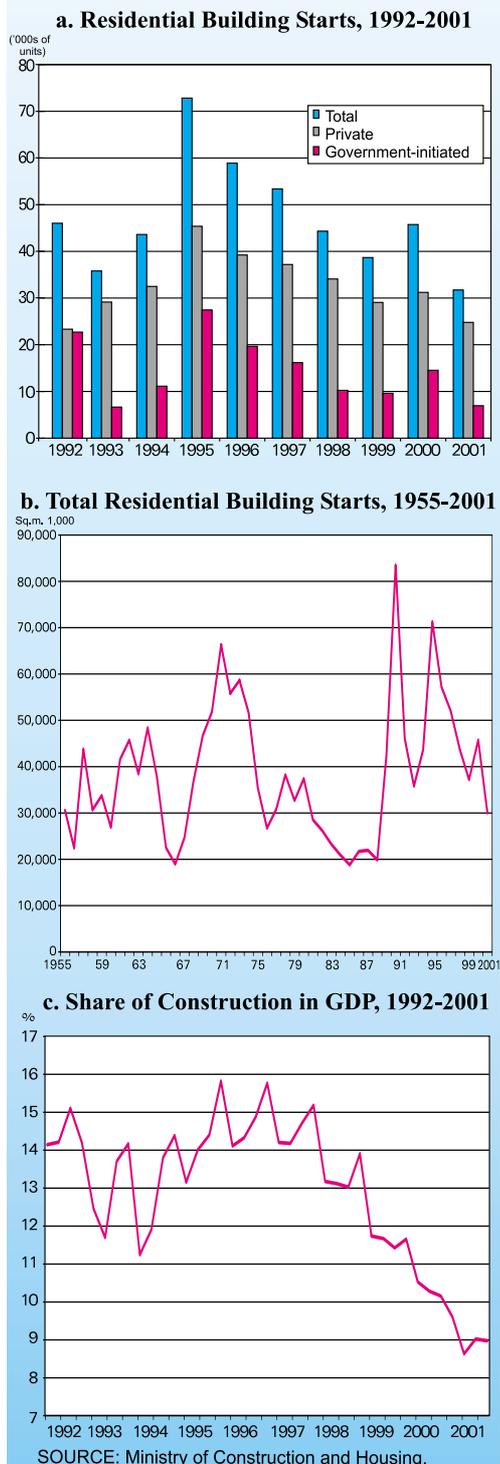


Table 4.3
Characteristics of the Construction Industry, 1997–2001

	1997	1998	1999	2000	2001	Real change (%) 2001
Total area under construction (<i>mill. sq. m.</i>)	19.4	17.6	16.7	17.1	16.4	-3.8
<i>of which</i> Residential	13.0	12.1	11.6	12.2	11.5	-5.5
Housing units under construction	93,667	84,664	77,236	79,801	74,689	-6.4
<i>of which</i> Government-initiated	34,050	27,101	19,999	24,114	22,881	-5.1
Building starts: housing units	53,495	44,620	38,950	46,188	31,736	-31.3
Total completions	67,960	53,847	46,293	43,298	36,580	-15.5
<i>of which</i> Government-initiated	22,580	17,649	16,732	10,353	8,030	-22.4
Sales of new units	n.a.	14,537	14,302	14,132	15,097	6.8
Sale of land for construction ^a	41,370	31,390	33,544	24,537	16,649	-32.1
Total cement sales (<i>mill. tons</i>)	5,519	5,087	4,841	4,502	4,382	-2.7
Construction investment/GDP (%)	13.1	13.4	11.7	10.3	9.3	-9.7
Construction employment/ total employment (%)	11.3	10.8	10.0	9.3	8.0	-14.0
Change in adjusted housing index ^b (%)	0.2	-0.7	-3.2	-2.9	5.6	
No. of real-estate transactions	96,643	88,674	101,452	95,676	95,862	0.2
Transactions by eligible persons/total transactions (%)	47	47	40	40	38	-5.0
Housing loans taken						
Total by eligible persons	45,578	41,062	40,241	38,518	36,521	-5.2
<i>of which</i> New immigrants	14,802	9,987	9,772	9,004	8,124	-9.8
Young couples	25,455	26,101	23,619	21,937	21,545	-1.8
Total no. of new immigrants	66,221	56,726	76,766	60,192	43,471	-27.8

^a In terms of housing units. The data refer to land for construction sold by the Ministry of Construction and Housing, and the Israel Lands Administration, at public auctions and in other frameworks authorized by the Israel Lands Administration.

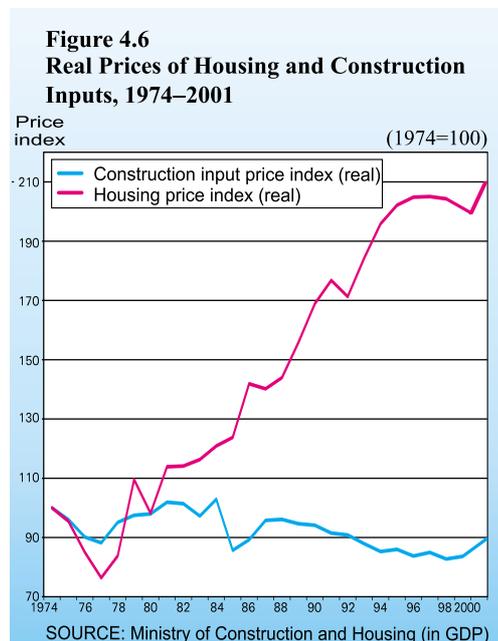
^b Change in housing price index deflated by CPI. As of January 1999 the price index of owner-occupied housing is calculated by a new method, the owner-occupied housing services index, based on the opportunity cost of rent.

SOURCE: Ministry of Construction and Housing, *Monthly Information*, March 2001.

Paralleling developments in the entire unindexed segment during the last two years, the proportion of unindexed credit to home-buyers rose for the third consecutive year in 2001.²⁰ However, the proportion of this credit is still relatively low and at the end of December, cumulative current extensions for 2001 accounted for 15 percent of total

²⁰ The banks currently offer two main unindexed sheqel credit tracks: (1) 'Balloon' loans for short periods at interest indexed to the prime rate, with the option of moving to any other track and without an early repayment commission; (2) Mortgages indexed to the prime rate for long periods. The mortgage banks also provide adjusted rate loans at the Libor interest rate.

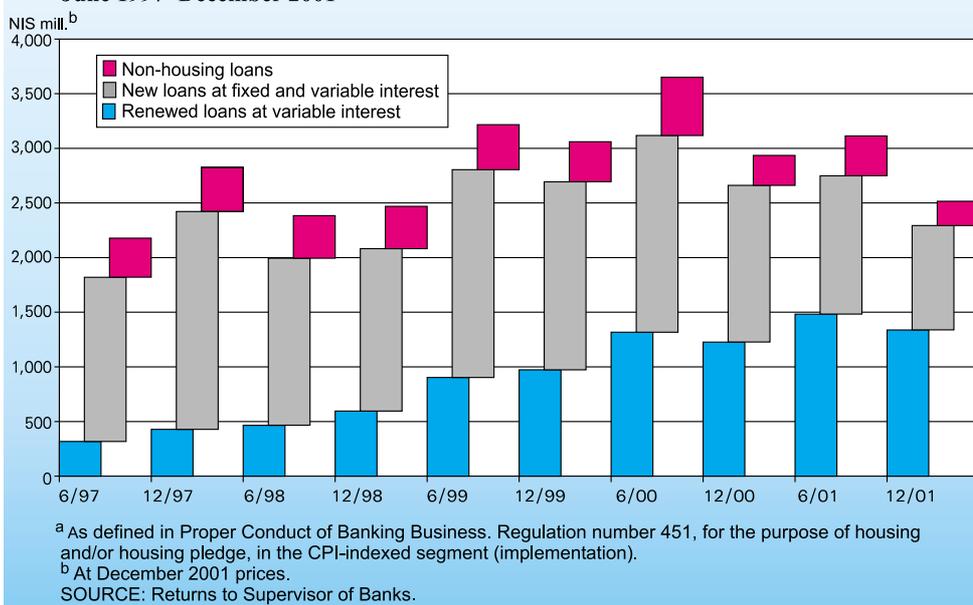
mortgage loans,²¹ compared with 5.7 percent and 2.8 percent in 1999 and 2000 respectively. The growth in activity was also apparent from the rapid increase in the balance of unindexed credit (Table 4.7). Unindexed activity began at a few banks, which intend to extend this credit mainly to affluent customers who wish to diversify their credit portfolio. Since the second half of 2000, all of the mortgage banks have been marketing unindexed loans. Part of the growing demand for loans derives from the slump in the housing market (Table 4.3), which is generating a need for bridging loans that are mostly for the short term of two to five years. The mortgage banks are also offering unindexed credit for the long term, and the opportunity to move between indexation tracks in a highly flexible manner. The advantages for customers with these loans under the tracks that are currently offered as compared to the indexed track lie in the non-indexation of the undischarged balance and the absence of an early repayment commission. However, the monthly payment is likely to be higher. (Interest rates range from the level of prime minus 0.5 percent to prime plus 1.5 percent.) A number of banks offer prime-indexed mortgages for the long term. The development of this sector of activity could partly solve the problem caused by the shortage of sources in the CPI-indexed segment.²² The attempts to market unindexed credit at fixed-rate interest during 2001 have proved unsuccessful so far, possibly due to the expectations of a decline in interest rates that prevailed for most of the year. One of the banks in the system raised fixed-rate long-term bonds in a special issue to the public, and concurrently offered fixed-rate unindexed credit. However, problems were encountered in the marketing of these loans. But this process, the decline in the sheqel interest rate during the last two years, government borrowing policy (which has been based solely on the issue of longer-term unindexed bonds), and successful issues of unindexed corporate bonds paved the way for the development of (adjusted-rate) unindexed sheqel credit. As in the case of the CPI-indexed market, a well-entrenched secondary unindexed bond market makes it possible to raise and price long-term unindexed sources (as in the CPI-indexed market).



²¹ The data relating to unindexed credit that are presented below are upward biased, because not all of the mortgage banks report to the Bank of Israel on this activity. Directive 877 stipulates that unindexed activity only needs to be reported if it is material. Currently however, this regulation is being amended in order to make the reporting requirement applicable to all mortgage activity, whether material or not.

²² While most of the mortgage banks are permitted to raise sheqel deposits from the public, only three of them actually do so.

Figure 4.7
Housing Credit^a Extended by Mortgage Banks, and Total Nondirected Loans,
June 1997–December 2001



In contrast to the trend of the past few years, when the proportion of adjusted rate loans to total new loans increased consistently, in 2001 the proportion of these loans fell to only 12.5 percent (Table 4.4), due to a large drop in demand for them. One of the reasons for the fall in demand is the development of a public controversy and a number of class actions that were filed concerning interest rate adjustments during the lifetime of a loan.²³ Apart from that, during periods when a reduction in short-term interest rates is expected (as in the year under review), consumers prefer to take adjusted rate unindexed sheqel credit, which provides greater flexibility,²⁴ instead of adjusted rate CPI-indexed credit.

