Chapter 4

The Subsidiaries of the Five Major Banks

The five major banks have many subsidiaries, in which they have invested extensively and which have contributed significantly to the profits of the banks that head the groups. The principal areas of activity of the subsidiaries are mortgages, activities abroad, and holdings of nonfinancial companies. The contribution of all the subsidiaries to profits declined from about NIS 1.8 billion in 1998 to NIS 1.5 billion in 1999. The mortgage banks, the return on which has been more stable and higher in recent years than that in subsidiaries in other sectors, increased their net profit by 25 percent in 1999. The rise in profit and profitability is noteworthy in the context of the continued economic slowdown in general, and in construction in particular, and stems from the sharp increase in credit (both directed and nondirected) extended in the second half of 1999 to households as well as for other purposes.

The contribution of subsidiaries abroad to net profit (after conversions into local currency and accounting adjustments) is volatile, depending to a great extent on real NIS appreciation/depreciation against the dollar and the European currencies. In 1999 the contribution of these companies to net profit amounted to NIS 204 million—less than a quarter of their contribution in 1998. The reasons for the decline in profit and profitability are the real NIS appreciation against the dollar and the European currencies as well as developments of a nonrecurring nature (e.g., tax refunds and the sale of some of the overseas offices) in 1998. If the effect of hedging against investment in banking companies abroad is taken into account, however, the decline in the contribution to net profit is smaller in 1999. Ordinary before-tax dollar profit grew by 17 percent, in line with the trend of the last few years, as a result of the expansion of classic banking activity and the steep drop in loan-loss provision made possible by the continued economic boom in the countries where the overseas offices are located.

The process of selling off the excess nonfinancial holdings of Leumi and Hapoalim banks ended in 1999, the proceeds generally being used to buy smaller

nonfinancial companies in various industries. These developments, which are characteristic of universal banking, may stabilize the banks' profit sources.

This chapter consists of three sections: the first reviews the structure of the principal holdings of the five major banks in subsidiaries; the other two sections analyze the activities, financial results and risks of the mortgage banks and the overseas offices.

1. SUBSIDIARIES

The balance of the five major banks' investment in subsidiaries amounted to NIS 19 billion at the end of 1999, and their contribution to profit was NIS 1.5 billion (Table 4.1). The banking groups in Israel operate via subsidiaries and affiliates in a set-up similar to that of universal banking, incorporating commercial banking (retail and private) as well as activities that supplement traditional activities, e.g., credit cards, financial leasing, capital market activities (conducted partly at the bank itself and partly by means of subsidiaries), mortgages, activities abroad, and nonfinancial holdings.

Because of the importance of subsidiaries, the structure of the holdings in them of the five major banks is analyzed by sphere of activity, extent of investment in them, and their contribution to profit. The banks hold two kinds of subsidiaries—consolidated and unconsolidated. The former include commercial banks, mortgage banks, merchant banks (investment finance), and other financial companies dealing with subjects that are supplementary to banking activity, e.g., capital market companies (managing investment portfolios and underwriting securities), and other financial companies (financial leasing and credit cards). The unconsolidated subsidiaries are companies whose financial statements are not consolidated with those of the bank holding them, whether because the proportion of the holding is relatively small, the bank intends to sell them in the future, or for other reasons. This group includes nonfinancial companies, investment and holding firms, and commercial banks.

In recent years the rate of return on investment in total unconsolidated companies has been higher than that in consolidated ones, while the standard deviation of this rate has been lower, largely due to the stability of the return on investment in consolidated commercial banks (Table 4.1). In the last few years the average return on capital in all the subsidiary commercial banks (both consolidated and unconsolidated) was 8 percent, below the return on investment in the banks themselves, apparently due to the utilization of economies of scale by the large banks (Table 3.10). The wide fluctuations in the return on investment in subsidiaries abroad, on the other hand, reduces the coefficient of variation (average return *divided by* standard variation) in the consolidated companies. Note, however, that among the various kinds of subsidiaries and affiliates, mortgage banks contribute the most to profit, being in second place as regards the extent of investment in

them. The coefficient of variation of the mortgage banks is high because the return on them has been greater, and less volatile, than that of other activities in recent years (Table 4.1). This may have led other entities (e.g., insurance firms and commercial banks) to enter the field of mortgages, a development that may have an adverse effect on profitability in the future.

