This survey was written by the Economics Unit of the
Banking Supervision Department.

Should there be updates to the survey, they will be published on the Bank of Israel's website: www.bankisrael.org.il

Translation and design: Publications Unit, Bank of Israel
Printed in Israel by Maor Wallach, Jerusalem

ISSN 1565-3250
Catalogue number 601868

Letter of the Supervisor of Banks submitted with the 2014 Survey of Israel's Banking System

The frequent changes in the economic environment—domestic and global—in which the banking system operates continued to pose challenges in 2014. The banks' composition of activity and their financial results were affected by Israel's relatively low growth rate and the slowdown in advanced economies' growth, the low interest rate environment over time, and by the trend of elevated activity in the housing market. In addition, banking activity was affected by some outlier events, including Operation Protective Edge and the realization of compliance risk in cross-border banking activity with US customers. At the same time, the banking system was affected by measures taken in order to increase competition both in banking and in the financial markets. This effort was a priority for policy makers—the government, the Knesset and the Bank of Israel—and is expected to increase in coming years.

This dynamic environment emphasizes the need to continue to improve banks' risk management and to define clear limits for their risk appetite; to entrench a culture of fairness in relations with customers and social and public sensitivity; to work diligently to improve efficiency and increase competition, and to embed an appropriate and robust level of corporate governance.

The banking system has continued to maintain its stability and resilience, as well as a high level of liquidity. The banks accumulated profits from business activity and have adopted policies to attain capital levels that are appropriate to their risk profiles. The results of stress tests carried out by the Banking Supervision Department this year support the assessment that the banking system is stable. The banks must continue the process of building up their capital in the next few years in accordance with the course set by the Banking Supervision Department and according to each bank's risk profile.

The return on capital in the banking system declined from 8.7 percent to 7.3 percent, which is below the long-term average of around 9.5 percent. This trend in profitability is expected to continue to influence the banks' strategy and risk policy in coming years. As a result, the banks must continue to streamline their operations in order to improve operational efficiency and at the same time develop high-quality banking services that will provide added value to the public even under more competitive market conditions than currently prevail.

With respect to liquidity adequacy, the Basel III framework, which takes into account the lessons learned from the financial crisis, includes a standard for the liquidity coverage ratio. In preparation for its implementation in Israel, the Banking Supervision Department conducted a QIS to determine its quantitative impact. The survey indicated that the banking system meets the minimum requirements set by the Basel Committee and that the aggregate level of the ratio in Israel is similar to the weighted average for the EU countries. The Banking Supervision Department will continue working toward the adoption of the additional liquidity standard included in Basel III—the net stable funding ratio.

Basel III includes an additional pillar that involves the requirement to meet the simple capital ratio—the leverage ratio. The Banking Supervision Department has decided that the minimum level in Israel will not be less than 5 percent and not less than 6 percent for the two largest banks. These rates are higher than the minimum rate of 3 percent called for by the Basel Committee, and this is consistent with the policy adopted by other supervisory authorities, which have also set targets that are higher than the minimum target set by the Committee. The banking system in Israel is required to meet the minimum leverage ratios starting from January 2018.

The steps taken in recent years to assimilate the three main pillars of the Basel III framework—capital adequacy, liquidity and leverage—are meant to ensure that the banking system maintains its resilience and will continue to meet international standards in coming years. Moreover, the adoption of Basel's corporate governance standard will also ensure this.

The Banking Supervision Department continued this year to monitor the policy adopted by the banks and the risk appetite derived from it. Considerable attention has been devoted to examining the management of exposure to household credit, since its rate of growth has accelerated in recent years and households' level of leverage has increased, though it is still low by international standards. The activity in household credit reflects the Banking Supervision Department's proactive policy, which is intended to reduce the risks to the banking system and which reflects a forward-looking approach.