Another reason for the drop in demand for adjusted rate loans is changes in the interest rates on fixed-rate loans, principally for the long term: While in the past adjusted rate loans were marketed at prices similar to those of fixed-rate loans, since the first quarter of 1998, when an upturn in the interest rate became clearly apparent, adjusted rate loans have been marketed more easily and at a premium that was no higher than fixed interest rates (Figure 4.7). Since 2000, the price of these loans has risen relative to fixed-rate loans, by 0.4 percent

²³ In August 2001, the Supervisor of Banks issued amendments that applied the principle of determining the interest rate on renewal in accordance with an objective and external base (the principle that had previously already been applied to new loans) to old adjusted rate loans. Currently however, due to regulatory procedures, there is a risk that a person taking loans of this type will suffer in the future as a result of an interest rate adjustment that does not conform to changes in the housing loan market. But some members of the public may avoid taking this type of credit, due to their failure to understand the updated mechanism.

²⁴ Unindexed credit provides the option of moving to any other track (including final repayment) at any time without having to pay a fine.

Table 4.4
Principal Data on the Mortgage Banks, 1996–2001

	1996	1997	1998	1999	2000	2001
Nondirected mortgage credit extended						
during year ^a (<i>NIS million</i>)	17,198	17,446	15,439	16,625	15,897	15,690
<i>of which</i> At variable interest (%)	38.8	37.5	41.2	43.5	29.4	12.5
Renewed credit at variable interest		3,517	5,467	9,436	13,666	15,401
Average loan size incl. directed credit (<i>NIS '000s</i>)	196	203	209	221	228	233
Average loan size (nondirected credit)		190,410	222,789	251,849	253,779	258,837
Average period of nondirected housing credit	10.5	10.7	10.6	10.4	12.5	15.4
Average interest on nondirected housing credit (%)	5.45	5.04	5.97	6.33	6.51	5.81
No. of housing loans	113,583	104,250	88,788	90,850	84,150	82,767
Value added per employee post ^b (<i>NIS '000s</i>)	675	730	639	679	774	742
<i>Percent</i>						
Return on equity (ROE) ^c	13.5	13.4	9.4	11.2	11.6	10
Efficiency ratio ^d	2.41	2.45	2.35	2.45	2.57	2.63
Operating expenses/assets ^e	1.03	0.97	0.90	0.86	0.79	0.75
Marginal interest-rate spread ^f	0.67	0.57	0.45	0.25	0.03	0.28
Margin on active assets	1.12	1.16	0.98	1.01	1.00	1.03
Duration gap ^g	1.5	1.5	1.3	1.2	1.3	1.6
Specific loan-loss provision/total outstanding credit (%)	0.15	0.19	0.25	0.24	0.20	0.14
Total accrued home-buyers' arrears (<i>NIS mill.</i>)						
<i>of which</i> Above 180 days	681	497	564	667	754	819
Total arrears/total outstanding credit ^h (%)	1.46	1.32	1.42	1.58	1.61	1.77
<i>of which</i> Home-buyers	0.77	0.80	0.83	0.88	0.90	0.93
Contractors and construction companies	6.13	6.95	11.04	17.20	15.93	18.52
Others	3.71	2.25	2.11	2.17	2.31	2.56
Total arrears/end-period capital ⁱ (%)	23.7	22.2	24.9	28.4	29.0	31.4
Weighted equity	3,413	3,980	4,482	4,685	5,043	5,319
Risk-based capital ratio	12.0	12.0	10.6	10.6	10.1	10.1
Tier 2 capital/Tier 1 capital (<i>max. 50%</i>)	32.7	35.6	40.1	42.2	37.6	38.0

^a Not including renewed credit.

^b Value added per employee post is calculated from ordinary before-tax income *plus* salaries and related expenses, as well as expenses due to amortization and deductions *divided by* the average number of posts.

^c Ratio of net income to capital at the beginning of the year, *plus* offerings weighted by date of issue.

^d Ratio of total non-interest income *plus* net interest income before loan-loss provision to operating expenses.

^e Ratio of total operating expenses to total assets.

^f The difference between nondirected indexed credit for housing and deposits of the public at banks received during the year.

^g The weighted gap between the duration of assets and the duration of liabilities in terms of years (Dgap).

^h Arrears accrued for more than 3 months (including loan-loss provision) *divided by* the end-year credit balance.

ⁱ Excluding arrears on direct credit.

SOURCE: Returns to Supervisor of Banks.

compared with an average of 0.1 percent during the years 1997 to 1999. For new customers, it therefore became less advantageous to take adjusted rate loans.

The number of new housing loan transactions fell by 1.6 percent in 2001, continuing a trend that began back in 1995, although the downturn during 2001 became more moderate²⁵ and the opposite trend was recorded with directed loans. The deviation from the downtrend in credit and the number of directed credit extensions during 2001 resulted from point government encouragement in a number of localities, which led to a 3 percent increase in the number of loan extensions. It is reasonable to assume that directed loan activity will decrease again following the end of this special government encouragement campaign.

Housing loan repayments increased considerably during 2001, by 10 percent, and totaled NIS 20.1 billion. The proportion to total repayments of early payments rose to 24 percent. The ratio of early repayments to the total balance of the credit portfolio stabilized in the region of 3.7 percent, which was greater than the multi-year average of 3 percent. The 22 percent increase in early repayments was largely centered in the second half of the year, concurrent with the decline in interest rates and the inversion of their timing structure (as described below in the section 'interest rates'). The large drop in yields on short-term sheqel investments²⁶ prompted households to make early repayments (Table 2.6).

Outstanding credit at the mortgage banks totaled NIS 105 billion in 2001, an increase of 8.5 percent compared with 2000. Credit to home-buyers rose by a similar rate, and totaled NIS 87.6 billion. Outstanding credit to contractors and building companies, which includes off-balance sheet credit, increased considerably, mainly due to the need for continuing interim finance²⁷ and difficulties in raising capital in the stock market.

Unlike the situation in the past, the mortgage banks are currently well within the credit risk exposure restriction defined for the industry.²⁸ The banks tend to extend contractors and building companies credit for projects that are regarded as low-risk. Projects are financed in a manner that provides extensive information on the contractor or building company, and that can reduce credit risks in the future. This balance-sheet credit rose by 6.5 percent to NIS 3.7 billion in 2001. Most of the credit was short-term, in the unindexed (60 percent) and CPI-indexed (29 percent) segments, and a very small

²⁵ The year 1999 was an exception due to transactions that were brought forward because of tax considerations.

²⁶ While government bond yields fell among all terms-to-maturity, the decrease was particularly apparent among short terms and amounted to 3 percentage points, to a level of 5 percent. Moreover, it should be remembered that the individual's considerations with respect to early repayment (even in cases where the customer is exempt from an early repayment commission) do not necessarily conform to the interest rate structure of the banks' sources and uses. An estimation of this flow on the basis of the timing structure alone is too simplistic; it is reasonable to assume that borrowers have additional considerations.

²⁷ The low pace of sales and the extension of the average construction time per apartment are increasing the financing requirements of contractors and building companies even during periods of recession in the industry.

²⁸ Credit risk in the construction industry plus off-balance sheet liabilities at the mortgage banks totaled NIS 10 billion at the end of the year. The construction industry's indebtedness at the single bank level ranged from 0.2 percent to 15.6 percent.

**Table 4.5
Loans Extended and Sources Raised by the Mortgage Banks, 1998–2001**

	Loans extended (NIS million) ^a			Real year-on- year change (%)		Distribution (%)			
	1998	1999	2000	2001	2000	2001	1999	2000	2001
Loans extended									
Total credit extended during the year	21,857	23,766	23,010	23,164	-3.2	0.7	100	100	100
<i>of which</i> To home-buyers	18,579	20,144	19,170	19,257	-4.7	0.5	85	83	83
Directed	4,778	5,306	4,717	5,089	-11.1	7.9	22	20	22
Nondirected	13,801	14,808	14,453	14,168	-2.4	-2.0	62	63	61
To contractors and construction companies	908	868	1,401	1,495	61.4	6.7	4	6	6
Other	2,370	2,785	2,438	2,411	-12.5	-1.1	12	11	10
Sources raised									
Total indexed sources raised ^b	16,907	20,868	19,978	23,591	-4.3	18.1	100	100	100
<i>of which</i> Deposits of the public	8,258	8,471	6,606	8,098	-22.0	22.6	41	33	34
Deposits from banks	8,649	12,379	13,371	15,493	8.0	15.9	59	67	66
Difference between non- directed credit and deposits	172	-2,407	-1,685	-5,517	-30	227			

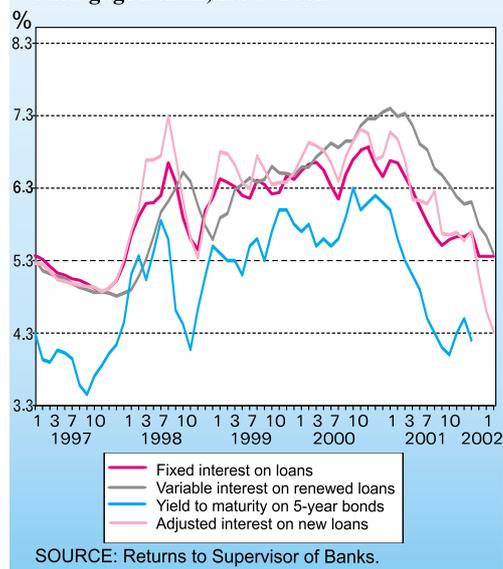
^a Including directed credit.

^b Sources raised during the year include savings schemes, but not deposits at the government's responsibility.

SOURCE: Returns to Supervisor of Banks.

part of it (11 percent) was in the foreign currency denominated segment. The balance of 'other' credit that the mortgage banks extend accounted for 13 percent of total credit to the public in 2001, and totaled NIS 17.5 billion at the end of the year (an increase of 3.5 percent; Figure 4.8). This credit is mainly channeled into loans against the mortgage of housing, and most of it is used to finance consumer uses and the purchase of business real estate (by private customers in the free professions). The banks prefer to grant this credit to established customers whose loan balance relative to the property value is low, and thereby increase the financial leverage of borrowers who are known to the bank. Historical information on the customer also enables the bank to price credit risk more accurately, and thereby offer different interest rates on loans for identical periods.²⁹ During 2001, the banks granted housing loans of this type mainly in the unindexed and foreign currency denominated segments.

Figure 4.8
Interest on New and Renewed Credit in Mortgage Banks, 1997–2001



(ii) Sources

On the sources side, the trend of recent years continued: an increase in the proportion of deposits from banks, principally from related banks, concurrent with a decrease in deposits from the public. Although the amount of deposits raised from the public increased during 2001, and their proportion accounted for 34 percent of total deposits raised (Table 4.3), this ratio was considerably lower than the 45 percent multi-year average for recent years. The reduced proportion of deposits from the public to total deposits during recent years is attributed to the drop in the demand for CPI-indexed holdings and the preference for unindexed forms of investment.³⁰ The average term-to-maturity of deposits from the public decreased in 2001 as well, and averaged only 6.5 years. Saving schemes as a new source accounted for only 12.2 percent of total deposits at the end of 2001, and short-term deposits from institutions accounted for 22 percent. A similar trend (the fall in demand for indexed assets) was recorded at commercial corporations as well. In the

²⁹ The information existing in the customer's portfolio makes it possible to reduce credit risks due to the opportunity for more accurate pricing.