The contribution of the subsidiaries abroad (after conversion into NIS and accounting adjustments) is very sensitive to the rate of NIS depreciation against the currencies of the principal countries in which the overseas offices are active—the dollar, the Swiss franc, and the pound sterling. As Figure 4.1 shows, the depreciation of the NIS against the dollar in 1994 and 1996 converted a dollar profit into an NIS loss, as real depreciation in 1997 and 1998 significantly increased profit in NIS, and the depreciation in 1999 acted to reduce it. Note, however, that the banks generally hedge against exchange-rate risk, so that in effect the return on investment in subsidiaries companies abroad, which includes coverage against this risk, is less volatile than portrayed in Figure 4.1. The consolidated companies, whose assets constitute some 59 percent of total assets of overseas offices (including branches and representative offices), achieved an NIS profit of NIS 204 million, compared with NIS 878 million in 1998 (Table 4.1). The main cause of the decline in profits in 1999 was the real NIS appreciation against the currency basket, and the Swiss

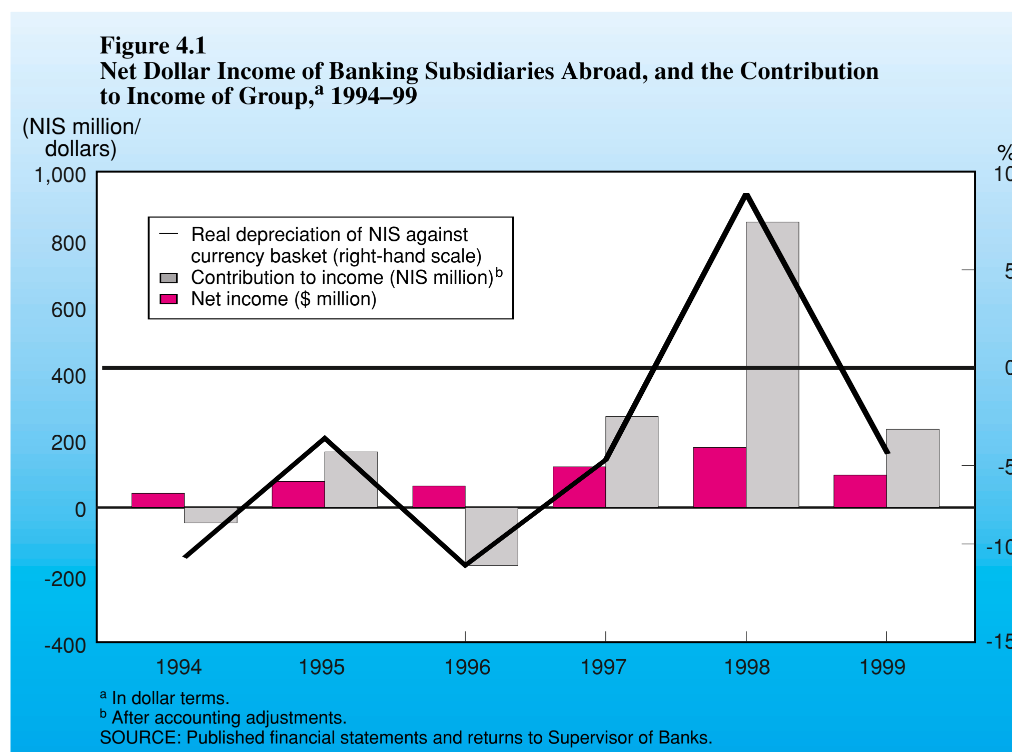


Figure 4.1
Net Dollar Income of Banking Subsidiaries Abroad, and the Contribution to Income of Group,[a] 1994–99

[a] In dollar terms.
[b] After accounting adjustments.
SOURCE: Published financial statements and returns to Supervisor of Banks.

Table 4.1
The Return on the Five Major Banking Groups' Investments in Subsidiaries, 1993–99

