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## **Letter of the Supervisor of Banks submitted with the 2015 Survey of Israel's Banking System**

In recent years, the banking system in Israel has displayed impressive stability, has become stronger through increases in capital and in liquidity, and has supported growth of the economy. The banking system also changed its business model, placing greater emphasis on households and small businesses—increasing competition in these areas—and significantly reduced concentration and exposure to large borrowers. Against the background of the system's resilience, and attentive to public discourse in Israel, the Banking Supervision Department sharpened the focus of its objectives and decided that, alongside maintaining stability, it will work in the coming years to actively promote competition through the implementation of structural reforms, to improve banks' efficiency, and to advance technology and innovation in the banks. The changes already implemented are intended to enable the public to benefit from convenient, more diversified, and less expensive services that are more aligned with its needs, as well as to ensure a flexible and sustainable banking system.

**The prudent activity of the banks, and of the Banking Supervision Department, enabled the banks in Israel to remain stable in recent years, despite the financial storm that struck throughout the world** and led many banks in Europe and the US to difficulties and failures. This is not self-evident, and many indices show that even today, the banks in Israel are more conservative than other banks around the world, and less exposed than them to various risks. Moreover, the banks have become stronger due to the significant requirements imposed on them by the Banking Supervision Department in recent years, and they currently have larger and higher-quality capital and liquidity buffers, as well as improved corporate governance and risk management. However, this does not ensure that risks will not be realized in the future in Israel as well, and the banks and the general public should be prepared at all times for the realization of new risks such as cyber risks and various operational risks, as well as for a broad economic crisis, in order to ensure that it will be weathered as well, while maintaining the stability of the banks and of the economy.

**The banks in Israel supported economic growth in recent years** by financing home purchases for tens of thousands of households and expanding the financing extended to small and medium businesses. The increased financing offered by the banks in Israel is exceptional against the background of developments in Europe, where the banks have reduced loans in recent years, thereby slowing those economies' exit from the financial-economic crisis.

**In recent years, the banks in Israel significantly changed the composition of their activities: They shifted their focus from large corporate customers to households and small businesses, leading to increased competition in these areas.** The change of focus was reflected, inter alia, in a greater variety of products and services to households and small businesses, and in a significant increase of credit to them. This change resulted in fewer financing difficulties for small businesses—as shown by the Bank of Israel's Companies Survey at the end of 2015—and a decline in credit margins to households and small businesses. The change took place alongside a reduction in credit to large borrowers, large groups, and holding companies, and was a result of regulatory changes and supervisory requirements, the realization of risks, the integration of financial institutions in the financing of these corporations, and the slowdown in investment in the economy.

**The prices of banking services for households declined in recent years**, both the fees collected by the banks from their customers, and the spreads between the interest on credit and the interest on deposits. International comparisons show that fees in Israel are among the lowest in the world, and domestic comparisons show that fees have declined in recent years. Moreover, since the customers are transitioning to consumption of financial services through direct means—such as the Internet, smartphone applications and ATMs—they are benefiting from the fact that these services are even less expensive. The interest rate spreads are also not exceptional relative to spreads around the world, although they are higher for households and small businesses than for large corporations or mortgages—similar to the situation in other countries. The Banking Supervision Department’s assessment is that if the banks significantly improve efficiency in the coming years, in accordance with the Department’s guidelines, it will be possible to further reduce the cost of banking services.

**In recent years there has been a change worldwide in policy concerning compliance, and many countries have enhanced enforcement of tax laws throughout the financial system. As a result, and as part of the lessons learned from the results of US authorities’ investigations of large banks around the world and in Israel, with the process not yet complete at some of the banks in Israel—the banks have improved their management of compliance risk and cross-border risks derived from activity vis-à-vis nonresidents.** Accordingly, the banks have imposed stricter requirements on these customers in tax matters and compliance obligations for a wide variety of laws (such as consulting laws) in their countries of origin. This was reflected in a significant decline in deposits by nonresidents in the Israeli banking groups, and a significant decline in the international deployment of the banking groups through the closure of branches, representative offices and subsidiary companies. The Banking Supervision Department is guiding the Israeli banking system to implement the most stringent compliance requirements and, in this context, relates to compliance with all laws applying to bank customers in their countries of origin and in the countries in which they operate. Furthermore, the Banking Supervision Department is guiding the banks to complete the handling of investigations and the broad lessons learned from them, and to meet the strict requirements imposed by European and other countries which are parallel to those of the US FATCA regulations.