The stress test carried out by the Banking Supervision Department this year focused on a domestic macroeconomic crisis accompanied by a global shock. The results of this scenario showed that housing credit and credit to the construction and real estate industry are sensitive to macroeconomic shocks and that there would be a major impact on the banking system under this scenario. The results thus emphasized the importance of the measures taken in recent years by the Banking Supervision Department to limit households' leverage in respect of housing credit and to reduce their exposure to an increase in mortgage repayments, which is part of a scenario in which interest rates rise markedly. The results of the scenario and the insights produced were also useful in processes meant to evaluate the adequacy of the minimal internal capital targets of the various banks.

The activity of the banks through their branches and subsidiaries abroad and with foreign customers involves certain risks, which are the result of, among other things, the legal and regulatory environments that vary from country to country. These risks have intensified in recent years due to the increasing scope of enforcement by various countries with respect to financial institutions, with the goal of locating funds on which their citizens are liable for taxes. The US government is at the forefront of this effort. As part of its activity, it has opened criminal investigations against three Israeli banks on the suspicion that they assisted US citizens to conceal funds that are liable for taxes. At the end of the year, the investigations of the Bank Leumi group were concluded, following agreements signed with two US authorities, which also included a major fine. Against the background of these trends, the Banking Supervision Department has moved forward with regulations and measures to ensure that the banks manage cross-border risks prudently and that they fulfill US FATCA regulations. The banking system must continue to work to integrate a risk-oriented approach to identifying activities or customers that are likely to expose it to the risk of being exploited or of assisting its clients in carrying out a transgression, as realization of this type of risk has major effects on a bank's activity and its reputation.

The Banking Supervision Department continued to work this year to improve the preparedness of the banking system to deal with cyber risks as well as with emergency and crisis situations. In the area of cyber defense, the Banking Supervision Department expanded its directives, in collaboration with the National Information Security Agency, and has issued a new Proper Conduct of Banking Business Directive. In the area of preparedness for emergency situations, it is continuing with the fortification of banks' critical sites and has also issued directives regarding the provision of services to the public, against the background of Operation Protective Edge.

In recent years, supervision has stressed the issuing of directives that govern the relations between a bank and its customers, regulations that strengthen the power of the banking consumer, encourage competition and fairness and reduce the costs of holding a bank account. The Banking Supervision Department has implemented most of the recommendations of a joint Committee to Examine Increasing Competition in the Banking System; it set a uniform format for reports to customers on their banking activity (a "banking identity card"); it has launched fee tracks, with control over the price of the basic track; and has published directives meant to simplify the process of transferring an account between banks, including the possibility of opening accounts by means of the Internet. In addition, banks are now required to provide a customer with comparative information on securities-related fees paid by customers with similar activity. These directives are meant to remove barriers to switching banks and to serve as leverage in order to increase the bargaining power of the retail customer, as well to increase competition. Supervisory attention has been given to the small business sector, which has included the expansion of the category of small businesses that are eligible for reduced fees according to the banks' retail fee schedules. In addition, the banks are obligated to notify these customers of their eligibility and how they can exercise it. Steps were also taken toward the launch of a debit card, a means of payment which has the advantage, among others, of potential cost savings for merchants.

Enquiries and complaints from the public, whether submitted in writing or by telephone, continue to be dealt with, and a new Proper Conduct of Banking Business Directive has been issued which is meant to ensure that the banks deal comprehensively, fairly and efficiently with complaints from the public. In order to increase the banks' awareness of the importance of dealing with customer complaints, the Banking Supervision Department organized a conference this year for banking system staff who are involved in bank-customer relations. The Banking Supervision Department continues to promote steps to improve the relations between the banks and their customers, including cases in which customers find themselves in adverse circumstances that make meeting their obligations to the bank difficult. According to the Banking Supervision Department's approach, encouraging fairness and competition will strengthen the confidence of the public in the banking system and as a result the system's stability as well.

The government that came into office in May 2015 included in its policy platform enhanced competition among the banks, the insurance companies and the investment houses, with the goal of reducing the price of services provided to the public and facilitating the provision of less expensive and more accessible credit for small and medium-sized businesses. The Banking Supervision Department supports these goals and has worked—and will continue to work—to encourage competition while at the same time maintaining the resilience and stability of the banking system, for the benefit of the public as a whole.

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CONTENTS