	Book value (NIS million)			Contribution to net income[a] (NIS million)		Composition (%)	Return (%)		Return (%) (1993–99)		
	1997	1998	1999	1998	1999	1999	1998	1999	Average	Standard deviation	Coefficient of variation[b]
Main consolidated subsidiaries											
Commercial banks	1,531	1,469	1,587	112	134	8.3	7.3	9.1	7.9	1.2	6.8
Mortgage banks	3,101	3,426	3,697	315	395	19.4	10.2	11.5	13.2	1.7	7.7
Holdings, investments, and others[c]	2,252	2,359	2,106	78	68	11.0	3.5	2.9	6.3	2.4	2.6
Subsidiaries and financial companies abroad	4,447	5,176	5,118	878	204	26.8	19.8	3.9	4.8	7.9	0.6
Total consolidated subsidiaries	**11,331**	**12,430**	**12,508**	**1,383**	**801**	**65.5**	**12.2**	**6.4**	**7.4**	**2.9**	**2.6**
Unconsolidated subsidiaries											
Commercial banks[d]	746	784	821	62	53	4.3	8.3	6.8	8.0	0.7	11.2
Nonfinancial and insurance companies	2,777	1,792	1,766	221	262	9.3	7.9	14.6	10.1	2.3	4.5
Holdings, investments, and others (including abroad)[c]	611	655	638	47	26	3.3	7.7	4.0	4.1	3.3	1.2

Table 4.1 (continued)

	Book value (NIS million)			Contribution to net income[a] (NIS million)		Composi-tion (%)	Return (%)		Return (%) (1993–99)		
	1997	1998	1999	1998	1999	1999	1998	1999	Average	Standard deviation	Coefficient of variation[b]
Total unconsolidated subsidiaries (in Israel & abroad)	4,135	3,231	3,225	329	341	16.9	8.0	10.6	8.3	1.6	5.3
Total main subsidiaries	15,466	15,661	15,733	1,712	1,142	82.4	11.1	7.3	7.6	2.2	3.5
Other companies[e]	1,058	2,201	3,353	103	360	17.6	9.7	16.3			
Total subsidiaries	16,524	17,862	19,086	1,815	1,501	100.0	11.0	8.4	7.7	2.1	3.7
Parent bank (solo)[f]	12,722	12,507	12,898	943	1,790		7.4	14.3	10.8	2.1	5.1

[a] Only ordinary income is included in income, but dividends and proceeds from the sale of excess holdings are not. Translation adjustments of unconsolidated subsidiaries operating abroad are included in equity.

[b] The coefficient of variation is defined as the average yield *divided by* the standard deviation, and measures the risk-adjusted yield on investment.

[c] 'Holdings, investments, and others' comprises merchant banks, investment finance banks, and capital market companies (for underwriting and management), as well as credit card and leasing companies.

[d] The profit of Bank Hapoalim does not include its share in the profit of Otsar Hahayal Bank, NIS 15 million, in both 1999 and in 1998. Investment in and profit of the Tarshish Holdings and Investment Company, which is affiliated to Bank Hapoalim, are attributed to the activity of the parent bank, most of whose investment is in Bank Hapoalim and tradable securities. The holdings of Discount Bank and First International Bank have not been deducted from their total investments and contribution to profit.

[e] Subsidiaries not specified as main in note number 6 of the financial statement.

[f] 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 ordinary income of all its subsidiaries.

SOURCE: Published financial statements.

franc in particular, but when hedging against translation risk is included, the profits are greater. In addition, nonrecurring events in 1998, such as tax refunds against losses in former years and the sale of some of the overseas offices, served to reduce profits in 1999, while the expansion of activity partly cancelled out the reduction. The low average return on investment in subsidiaries abroad (only 4.8 percent), and its wide volatility (standard deviation of 8 percent) brought (excluding the effect of hedging) the coefficient of variation (the average return *divided by* the standard deviation) to 0.6 percent—the lowest figure in any investment category.

The nonfinancial companies and the main insurance firms, the extent of investment in which has declined in recent years as a result of the sale of excess holdings[1] by the Leumi and Hapoalim banks, contributed NIS 262 million to profits in 1999 (Table 4.1). In general, the nonfinancial companies improved their profits significantly, often even more than offsetting the decline in the extent of their holdings. The proceeds of the sales of the two largest banks, both in 1999 and at the beginning of 2000, were used to buy other nonfinancial companies, albeit representing a smaller extent of holding, and this explains the increased investment in other (not main) companies.[2] The average annual rate of return on investment in principal nonfinancial companies in 1993–99 (10 percent) is second highest to the mortgage sector. In the framework of the utilization of the proceeds from the sale of excess holdings, the two major banks invested in companies in the hotel, petro-chemical, and vehicle industries as well as in various investment and holding companies. The spread of smaller investments across a larger number of different companies and in varying industries embodies the potential for stabilizing banks' profits due to diversification—an advantage that is characteristic of universal banking.