³⁰ The sources deriving from institutional investors may decrease even more in the future. This is because under new Finance Ministry regulations (that have not yet been approved by the Knesset), all the restrictions applying to investment in the capital market will be removed.

course of the year, a negative net accrual of NIS 7.7 billion was recorded in CPI-indexed saving schemes in the entire system, similar to the net accrual in 2000.³¹ Although institutional investors' indexed deposits at the mortgage banks increased in 2001, the term-to-maturity on these deposits decreased. This development had the effect of increasing the proportion of deposits from the banks to the mortgage banks' total liabilities from 35 percent in 1997, to 41 percent in 1999 and 46 percent in 2001 (Table 4.6). Since the fall in yields in the capital market affected the prices of the mortgage banks' sources, the cost of these sources fell by an average of 1 percent more than the fall in yields on bonds for parallel periods.

Table 4.6
Assets and Liabilities of the Mortgage Banks, 1999–2001

	End-year balances (NIS million)			Real year- on-year change (%)		Distribution of balances (%)		
	1999	2000	2001	2000	2001	1999	2000	2001
Cash and deposits in banks	424	592	1,509	39.6	154.9	0.4	0.6	1.4
Loans to government	210	5	4	-97.6	-20.0	0.2	0.0	0.0
Nondirected credit to the public	75,815	83,624	87,655	10.3	4.8	80.4	81.9	81.5
Loans to construction firms and contractors	2,891	3,454	3,679	19.5	6.5	3.1	3.4	3.4
Other loans and assets	14,792	14,466	14,641	-2.2	1.2	15.7	14.2	13.6
Total assets	94,311	102,140	107,488	8.3	5.2	100	100	100
Deposits of the public	45,594	46,435	46,684	1.8	0.5	48.3	45.5	43.4
Deposits from banks	38,159	44,082	49,061	15.5	11.3	40.5	43.2	45.6
Government deposits	839	1,862	1,535	122.0	-17.6	0.9	1.8	1.4
Other liabilities	4,655	4,294	4,340	-7.8	1.1	4.9	4.2	4.0
Total liabilities	89,246	96,673	101,620	8.3	5.1	94.6	94.6	94.5
Equity	5,065	5,466	5,868	7.9	7.4	5.4	5.4	5.5
Total liabilities and equity	94,311	102,140	107,488	8.3	5.2	100	100	100
Balance of directed credit	41,697	42,316	42,020	1.5	-0.7	44.2	41.4	39.1

SOURCE: Returns to Supervisor of Banks.

Interest rates

Following several years when the slope of the yield curve had been negative, the slope changed in 2001 and became positive. The Bank of Israel's interest rate reductions and the large decline in inflation expectations led to a sharp drop in short and medium-term interest rates. At the same time, the growth in government borrowing and uncertainty over future fiscal policy had the effect of increasing long-term yields. Yields on short-

³¹ To date, 2002 has been notable for the opposite trend, due to the sharp drop in provident fund yields and possibly also the fears of an upsurge in inflation. At the time this review was being written, it was still too early to assess whether the trend would prevail during the year as a whole.

term unindexed bonds fell by an average of three percentage points, compared with a 1.5 percentage point decrease with long-term unindexed bonds. In the CPI-indexed segments, the difference between short and long terms averaged two percentage points (Figure 4.10). These developments had a major impact on the mortgage banks' activity during 2001. In the unindexed segment, interest rates fell heavily, increasing the demand for unindexed loans, which to some extent served as a substitute for adjusted rate indexed loans. In addition, the change in the slope of the yield curve led to the postponement of repayments of credit that had been taken in the past at adjusted rate interest, due to the expectation of a further decline in the level of interest rates. However, the continued preference for holding short-term unindexed assets led to a sharp drop in the supply of sources for

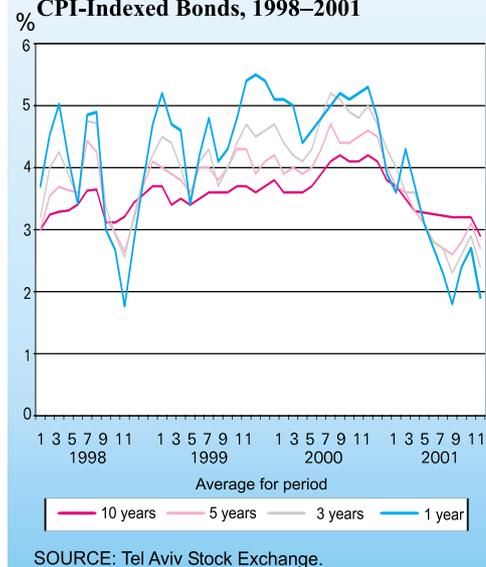
long terms (for the mortgage banks). Unlike short-term loans, the cost of long-term loans was therefore not reduced. But despite this, during 2001 the public preferred fixed-rate loans for the medium and long term (at the expense of long-term adjusted rate credit as well). The cost of these loans was reduced by an average of half a percentage point to 5.8 percent. Another phenomenon related to developments in the interest rate structure is the large increase in the proportion of early repayments.³² This phenomenon became increasingly apparent during the second half of the year, and may have been speeded up by the interest rate cut towards the end of the year. This is because the opportunity cost for households that had mortgages and cash surpluses, increased greatly.

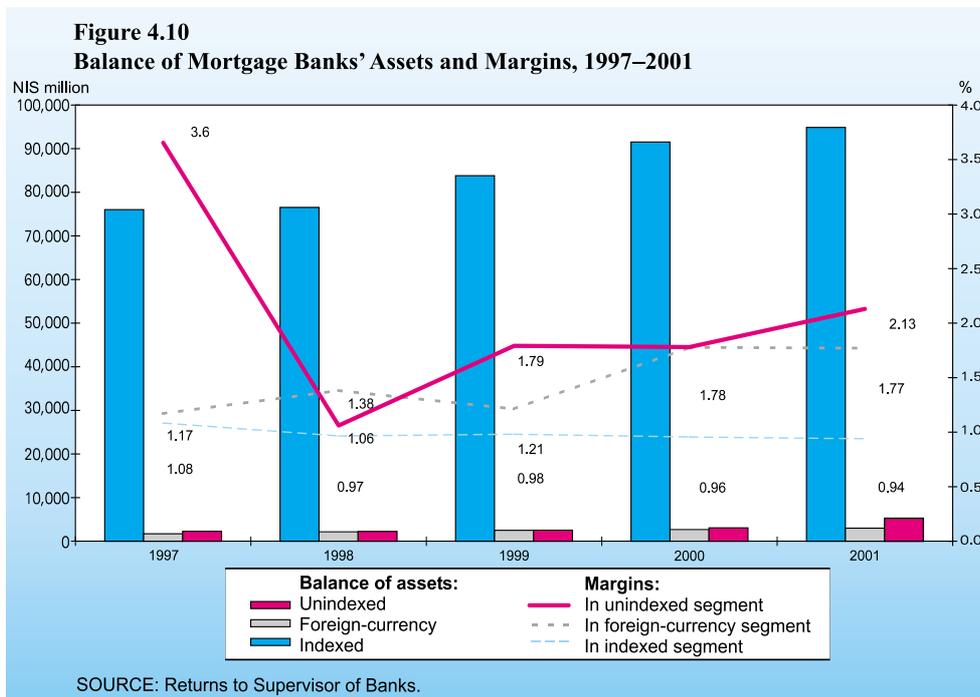
The average price of the mortgage banks' total sources amounted to 5.53 percent in 2001, compared with 6 percent, 6.48 percent and 5 percent in the years 2000 to 1998 respectively. (Prices of uses also fell, but less than prices of sources, with the result that the average price of credit at a bank's risk fell from 6.4 percent in 2000 to 5.95 percent in 2001.)

Interest spreads on mortgage loan activity increased during 2001 as a result of the

³² The average proportion of early repayments to total credit during recent years was in the region of 3 percent. An average of NIS 320 million a month was repaid during the first half of 2001, compared with NIS 540 million in the second half—a level representing an average of 5 percent of the year-end balance of credit. Data for the first quarter of 2002 indicate that this phenomenon is growing, and the monthly average rose to NIS 800 million. Part of the growth resulted from early repayments of adjusted rate credit, and its replacement by fixed-rate CPI-indexed credit. This can be related to as a 'recording' operation. At the same time, part of the repayments can be related to as repayment for 'recording' purposes alone.

Figure 4.9
Real Yield to Maturity on Fixed-Interest
CPI-Indexed Bonds, 1998–2001





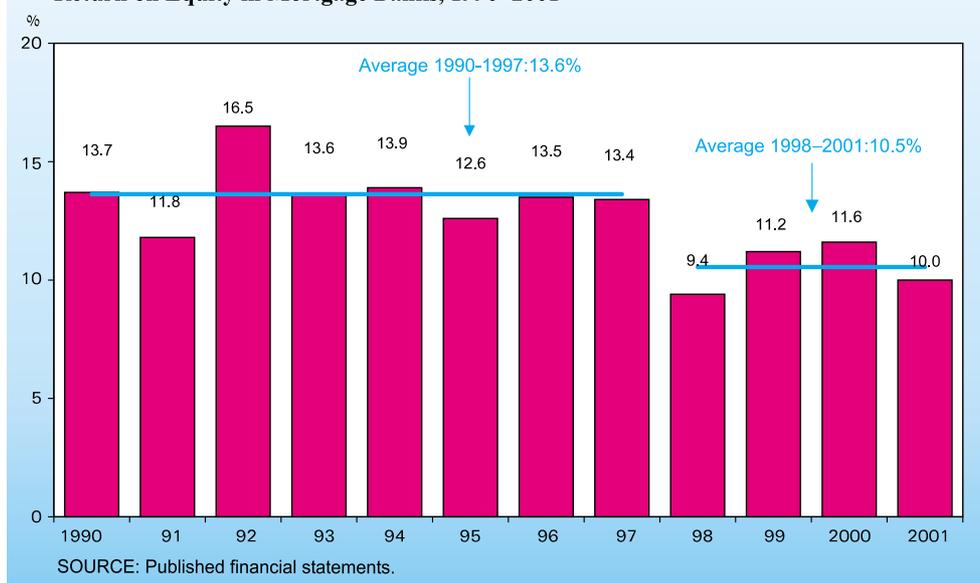
decline in interest rates in all segments (Table 4.9 and Figure 4.11). In the CPI-indexed segment, this development resulted from the considerable decrease in interest rates that led to a rise in the size of loan applications among all terms, although the mortgage banks' interest rates are adjusted with a lag. The number of new fixed-rate CPI-indexed loans rose by 9% during 2001. Part of the increase reflects a move from adjusted rate to fixed-rate loans in the unindexed segment, where interest rates are adjusted without a lag. The growth in interest spread reflects the large increase in the size of applications for these loans.

The interest spread on new fixed-rate CPI-indexed housing loans (which account for 72 percent of current activity) grew to 0.39 percent in 2001. The interest spread in adjusted rate interest activity which had decreased and accounted for only 12.5 percent of new loans, grew considerably and amounted to half a percent while the gap on renewed loans rose more moderately. The growth in interest spread may reflect the increased credit risk of mortgages during the past two years.

b. The mortgage banks' financial results

The mortgage banks' net income fell by 9 percent in 2001 and totaled NIS 533 million. The decrease reflects the large rise in loan-loss provisions that resulted from the growth in arrears among all types of loans, a moderate increase in net interest income, and stability in other income and loss items (Table 4.9). This net income was the equivalent of a return on equity of 10 percent, a decrease of 1.6 percentage points compared with

Figure 4.11
Return on Equity in Mortgage Banks, 1990–2001



2000 (Figure 4.11).