**The low interest rate environment in Israel and around the world—a necessary response to the low growth environment—poses a challenge to the banks: It negatively impacts interest income and serves to increase future credit risk.** The low interest rate environment over time requires the banks to examine their business model and focus on reducing costs. In addition, from a forward-looking perspective, it increases credit risk, inter alia because it may encourage investors to take greater risks in the search for yields, and because it increases the risk of over-leveraging of borrowers, chiefly households. Yet, in the short term, the low interest rate makes it easier for companies and contributes to the low credit losses recorded in the banks’ financial statements.

Against the background of the robustness of the banks in Israel, and with forward-looking attentiveness to the public discourse, **the Banking Supervision Department honed its vision—to be a professional and proactive supervisory authority for the benefit of the public and the economy.** Accordingly, the Department has formulated supervisory points of emphasis for the coming years and the initiatives it will promote, which include:

- **Maintaining the stability of the banking system**, with the objective of continuing to ensure the public's money, and so that the banks will continue to support economic activity over time;
- **Actively promoting competition in banking**—particularly regarding households, small businesses and settlement—inter alia through structural changes and support for the removal of significant barriers;
- **Retaining fairness of the banking system toward its customers**, and dealing with cases raised by the public in reference to the various banks.

The Banking Supervision Department has established enablers for these objectives, on which it will focus in the coming years. These include:

- **Promoting efficiency** in the banking system;
- **Encouraging the banking system to implement innovation and to adopt new technologies, while adjusting regulation to this objective;**
- **Balancing regulation** while strengthening risk-based supervision.

The Banking Supervision Department's assessment is that the implementation of structural changes coupled with the promotion of technology and innovation and encouraging significant increases in efficiency will act to increase competition in the banking system and will boost the value to customers—leading to improved service and convenience and to lower prices.

**In recent months, the Banking Supervision Department has begun advancing a variety of supervisory initiatives, and has published new policy documents and guidelines. These initiatives, alongside those formulated by the Committee to Increase Competition in Financial Services, will, in coming years, create an infrastructure for competitive and efficient banking that has more value to customers.** The main initiatives promoted by the Department—which are described in this report—include:

- **A new policy on banking through means of communication:** This policy removes the barriers to banking through means of communication, creates an infrastructure for the establishment of a digital bank with no branches, and transfers “ownership” of financial information to the customers.
- **Guidance to the banks on increasing efficiency:** This guidance requires the banks to formulate significant streamlining programs in order to reduce the efficiency gap between them and banks around the world, and with the objective of adapting the system to the technological revolution taking place in the financial arena.
- **Formulating an outline for support of the establishment of new banks in Israel,** including by (a) removing barriers in the area of computerized infrastructure: it will be possible to establish a joint computer center, and new banks, as well as existing small and medium-sized banks, will be able to purchase computerization and operations services from it; (b) streamlining and accelerating the process of licensing new banks, and (c) updating capital requirements. The Israeli economy is small, and in the banking industry there are size advantages. However, this outline, together with the leniencies presented in terms of banking through means of communication, could lead to the establishment of one or two digital banks in the coming years, and create a competitive threat

(contestability). These, in turn, will contribute to the creation of more competitive equilibrium in retail areas.

- **Creating another supervisory “level” that makes it easier for entities that do not take deposits**, such as merchant acquirers, by reducing capital requirements from them and bringing them in line with international standards, with the aim of advancing competition in the clearing market.
- **All of the aforementioned is in parallel with the support for the promotion of a credit register**—a project that the Bank of Israel is leading together with the Ministry of Finance—which will serve as the infrastructure for increasing competition.

**In conclusion, the changes in banking expected in the coming years, mainly the technological revolution, will markedly impact bank customers, employees, and shareholders** (which are primarily the general public). The changes create many opportunities, as well as new risks that must be recognized and managed. The Banking Supervision Department will accompany these processes while making sure that the adjustment of the system to the changes will respect the broad range of customers and employees, with an emphasis on increasing competition and maintaining stability.

A handwritten signature in black ink that reads "Hedva Ber." with a period at the end. The signature is written in a cursive, slightly slanted style.

Dr. Hedva Ber  
Supervisor of Banks

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