Net interest income before loan-loss provision grew by 5.4 percent (NIS 63 million) due to a combination of two factors: an increase in the average balances of credit in all segments and a growth in interest spreads—and totaled NIS 1.2 billion. In the CPI-indexed segment, a growth in activity contributed to an incremental income of NIS 32 million despite a slight decrease in (average) margins from 0.96 percent to 0.94 percent. The expansion of unindexed activity, which was accompanied by a growth in margins, contributed to an incremental income of NIS 39 million, of which NIS 10.5 million derived from the growth in margins. Activity in the foreign currency segment contributed to an incremental income of NIS 6 million, all of it due to an expansion in activity (Table 4.7 and Figure 4.11). The remaining difference in income is attributed to a slight decrease in other items.

The expense on the loan-loss provision rose by 47 percent in 2001, and totaled NIS 292 million. A particularly large increase was recorded in that part of the mortgage banks' provisions that relates to activity with home-buyers. In the past, these loans were regarded as relatively low-risk but in 2001, the provisions derived from them, which are calculated on the basis of the extent of arrears in repayment, rose sharply. Moreover, the proportion of arrears for medium and long terms (over 15 months), which necessitate provisions at increasingly high rates, rose considerably (Figures 4.13 and 4.14, and Table 4.10). As an example, arrears of over 15 months, which necessitate a provision of 32 percent of the balance of the revalued debt and another 8 percent in respect of each additional three months arrears, increased by 11 percent. The balance of these loans-in-arrears (less

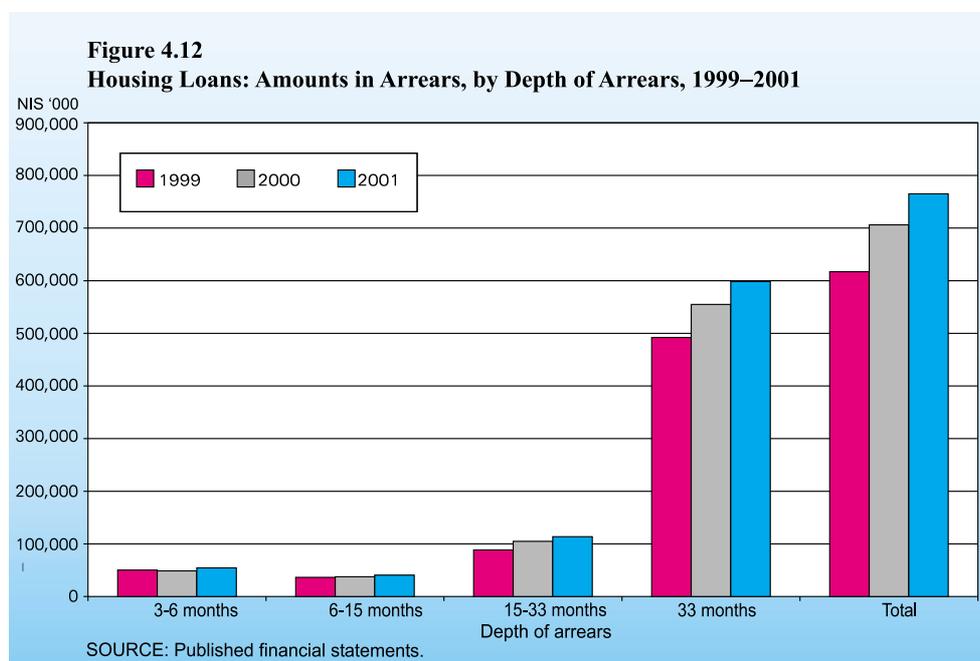
Table 4.7
Interest-Rate Spreads in the Mortgage Banks, 1998–2001

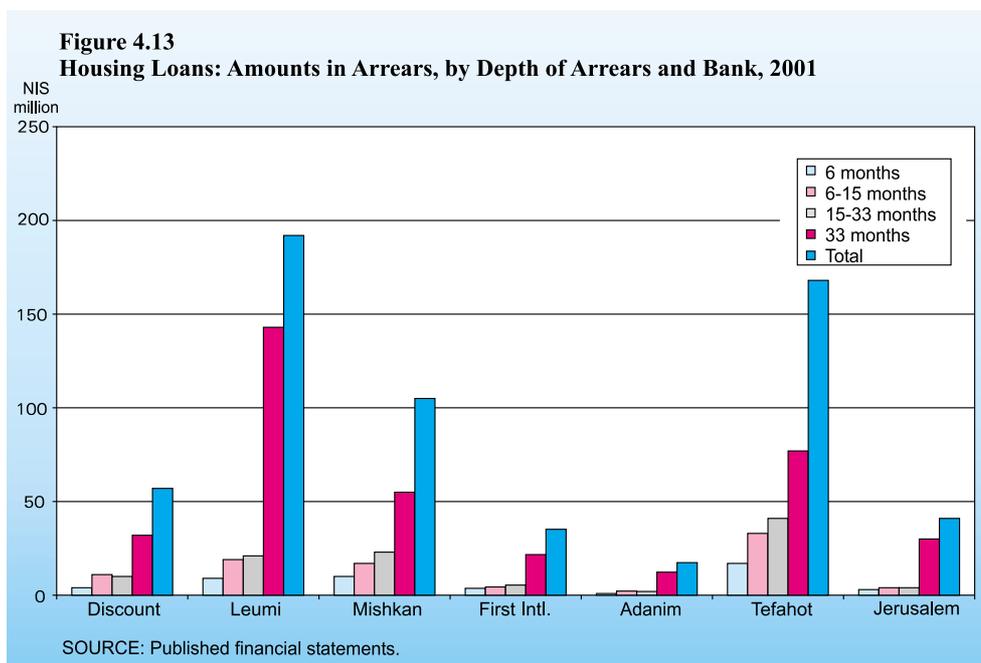
(cumulative, end-period data, NIS million, December 2001 prices)

	1998	1999	2000	2001
CPI-indexed segment				
Average assets balance	76,532	83,792	91,517	94,869
Interest income (<i>NIS mill.</i>)	3,711	4,636	5,370	5,634
Income ratio (<i>percent</i>)	4.85	5.53	5.87	5.94
Expenditure on sources (<i>NIS mill.</i>)	2,973	3,813	4,495	4,741
Average spread per unit of credit (<i>percent</i>)	0.97	0.98	0.96	0.94
Foreign-currency segment				
Balance	2,141	2,510	2,663	3,004
Net income	29.6	30.4	47.4	53
Average spread per unit of credit (<i>percent</i>)	1.38	1.21	1.78	1.77
Unindexed segment				
Balance	2,247	2,535	3,063	5,259
Net income	23.8	45.5	54.6	111.9
Average spread per unit of credit (<i>percent</i>)	1.06	1.79	1.78	2.13

SOURCE: Returns to Supervisor of Banks.

provisions for principal and interest) rose by a similar rate and totaled NIS 447 million. The higher proportion of arrears, relative to the balance of credit to home-buyers [0.93



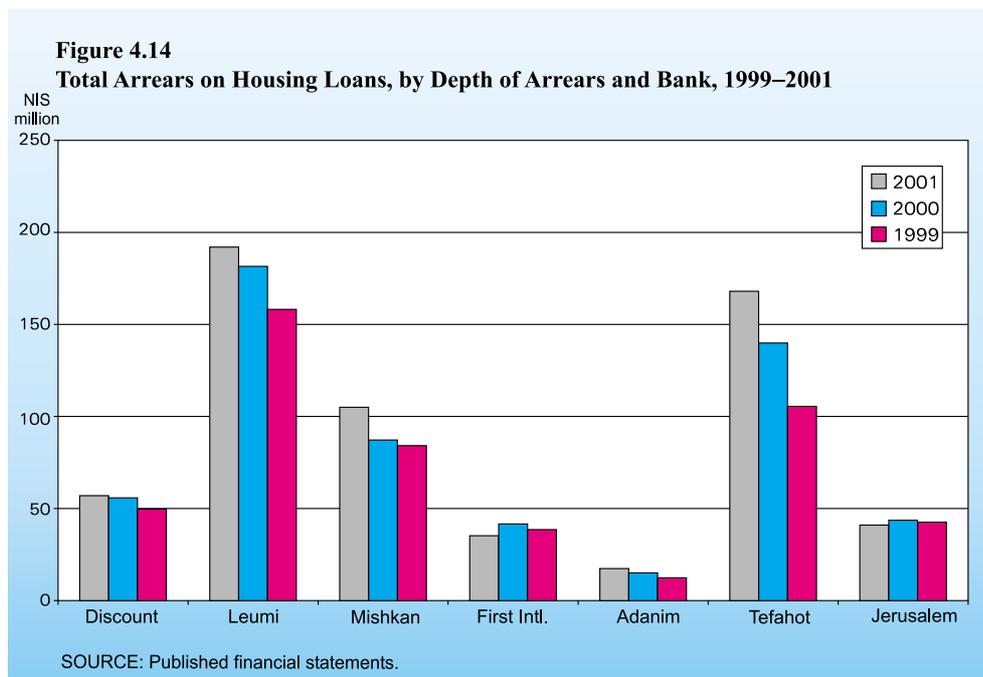


percent compared with 0.9 percent in 2000 (Table 4.4 and Figure 4.16)] and in absolute terms, mainly resulted from the recession in the economy, which impaired borrowers' repayment ability and necessitated an increase in specific loan-loss provisions. The specific current provisions in respect of the housing loan item (provisions deriving from the extent of arrears) for example, rose from NIS 257 million in 2000 to NIS 292 million in 2001.³³

Since the beginning of the slump in the construction and real estate industry, some element of arrears has been apparent in the collection of debts in respect of which a provision was made on the basis of the extent of arrears, against provisions in respect of loan losses for which parallel income was not recorded. The banks have increased their collection efforts since 2000, and the 'net' amount of provision charged to the statement of income has decreased as a result. During the year under review, this activity resulted in the write-off of NIS 333 million of provisions, compared with NIS 32, 44 and 45 million in 1998, 1999 and 2000 respectively.

The operational side of the mortgage banks remained stable in 2001 and continued to yield income. Total operating expenses remained unchanged, while non-interest income fell slightly (Table 4.9). Operating fees totaled NIS 866 million in 2001. The principle items—commissions from life and housing insurance transactions—remained unchanged, while collection fees on credit from Treasury sources fell by 6 percent. The decrease is attributed to the reduction in commissions in respect of the granting of new credit according

³³ These are net amounts, after the reduction of provisions following the collection of past debts that were not written-off.



to the extent of collection (Treasury sources) that resulted from the Finance Ministry's tender for this activity, a large increase in early repayments that are notable for high commission rates, and a decrease in the proportion of the large stock of this type of credit that was extended in the past in return for high fees. Due to this stock of credit, the reduction in fees will continue to exert a slow effect in the short run.

Income from portfolio management fees and portfolio preparation fees rose by a cumulative 70 percent during recent years and totaled NIS 97 million. Banks that in the past exempted many customers (principally those eligible under Housing Ministry criteria) from these fees, are now charging them from all customers (possibly in order to compensate themselves for the large drop in fees on funds deriving from Treasury sources). In addition, the banks have endeavored to price these fee more accurately during recent years, with the result that the customer is paying for the increase. Although the competition in the mortgage market is among the fiercest in the banking industry, it is focused not on commission fees, but on the level of the interest rate—the most important consideration in the decision-making process, which affects the borrower throughout the entire lifetime of the loan. Other parameters, such as the quality of service and level of fees (which by their nature are one-time), and their cost relative to interest expenses have a minor affect on demand. All these factors have led to a rise in fees, principally at the portfolio-opening stage.

Operating and other expenses remained unchanged in 2001, and totaled NIS 803

³⁴ Twenty-two branches were closed during the last three years.

Table 4.8
Distribution of Operating Fees, Other Income, and Operating and Other Expenses of Mortgage Banks,^a 1999–2001

	NIS million ^b			Year-on-year change (%)		Distribution (%)
	1999	2000	2001	2000	2001	2001
Operating fees						
Life insurance fees	226	225	222	-0.6	-1.4	25.1
House insurance fees	137	141	148	3.2	4.5	16.7
Government credit commissions	320	322	302	0.6	-6.2	34.1
Rent commissions	49	53	59	8.4	11.7	6.7
Credit management and contract preparation fees	87	99	97	14.1	-1.7	11.0
Portfolio management fees	0	16	1			0.1
Other	31	9	35	-72.1	296.6	3.9
Total fees and commissions	850	864	863	1.8	-0.2	97.7
Other income						
Provident fund management fees	12	10	8	8.8	-17.9	0.9
Rent	6	5	6	-16.4	-11.5	0.7
Other	6	7	6	-19.7	8.2	0.7
Total other income	25	22	21	-6.5	-9.8	2.3
Total non-interest income	874	887	883	2.8	1.4	100.0
Operating expenses						
Salaries and related expenses	411	430	427	4.7	-0.7	53.2
Depreciation amortization, and maintenance of buildings and equipment	119	119	112	-0.6	-5.6	13.9
Marketing and advertising	41	39	38	-6.1	-2.8	4.7
Administrative fees to related companies	55	26	56	-53.2	118.7	7.0
Professional services	26	25	24	-3.9	-2.4	3.0
Communications	19	18	20	-27	7.7	2.5
Computers	47	53	52	14.0	-2.3	6.5
Office services and insurance	17	20	22	16.1	14.4	2.8
Other	78	74	52	-4.9	-29.5	6.5
Total operating and other expenses	812	803	803	-1.1	0.02	100.0

^a As of December 1997 management fees from insurance collected via subsidiaries, as well as salaries paid to these insurance employees, are also included in management fees. The returns of the First International Mortgage Bank and Bank of Jerusalem are not consolidated (excluding insurance, as above).

^b At December 2001 prices.

SOURCE: Published financial statements.

Table 4.9
Main Items in the Profit and Loss Statement of the Mortgage Banks,
1999–2001

	Cumulative results to 31.12 (NIS million) ^a			Real change (%)	
	1999	2000	2001	2000	2001
Net interest income before loan-loss provision	1,102	1,160	1,223	5.3	5.4
Loan-loss provision	221	199	292	-9.9	46.5
Total non-interest income	887	898	890	1.3	-1.0
<i>of which</i> Fee income	852	868	866	1.9	-0.3
Total operating expenses	812	803	803	-1.1	0.0
<i>of which</i> Salaries and related expenses	448	437	434	-2.4	-0.8
Ordinary before-tax income	956	1,057	1,018	10.5	-3.7
Provision for taxes	429	472	483	10.0	2.4
Net income	523	585	533	11.8	-8.9

^a At December 2001 prices.

SOURCE: Published financial statements.

million. This was due to the operational streamlining measures³⁴ that certain banks (mainly the independent banks) adopted and that were reflected by the closure of branches and the encouragement of voluntary retirement. The decrease in the operational coverage ratio (the ratio of operating expenses to non-interest income) mainly derived from streamlining processes and organizational changes at the independent banks (those that operate separately, and not at branches of the large banks). Salaries and related expenses, which are the largest expense component, fell by a negligible rate in 2001. The total number of FTEs (employee posts) fell slightly, by 0.7 percent. The decrease was recorded mainly among relatively high-cost personnel (permanent employees), and therefore had effects that will be apparent in the long run as well. The result was an increased proportion of low-salary employee posts (temporary employees), whose employment is relatively easy to terminate in times of recession. Salary expenses remained unchanged and employees' productivity grew as a result of the decrease in the number of permanent employee FTEs, the increase in inexpensive personnel, and the decreased usage of relatively expensive overtime hours.

As stated, developments in non-interest income and operative expenses show an improvement in the mortgage banks' operational efficiency. Operating expenses per balance-sheet sheqel fell from 0.86 percent in 1999, to 0.79 percent in 2000 and 0.75 percent in 2001, while the added value employee post fell slightly and totaled NIS 764 thousand. The efficiency ratio, which incorporates net interest income as well, amounted to 2.63 at the end of 2001, the highest level for the past decade (Table 4.4). The ratio of commission income to operating expenses and the ratio of total non-interest-income to total operating expenses remained at the previous year's levels in 2001.

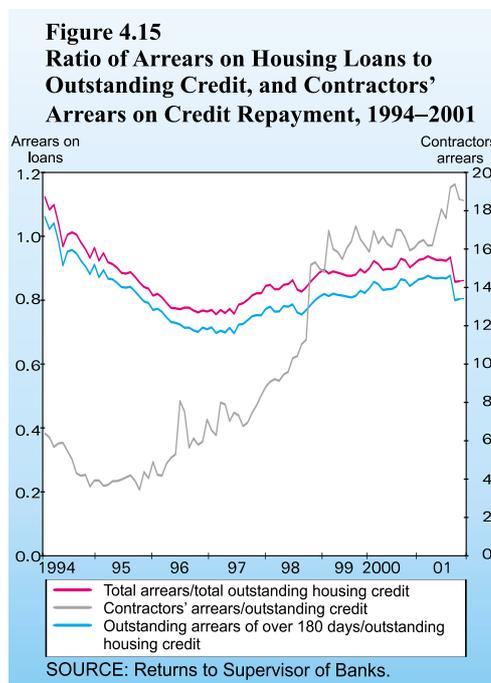
c. Risks and capital at the mortgage banks

The economic environment in which the mortgage banks functioned during 2001, and assessments regarding the coming years show a rise in the level of business risk. This is because the recession, and especially the rise in unemployment, are adversely affecting borrowers' repayment ability. The shortage of long-term sources and the uncertainty regarding income from insurance activity could harm the mortgage banks' profitability. The entry of additional entities into the mortgage market and the insurance companies entry into the directed credit market will have a similar effect.

The continuing growth in the proportion of credit at the banks' risk to total loans and total assets is increasing the banks' quantitative exposure to credit risk. As regards the quality of credit, several indexes

show a rise in the level of risk inherent in the mortgage banks' activity: Outstanding arrears on credit extended to home buyers rose by 8.6 percent and totaled NIS 820 million. The increase is largely attributed to arrears over 180 days, in which the credit risk is higher (Figures 4.13 and 4.14). The ratio of arrears to outstanding credit to home-buyers also increased, and amounted to 0.93 percent in 2001. Although this ratio is low and less than 1 percent of outstanding credit in arrears, it has been rising consistently since 1996, when it amounted to 0.73 percent. The serious recession in the economy has led inter alia to growing arrears in repayments of housing loans to the mortgage banks. In order to examine the macro-economic factors that affect apartment buyers, we will build an index for estimating apartment buyers' financial position, an index that is comprised of three factors—mortgage payments the unemployment rate and the household's income. This index,³⁵ which is calculated as the ratio between mortgage payments and the average income of a salaried employee standardized in respect of the rate of employed persons, fell sharply, mainly in the last quarter of the year (Figure 4.16a). Another factor, which is indicative of a deterioration in the quality of credit as a whole and credit to home-buyers in particular, is the specific provision by extent of arrears relative to outstanding credit to home-buyers. The portion of current provisions attributed to home-buyers' activity grew

³⁵ This index, with a slight change, was developed by Mishkan Bank and appears monthly on the Mishkan Bank's website.



during the year and totaled NIS 364 million, compared with NIS 240 million in 2000. The ratio between the specific provision by extent of arrears and outstanding credit (to home-buyers) rose from 0.19 percent to 0.21 percent. Although these levels are still low, a decline in the quality of credit is apparent. Another indicator of the decline in the quality of credit to home-buyers is the undischarged amount (less the provision for interest on arrears and the loan-loss provision) of loans in arrears for which a loan-loss provision has been made. This amount increased in 2001 and totaled NIS 2.4 billion, compared with NIS 2.1 billion in 2000. The average loan balance in arrears increased among all arrears ranges in 2001 (Table 4.10).

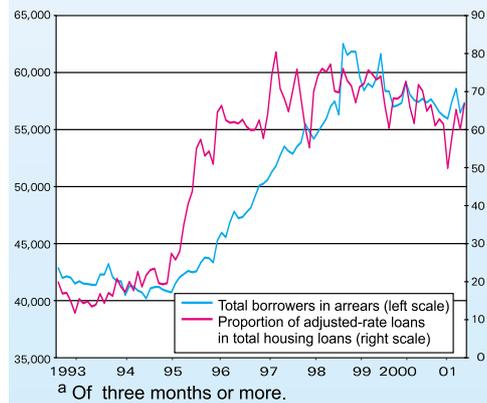
Similar trends were recorded during 2001 in the mortgage banks' activity with contractors. The ratio of arrears to outstanding credit to contractors rose sharply and amounted to 19 percent, compared with 16 percent in 2000 (Figure 4.15). The current specific loan-loss provision is also indicative of a deterioration in the quality of credit. This ratio reached 1.2 percent, the highest level recorded in recent years.

As a result of these and other developments, the proportion of arrears to the mortgage banks' shareholders' equity rose³⁶ and reached 31 percent at the end of the year. After expanding for several years, adjusted rate loans fell again in 2001: their proportion to total new loans amounted to

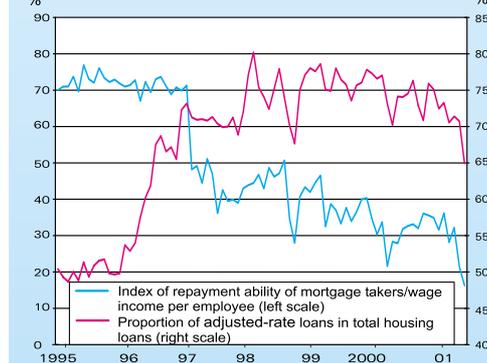
³⁶ If arrears in respect of directed credit are included in this ratio, the weights obtained range between 75 percent at Discount Mortgage Bank to 7.7 percent at First International Mortgage Bank. A direct connection was found between this ratio and outstanding credit to contractors and building companies.

Figure 4.16
Indices of Credit, 1993-2001

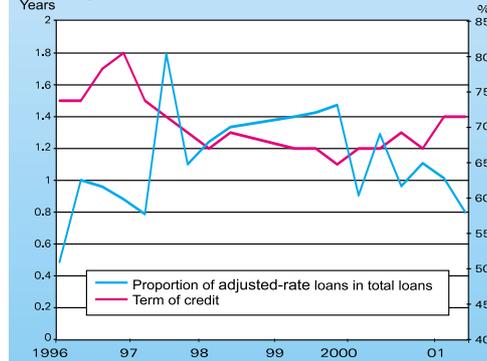
a. Proportion of Adjusted-Rate Loans and Numbers of Borrowers in Arrears^a on Mortgages, 1993-2001



b. Proportion of Adjusted-Rate Loans in Total (New and Renewed) Loans and Index of Home Buyers, 1995-2001



c. Term of Credit and Proportion of Adjusted-Rate Loans, 1996-2001



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

Table 4.10
Arrears on Housing Loans,^a and Loan-Loss Provision, 1999–2001

	1999				Total
	3-6 months	6-15 months	15-33 months	Over 33 months	
Amount in arrears	40	75	80	297	492
Outstanding loan-loss provision, by arrears	0	107	184	206	496
Outstanding loans in arrears <i>less</i> provision for loans and interest	919	723	236	82	1,960
Average amount in arrears ^b	180	792	1,920	10,692	13,404
Average amount of loan ^b	4,136	14,824	5,664	2,956	27,579
Average arrears on loan in arrears (months)					27.23
Average arrears on outstanding loan (months)					14.07
	2000				
Amount in arrears	42	79	96	337	554
Outstanding loan-loss provision, by arrears	–	122	229	271	623
Outstanding loans in arrears <i>less</i> provision for loans and interest	952	773	277	112	2,113
Average amount in arrears ^b	189	827	2,299	12,136	15,452
Average amount of loan ^b	4,282	15,838	6,643	4,018	30,781
Average arrears on loan in arrears (months)					27.90
Average arrears on outstanding loan (months)					14.57
	2001				
Amount in arrears	48	91	106	371	616
Outstanding loan-loss provision, by arrears	–	120	210	270	600
Outstanding loans in arrears <i>less</i> provision for loans and interest	1,064	846	307	139	2,356
Average amount in arrears ^b	214	951	2,554	13,356	17,075
Average amount of loan ^b	4,788	17,349	7,361	4,997	34,495
Average arrears on loan in arrears (months)					27.74
Average arrears on outstanding loan (months)					14.64

^a By depth of arrears.

^b Average amount in arrears and average amount of loan are obtained by multiplying the mid-period relevant balance.

SOURCE: Published financial statements.

only 12 percent, compared with 29 percent and 39 percent in 2000 and 1999 respectively. Outstanding credit contracted more slowly, since it is affected by the timing of exit stations after early repayments, and averaged NIS 19.6 billion in 2001 compared with NIS 21 billion in 2000.

Part of the growth in home-buyers' arrears can possibly be attributed to the upturn in

interest rates, principally on adjusted rate loans and especially those that have been renewed. Figure 4.15 presents home-buyers' arrears and the number of borrowers compared with the proportion of adjusted rate loans, and reveals a potential relationship between this type of loan and the mortgage banks' credit risk.

The decrease in new adjusted rate loans had the effect of increasing the duration of assets. As a result, the duration gap rose from 1.3 in 2000 to 1.6 in 2001. (Figure 4.16c).

The rate of exposure of net worth to interest-rate risk amounted to 16.8 percent in 2001 compared with 17.3 percent in 2000. Since the duration of assets at the mortgage banks is higher than the duration of liabilities, these banks are exposed to the risk of an unexpected rise in interest rates. When early repayment³⁷ of 3 percent of the credit portfolio (in both years) is assumed, exposure fell from 9.1 percent in 2000 to 8.7 percent in 2001.

The situation was similar at all the mortgage banks: The rate of exposure fell during 2001, but the variance between the banks was high. The rate of exposure to interest rate adjustments (assuming early repayment of 3 percent of the portfolio) ranged between 1.52 percent and 21.5 percent. The risk-based capital ratio of the mortgage banks remained unchanged and amounted to 10.1 percent in 2001 (Table 4.4).

Total capital sources (for the purpose of calculating Tier 1, Tier 2 and Tier 3 capital ratios) expanded by 7.7 percent in 2001, mainly due to a growth in Tier 1 capital (net income accrual of NIS 400 million) and to an increase in approved Tier 2 capital (the issue of deferred notes), which totaled NIS 8.3 billion at the end of 2001 compared with NIS 7.7 billion at the end of 2000.

The balance of weighted assets for the purpose of calculating the capital ratio rose by an average of 7.1 percent, primarily due to the large increase in 100 percent weighted credit (balance-sheet and off-balance-sheet credit, mainly to contractors), compared with a decrease in 50 percent weighted assets (housing credit, in which the ratio of the loan to the value of the asset is less than 50 percent). The decrease may have derived from old loans that were discharged by means of early repayment. Risk assets totaled NIS 81.1 billion in 2001 compared with NIS 76.7 billion in 2000.

Box 4.1 **Analysis of the Mortgage Banks' Profit Centers**

For the first time, the mortgage banks reported on profit centers in 2001, within the framework of their statements of income and loss. For some considerable time, the mortgage banks have been trying to expand their activity to additional areas outside of their main area of activity—the

³⁷ The ratio between the amount of early repayments and outstanding credit to home-buyers in 2000, 1999 and 200 amounted to 3.22 percent, 3.7 percent and 3.15 percent respectively.

extension of long-term credit backed by real estate. Since the banks incurred losses on loans for (home) renovations and on credit to the local authorities, they are now avoiding such activity. During recent years however, a few banks have made preparations for engaging in unindexed short-term activity. This they have done by establishing a network for raising deposits from the general public, and directing these deposits to business uses. The banks involved took this action as a result of the paucity of long-term sources from the public, and the growing competition for these sources.

A natural profit center that is complementary to activity with home-buyers is the building companies and contractors sector. The mortgage banks are interested in supplying credit to contractors in order to diversify their uses, principally from the aspect of timing and indexation basis. Project-financing activity also provides the mortgage banks with access to apartment buyers, for the purpose of extending additional mortgage loans. Nevertheless, only two banks conduct extensive activity in this segment: Bank Discount (9.6 percent) and Bank Tefahot (8 percent). Also active in the sector to a lesser extent are Bank Jerusalem, Bank Adanim and Leumi Mortgage Bank (5 percent, 6 percent and 1 percent respectively). This reporting reveals very high profitability on housing-loan activity, which contributes 85 percent of the income deriving from activity with home-buyers, and 11 percent of the income from consumer credit activity with respect to residential apartment collateral. Loans to contractors contribute an average of only 2 percent of net income, while the average proportion of these outstanding loans to the mortgage banks total assets is 3.6 percent. This phenomenon partly results from the labor-intensive nature of construction activity, and the high risk involved relative to activity with home buyers. As an example, the ratio of non-interest income to operating expenses in this activity amounts to 40 percent, similar to the ratio at the commercial banks, compared with a coverage ratio of 122 percent in housing loan activity and loans secured by a residential apartment as collateral. On the credit risk side as well, it transpires that the average ratio of the loan-loss provision (which is mainly specific, but also includes supplementary provisions) to the average balance of assets in activity with contractors, 1.6 percent, is considerably higher than in activity with home-buyers (0.2 percent). These data highlight the issue of the feasibility of activity in areas that overlap with housing loan activity. As stated, activity with contractors can also yield a income if the contractors refer customers to the bank providing project financing. If not, the high risk involved in this activity does not appear to be reflected by the return.

4. OVERSEAS OFFICES

a. Introduction

The five largest banks conduct their activity abroad via 111 offices, of which 19 are subsidiaries, 21 are branches and agencies, and 43 are representative offices of the parent bank that are widely dispersed geographically. The activity of companies in which the banks have a holding and branches of the parent bank account for the majority of activity abroad and are located mainly in world's major financial centers—New York, London, Zurich, Paris and Luxembourg. Branches also operate in major cities in the USA, and in off-shore banking centers. The representative offices, which are mainly involved in raising deposits, are extending their deployment in South America, Germany, Canada and Australia.

This extensive deployment is exploited in order to expand private banking activity, and to extend financial services to Israeli customers operating abroad (individuals and businesses) that channel part of their financial activity abroad, to international entities operating in Israel, and to the Jewish communities in the countries where the overseas offices operate. The overseas offices' principal target clientele are affluent private customers and business firms.

The total dollar balance sheet of the overseas offices rose by a relatively moderate 7 percent in 2001 (Table 4.10), and their net income grew by 4 percent to \$ 155 million. Subsidiaries recorded net income of \$ 97 million, a minor increase of 2 percent compared with 2000. This income was equivalent to a return on equity of 7.2 percent,³⁸ similar to the ratio recorded in 2000. Subsidiaries' sheqel contribution to the five banks heading the groups was higher and totaled NIS 820 million. This contribution included income in respect of exchange rate differentials on investment (but not the \$ 57 million income of branches operating abroad, and financing expenses of income against coverage of investment in overseas offices). Due to a balance-sheet structure that is characterized by a high ratio of investments in securities to credit (a change typical of recent years), the decline in interest rates in all currencies had only a minor affect on net interest income. However, the economic recession and the decrease in world trade resulting from the crisis in the high-tech industries and the terror attacks in North America made it necessary to increase loans-loss provisions. The total net income recorded in 2001 derived from a fall in income deriving from the banks' activity in North America concurrent with a rise in income from activity in Western Europe (Table 4.11). Overseas offices' share in the

³⁸ Since part of the activity at overseas offices is conducted via branches, whose shareholders' equity is based on that of the parent company, we based our profitability calculation on the data of subsidiaries alone.

Table 4.11
Assets, Liabilities, and Spreads of the Overseas Offices, ^a 2000-2001

	(\$ million)								
	North America			Western Europe			Total		
	2000	2001	Change (%)	2000	2001	Change (%)	2000	2001	Change (%)
Credit to the public	6,985	7,063	1.1	3,279	3,115	-5.0	10,382	10,313	-0.7
Cash and bank deposits	3,379	4,025	19.1	1,977	1,694	-14.3	5,423	5,788	6.7
<i>of which</i> In banks owned by group	507	1,209	138.6	462	565	22.3	1,022	1,826	78.6
Securities	6,533	7,563	15.8	1,769	2,118	19.8	8,306	9,684	16.6
Total assets	17,288	19,134	10.7	7,261	7,168	-1.3	24,743	26,516	7.2
Deposits of the public	13,547	13,996	3.3	3,663	3,672	0.3	17,366	17,832	2.7
Deposits from banks	1,898	2,340	23.3	2,334	2,284	-2.1	4,260	4,663	9.5
<i>of which</i> From banks in group	1,179	1,714	45.4	1,073	1,510	40.8	2,273	3,260	43.4
Total liabilities	16,440	18,131	10.3	6,747	6,635	-1.7	23,374	24,970	6.8
Equity	842	1,003	19.1	514	533	3.8	1,364	1,546	13.3
Interest-rate spreads on credit ^b and deposits of the public	3.12	2.45		1.36	1.57		2.57	2.21	
Net interest margin on total assets and liabilities ^c (incl. off-balance-sheet items)	1.78	1.78		1.59	1.36		1.73	1.67	

^a Selected items.

^b On balance sheet, at bank's responsibility.

^c The net interest margin is the ratio of net interest income before loan-loss provision to total financial assets.

SOURCE: Returns to Supervisor of Banks.

total sheqel balance sheet of the five largest banking groups increased at the end of 2001 as a result of the rapid depreciation of the sheqel, and the real growth in the foreign currency share of the offices balance sheets. This share averaged 14.7 percent of the total consolidated balance sheet of the five largest banks, an increase of one percentage point compared with 2000. However, an inter-bank comparison reveals considerable differences: The lowest ratio of 5.6 percent was recorded at the First International Bank, and the highest ratio of 28 percent was recorded at Bank Discount. The average increase is attributed to an expansion of the Israeli banks' international activity, in line with the globalization of the Israeli economy and the deregulation of the money and capital markets, especially in all matters relating to Israelis' investments abroad and foreign residents' investments in Israel. The growth in activity abroad also resulted from the expectations of increased competition within the local banking system, with the entry of foreign banks and representative offices into the Israeli economy. Since the foreign banks offer an extensive international geographical dispersal in the worlds' financial centers, Israeli banks are also interested in taking a share of this global deployment. Overseas offices' performance is affected by the economic situation in the countries where they operated, and by changes in local banking legislation. The Gramm Leach Bliley Act³⁹ was passed in 2000. This law will have a major impact on the nature of the banks' activity in the USA during the coming years. In the short run however, the law is not expected to lead to any substantial change in the nature or deployment of overseas offices, except for changes that are required by the law, such as the transfer to a separate company of the majority of securities activity that is conducted on behalf of customers. (The actual implementation of the law was postponed from June 2001 to May 2002.)

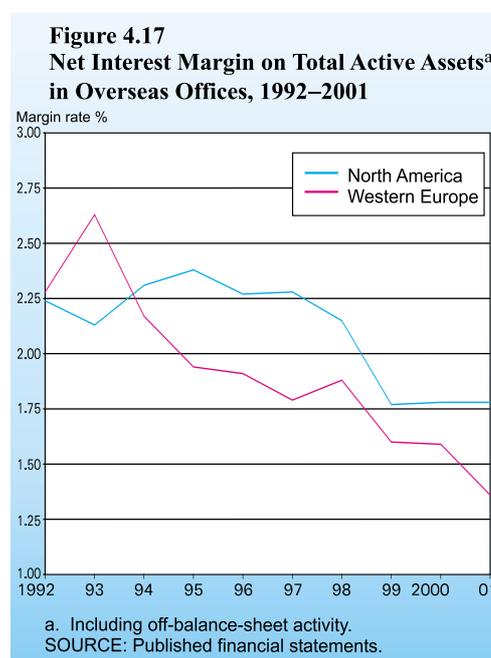
b. The extent of overseas offices' activity

Overseas offices activity expanded by the high rate of 7 percent in 2001, following an increase of 16 percent during the last two years (Table 4.10). The growth in the offices' balance sheet in 2001 mainly derived from an increase in investment in securities and in deposits at the banks on the assets side, and in deposits from the public and from the banks on the liabilities side.

Credit to the public remained stable at the overseas offices during the year, as the result of a minor increase in North America and a 5 percent decrease in Western Europe. This development is attributed to the fact that during recent years, the offices usually extended credit via participations in international syndicates while in 2001, these ventures were reduced because of the recession. On the retail side, activity has been at a low level

³⁹ This law, which marks a revolutionary development in the banks' activity in the USA, abolishes many of the prohibitions that were imposed following the stock exchange crisis of 1993 on the banking system in the USA, under the Glass Steagall Act. Under the new law, the banks are permitted to engage in most financial activities that are outside of pure banking activity (raising deposits and extending credit).

for some time now, and the slowdown during 2001 following a long period of buoyant economic activity, principally in North America, had the effect of halting the growth in credit. As stated, a larger decrease was recorded in Western Europe. The difference reflects the non-uniform composition of credit: At offices in North America, 43 percent of credit is extended to industry and commerce, and only 3.5 percent is granted to private individuals. At offices in Western Europe, 28 percent of credit is extended to industry and commerce, and 15 percent is granted to private individuals. Similarly, credit (including off-balance-sheet credit) per borrower at offices in North America averaged approximately one million dollars in 2001, compared with \$ 600 thousand in Western Europe. These differences reflect

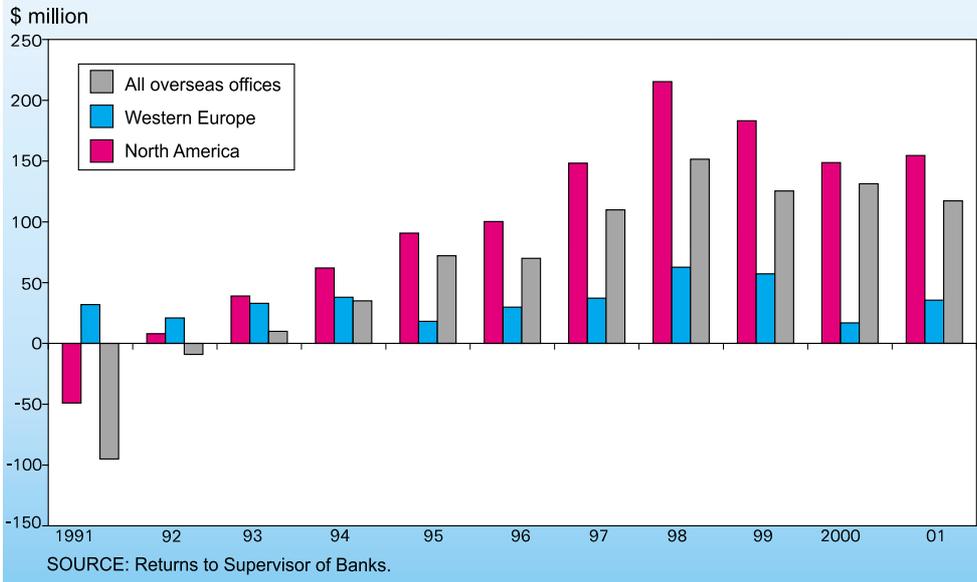


the relatively high proportion of commercial and business banking at North American branches, compared with the high proportion of private banking at West European offices. Another notable phenomenon during 2001, which resulted from the weak state of the local economies in the countries where the branches operate, was the increased extension of loans for uses in foreign countries (including Israel). In Western Europe, this activity increased by 10 percentage points compared with 2000 and accounted for 60 percent of the offices' activity. In North America, a more moderate increase of two percentage points was recorded, and the proportion of this activity amounted to only 10 percent. The largest increase in this area, 34 percent, was recorded in the extension of credit for use in Israel—apparently due to the weakness of the capital markets, which Israeli firms had used as an alternative source of finance to bank credit (mainly during the years 1999 to 2000).

The proportion of credit to the overseas offices' total balance sheet continued to decline in 2001, and averaged 39 percent. At offices in North America, this ratio amounted to 37 percent. Banks that engage in private banking activity are notable for a low proportion of credit in the balance sheet. However, the ratio was low even in comparison with banks that operated in the USA (banks of comparable size to Israeli banks⁴⁰), in which the

⁴⁰ The peer group is comprised of 320 commercial banks that operate in the USA whose assets averaged \$ 2.9 billion during 2001. The comparison is therefore mainly valid for offices that operate in North America. Source for the data: Quarterly Banking Profile, FDIC. Table 4.14 presents a comparison of the two largest Israeli banks with this group.

Figure 4.18
Net Income of Overseas Offices, 1991–2001



proportion of credit averaged 62 percent in 2001.

The overseas offices' surplus sources are redeposited as large deposits at the commercial banks. During 2001, these deposits increased at a rate similar to that recorded in 2000. The growth in the entire system amounted to 6.7 percent, with a notable difference between the 21 percent increase at offices in North America and the 14 percent decrease in Western Europe. The proportion of securities investment activity has risen during recent years, and the extent of this activity is almost the same as that of credit activity. The high rates of growth in this item are indicative of the great difficulty encountered in extending credit, and are attributed to unsuccessful attempts in the past to extend credit for retail activity. However, investment in securities yielded a favorable return. Such investments are centered in bonds, 95 percent of which are classified as available for sale. This proportion is similar to the average for all of the banks operating in North America: 92 percent of total investments in securities there at the end of 2001 was in securities available for sale. The expansion of more risk-oriented activities (credit to the public and the securities portfolio) suggests that returns are increasing concurrent with a growth in risk exposure.

The increase in total uses was partly financed by means of a growth in the balance of deposits from the public and deposits from the bank. Deposits from the public at the overseas offices rose by 2.7 percent (Table 4.10) due to a growth in the amount of deposits raised from the business sector (large deposits) and a decrease in deposits raised from small private customers. The proportion of large deposits (of over \$ 4 million) rose by two percentage points compared with 2000, while the average deposit (among the large

deposits) increased by 16 percent to a level of \$ 12.3 million. A large increase of 18 percent was recorded in deposits deriving from Israel, concurrent with a decrease in deposits from countries outside of the overseas offices host countries. This resulted from the increased supply of deposits from Israelis for investment outside Israel, and from the withdrawal of deposits by foreign depositors. The same phenomenon was apparent in deposits from the banks at overseas offices, where a very large rise of 44 percent was recorded in deposits deriving from Israeli banks concurrent with the withdrawal of deposits deriving from foreign banks. The increased proportion of large deposits and the growth in the size of the average deposit are in line with the strategic changes that the overseas offices implemented during recent years—a growth in private and commercial banking activity at the expense of retail activity, of which the expenses are high. During recent years, the overseas offices have made extensive efforts to attract affluent local customers whose activity is characterized by large deposits.

As in 2000, off-balance-sheet activity and the usage of derivative financial instruments continued to grow in 2001 to a considerable extent. The growth in this activity has continued for several years and reflects *inter alia* the expansion of business and private banking activity, at the expense of traditional retail banking activity. Total transactions in derivative financial instruments increased by 44 percent in 2001 and totaled \$ 16.2 billion (in nominal value terms). A particularly large increase of 120 percent was recorded in transactions involving financial instruments that are used for hedging against interest-rate risk and inter-currency exchange rate risk. This was due to the frequent fluctuations in interest rates and exchange rates in Europe and North America during 2001.

Outstanding guarantees and contingent liabilities (off-balance-sheet transactions in which the nominal balance represents credit risk) at overseas offices totaled \$ 7.5 billion at the end of 2001, compared with \$ 7.9 billion at the end of 2000. The more moderate level of demand for guarantees and other liabilities (principally guarantees for securing credit and unutilized overdrafts) was consistent with the slowdown in economic activity, principally in North America.

The interest margin on total earning assets⁴¹ (including off-balance-sheet assets) of the overseas offices fell slightly in 2001 and amounted to 1.67 percent, which was considerably less than in the peer group. The decrease in the interest margin during 2001 resulted from the fall in interest rates in the overseas offices' host countries. The drop in interest rates was reflected immediately in the rates of income and expenses from financial intermediation activity, and was less apparent in the rates of income from securities activity. As an example, the rate of income from credit fell by 2.95 percentage points and the rate of expense on deposits dropped by 1.04 percentage points, while the rates of income from securities activity (government bonds), which accounted for 38 percent of total activity at the end of 2001, fell by only one percentage point.

c. The overseas offices' financial results

⁴¹ Earning assets are assets yielding net interest income, and do not include other assets such as buildings and equipment.

The net income of the overseas offices rose slightly, by 4 percent, from \$ 148 million in 2000 to \$ 155 million in 2001 (Figure 4.13). Major differences were again apparent between geographical regions: Income fell by 11 percent at North American offices, but rose sharply at offices in Western Europe (Table 4.12).

The large increase at west Europe offices derived from one-time losses of \$ 31.4 million that were recorded in 2000 at Bank Leumi Switzerland due to an act of embezzlement by one of its senior employees. The decrease at North American offices in 2001 derived from a growth in operating expenses that have yet to be accompanied by a rise in non-interest income at one of the new offices of the Bank Hapoalim group. Contributing to the growth in income were the 5 percent increase in net interest income, which mainly resulted from an expansion of banking activity, and a rise in the proportion of securities activity. At the same time, income was adversely affected by a 19 percent increase in the loan-loss provision, an 8 percent decrease in non-interest income, a rise in operating expenses (at North American offices), and the provision for taxes.

Net interest income before loan-loss provision at all overseas offices rose by 5 percent in 2001 (Table 4.12), mainly due to an expansion of balance-sheet and off-balance-sheet banking activity. The net interest margin on total earning assets fell slightly during the year and offset to some extent the affect of the expenses on loan-loss provisions, which increased by 19 percent during the year, and whose ratio to total credit at the banks' risk reached 0.3 percent (Table 4.11). The growth in provisions was recorded in both regions of activity, and derived from a large 41 percent increase in the specific provision, which was partly offset by a decrease in the general provision. The growth in the specific provision is attributed to specific borrowers, and is indicative of a deterioration in the quality of the credit portfolio as a result of the economic slowdown in the USA and Europe during 2001. Specific provisions for the financial and business services industry rose considerably, leading to a large rise in the ratio of the expense on the specific provision to outstanding credit to this industry.

Income from operating fees remained relatively stable in 2001 due to a decrease in this income at West Europe offices and an increase at North American offices (Table 4.12). The differing pattern of development of non-interest income in the different regions of activity resulted from the differences in the nature of activity in the two regions: Activity at West European offices is oriented towards private banking, which is commission-intensive, while North American offices focus on commercial and business activity, on which the non-interest income is lower. The commission income from capital market activity of the offices specializing in private banking (mainly in Western Europe) fell as a result of the weak state of the principal capital markets.

Salary and related expenses rose by 18 percent in 2001, and the average number of employee posts increased by 5 percent. The growth in salary expenses reflects a large increase in the number of employees in part-time posts (and temporary employees), with respect to whom salary costs are relatively low, a growth in the number of permanent employees in full-time posts, whose salaries are higher, and the increased use of overtime

Table 4.12
Main Items in the Profit and Loss Statements of the Overseas Offices,^a 2000-2001

	(\$ million)								
	North America			Western Europe			Total		
	2000	2001	Change (%)	2000	2001	Change (%)	2000	2001	Change (%)
Net interest income before loan-loss provision	367	404	10.0	127	115	-9.2	499	524	5.0
Loan-loss provision	22	27	24.3	4	4	-4.5	26	31	19.0
Operating fees	36	51	42.3	58	50	-13.5	96	103	7.8
Other income	18	21	15.9	28	4	-84.1	46	26	-43.6
Total non-interest and other income	58	75	29.5	86	57	-34.4	147	135	-7.9
Salaries and related expenses	112	139	23.2	50	53	5.5	165	194	17.5
Other expenses	72	83	15.6	116	49	-58.0	191	135	-29.5
Total operating and other expenses	213	260	22.1	181	120	-33.7	400	387	-3.5
Ordinary before-tax income	190	192	0.8	28	48	72.4	219	242	10.3
Provision for taxes	60	77	28.4	16	13	-18.5	77	91	18.4
Net income	131	117	-10.7	17	36	111.0	149	155	3.9

^a Selected items.

SOURCE: Returns to Supervisor of Banks.

Table 4.13
Credit Risks in Overseas Offices, 2000–2001

	(percent)					
	North America		Western Europe		Total	
	2000	2001	2000	2001	2000	2001
Quantity of credit						
Credit to public/total assets	40.4	36.9	45.2	43.5	42.0	38.9
Quality of credit						
Annual loan-loss provision/total credit	0.31	0.40	0.11	0.10	0.25	0.30
Problem debts/total credit	3.25	4.80	2.06	2.70	2.84	4.20
Charge-offs/total credit	0.04	0.19	0.64	0.10	0.23	0.16
Concentration of credit						
Share of credit to single borrowers (\$ 8 mill. or more)	63.1	63.0	42.6	40.3	57.0	56.7
H-Index of by-industry credit concentration	0.166	0.159	0.141	0.130	0.151	0.145

SOURCE: Returns to Supervisor of Banks.

hours, which pushes up labor costs. One of the reasons for the increased number of employees earning a higher level of salary appears to be the attempt to improve the quality of the personnel in the worldwide banking system, as reflected by the absorption of highly-qualified employees and the dismissal of junior employees as a result of technological developments that necessitate the employment of more highly-skilled employees. The rise in expenses per employee post also resulted from the growing need to remunerate professional and high-quality employees, in view of the fierce competition for personnel in the financial services sectors worldwide. In order to retain their high-quality employees, the relatively small banks, including the Israeli banks that operate abroad, have been forced to raise their salaries and improve their conditions of employment (Table 4.15). The average annual salary at overseas offices amounted to \$ 87 thousand in 2001, compared with \$ 78 thousand in 2000 (Table 4.12). The average salary per employee post at West European offices is usually higher than in North America. This is because of the differences in the cost of living and salary costs in the two regions, and the nature of banking activity: West European offices specialize in wholesale and private banking, which requires the employment of more highly-specialized and relatively expensive personnel.

The previously-mentioned developments in net interest income, non-interest income and operating expenses led to a rise in the efficiency ratio⁴² from an average of 161 percent to 171 percent at all overseas offices (Table 4.14), similar to the ratio of 179

⁴² Calculated as total (net interest and non-interest) income divided by total operating and other expenses.

Table 4.14
Operating and Yield Indices in Overseas Offices, 2000–2001

	North America		Western Europe		Total	
	2000	2001	2000	2001	2000	2001
Annual wage per employee post (\$'000s)	77	86	82	95	78	87
Financing coverage ratio ^a	1.72	1.55	0.70	0.96	1.25	1.36
Operating coverage ratio ^b	0.27	0.29	0.48	0.47	0.37	0.35
Efficiency ratio ^c	2.00	1.84	1.17	1.43	1.61	1.71
<i>Percent</i>						
Return on assets ^d (ROA)	0.85	0.68	0.29	0.49	0.69	0.62
Return on equity ^d (ROE)	11.2	9.5	1.7	3.3	7.3	7.2

^a Ratio of net interest income before loan-loss provision to operating and other expenses.

^b Ratio of non-interest and other income to operating and other expenses.

^c Ratio of all non-interest and net interest income to all operating and other expenses.

^d Net income (incl. imputed tax and extraordinary income) *divided by* capital/assets at beginning of year; refers to subsidiaries only.

SOURCE: Returns to Supervisor of Banks.

percent recorded at the peer group (Table 4.15).

Shareholders' equity rose by 19 percent at offices operating in North America, mainly due to the accrual of income, and remained stable at west European offices (Table 4.10). The dollar return on equity (ROE) remained almost the same as in the previous year, at 9.5 percent, due to a decrease at subsidiaries operating in North America. This rate was much lower than the 13.8 percent ROE recorded at the peer group. Although an increase was recorded in Western Europe compared with 2000, the rates of return remained very low (Table 4.14). The dollar return on assets (ROA) fell by an average of 0.6 percent at all offices in 2001 compared with 1.3 percent at the peer group. These rates are also indicative of the large differences between the activity of the offices and the local banks, especially in North America.

d. Risks at the overseas offices

The risk exposure of overseas offices in both major regions of activity increased during 2001. The credit risk indexes, relating to size, quality and concentration of credit, show a rising trend in risk exposure. While the amount of credit remained at the same level as in the previous year, the proportion of outstanding credit to total assets fell as a result of the large increase in the overseas offices' securities portfolio. Although most of the securities portfolio is classified as available for sale, the credit risk exposure in respect of it increased.

Most of the indexes relating to credit quality reveal a deterioration in the course of

Table 4.15
US Subsidiaries of Israeli Banks vis-à-vis Similar US Banks, 2000–2001

	2000			2001		
	IDB New York	Bank Leumi USA	US peer group ^a	IDB New York	Bank Leumi USA	US peer group ^a
Balance sheet	5,383	4,079	2,801	6,020	4,082	2,861
Loan-loss provision	7.5	1.0	15.2	9.4	2.0	18.1
Charge-offs	1.347	0.132	12.010	1.276	4.288	17.831
Credit/assets	34	41	62	29	41	61
Securities/assets	58	50	23	59	52	23
Quarterly loan-loss provision/assets	0.41	0.06	0.87	0.54	0.12	1.05
Capital/assets	7.86	8.83	8.98	8.07	9.27	9.76
Capital adequacy	14.11	11.66	12.81	14.94	13.49	13.77
Net interest-rate spread	2.71	2.64	4.27	2.93	2.37	4.31
Net non-interest income/assets	1.03	0.86	1.31	1.06	0.78	1.26
Return on assets	1.03	0.86	1.28	1.09	0.90	1.31
Return on equity	12.46	9.52	14.42	13.54	9.67	13.77
Efficiency ratio	2.00	1.88	1.78	2.1	1.81	1.79
Annual wage per employee post (\$ '000s)	68	87	49	76	90	50
Assets per employee (\$ million)	8.28	10.43	3.56	8.87	10.31	3.70

^a This group includes US banks whose total assets are between \$1 billion and \$10 billion. The data are the average of the banks in the group.

SOURCE: Federal Deposit Insurance Corporation.

the year. As a result, the rate of the loan-loss provision and the proportion of problem loans to total credit at the banks' responsibility rose at all overseas offices (Table 4.11). However, the ratio of write-offs to total credit fell. Nevertheless this index is affected by debts that were in the past classified as problematic, and does not reflect the quality of the credit that was granted in the course of the year.

The expansion of business activity at North American offices had the effect of increasing the concentration of credit at these offices, as compared to a slight decrease at Western Europe offices (Table 4.13). As a result, the Herfindahl-Hirschmann index (H-index), which reflects dispersal by economic sector (including households), at Western Europe offices fell from 0.141 to 0.13, compared with a more moderate decrease at North American offices. The proportion of large deposits (over \$ 4 million) rose by two percentage points compared with 2000, while the average deposit (among the large deposits) increased by 16 percent, reflecting the concentration by borrower size.

The overseas offices' nostro portfolio expanded to a considerable extent in the course of the year. The amount of securities that the offices decided to hold until maturity also increased. The offices' market risks in respect of the securities portfolio therefore appear to have grown.

Certain overseas offices, particularly those located in North America, underwent a process of strategic restructuring, whereby retail activity was reduced at some offices and an emphasis was placed on more profitable areas. This process had the effect of increasing income during recent years due *inter alia* to the economic prosperity in the countries in which the branches operated. The numerous risks inherent in the offices' activity, especially credit risks, not to mention the exigencies of control and monitoring, make it necessary for them to adopt an extremely cautious approach. The physical distance and business environment, which is not adequately known, also mean that the overseas offices must be extremely cautious in their current activity. This includes the need to closely scrutinize high-risk borrowers and sectors. Sophisticated risk management and the refinement of business policy will be essential conditions for achieving favorable results in the future as well, even in years of economic slowdown.