The banks also hold other companies engaging in activities that supplement banking activity, e.g., companies operating in the capital market (managing investment portfolios and underwriting securities) and other financial companies (financial leasing and credit cards). While the rise in the level of activity in the capital market had a positive effect on the contribution to profit, the Visa Alpha credit card company suffered heavy losses (see Chapter 3).

The average rate of return of all the main subsidiaries declined from 11.1 percent in 1998 to 7.3 percent in 1999—similar to the long-term average but significantly below the return on capital of the banks at the head of each banking group.

There are sometimes significant differences between the five major banks as regards their investment mix, and these explain part of the high variance in the profitability of

[1] Under an amendment to the Banking (Licensing) Law, 5741–1981, as of 2000, a bank may not hold more than 20 percent of a controlling interest in nonfinancial companies, and each of the two largest banks may own no more than one conglomerate. Consequently, Leumi and Hapoalim banks sold their holdings in the Clal, Delek, Ampal, Africa-Israel, and Leumi Insurance companies.

[2] Other (not main) companies are those in which investment is small, so that the parent-bank does not have to give a detailed report on them in its financial statements.

banks' investments in subsidiaries (Table 4.2). As a share of equity, investment in subsidiaries ranges from 29 percent in First International to 72 percent in Mizrahi, while the contribution of subsidiaries to total net profit varies from 92 percent in Discount to a negative contribution in First International. Banks which rely in the long run on profit from subsidiaries in limited areas of activity are more exposed to macroeconomic and industry developments than banks which diversify their investments across many spheres. Thus Discount Bank, for example, about one third of whose equity is invested in subsidiaries abroad, was affected to a greater extent by the fall in the contribution of these companies than were other banks with similar holdings. Mizrahi Bank, on the other hand, about 49 percent of whose equity is invested in mortgage banks, benefited to a greater extent than other banks from the increase in profitability of the mortgage sector in 1999.

In the last few years the major banks have invested in developing systems for assessing the risks embodied in various areas of activity, allocating appropriate capital against them. These systems enable the bank's management to analyze the profitability of activities while taking the risks into account and relating to the banking group as a diversified portfolio within which financial intermediation is just one activity. This is usually done by means of indices of risk-adjusted return. Figure 4.2 presents the structure of the investments of the five major banking groups in subsidiaries according to the nature of their activity in 1999 and their relative performance in 1993–99 using the Sharpe Index.[3] According to this index, the mortgage banks are generally more profitable than a riskless investment, and the differences between the banking groups are not great. This result derives from the high and stable profitability of the mortgage sector in the last few years.

The picture is not very different as regards nonfinancial companies, currently held solely by Hapoalim and Leumi banks, even though their Sharpe indices are lower than those obtained in the mortgage banks.

The Sharpe Index for subsidiaries abroad indicates that the return on them is very similar to that on a riskless investment, with variations in both directions between banks. This is due to the shifts in the NIS exchange rate and the continued appreciation of the last few years, which have reduced profits in NIS (ignoring the effect of hedging), as well as to the wide fluctuations in the yield on investment in subsidiaries abroad.

Investment in other commercial banks is generally profitable, although there are marked differences between banks.

Investment in the parent-bank itself is also generally profitable, albeit less so than in mortgage banks. Here, too, there are considerable variations between banks, with an index of 6 for First International and a negative return of 0.19 percent in Discount Bank.

[3] This index is defined as the surplus risk-adjusted return on a sphere of activity: $S_i = \frac{R_i - R_f}{\sigma_i}$, where S_i is the Sharpe Index of activity i, R_i is the real average return on investment in activity i, R_f is the average real riskless interest rate for the period, and σ_i is the standard deviation of the return in the field of activity i. This index is best suited for measuring performance in a well-diversified portfolio.

Table 4.2
Investment in Subsidiaries and their Contribution to Net Income,[a] the Five Major Banks, 1999

	Bank Leumi				Bank Hapoalim			
	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	246	49	19.9	2.5	665	29	4.4	6.3
In mortgage banks	877	84	9.6	8.9	729	108	14.8	6.9
In holdings, investments and others[c]	1,425	78	5.5	14.5	929	46	4.9	8.9
In banking and financial companies abroad	2,136	140	6.6	21.8	867	–55	–6.3	8.3
In nonfinancial and insurance companies	424	89	21.0	4.3	1,368	173	12.7	13.0
Total in main subsidiaries and affiliates	**5,108**	**440**	**8.6**	**52.0**	**4,558**	**301**	**6.6**	**43.4**
Not in main investments[e]	407	7	1.7	4.1	1,793	333	18.6	17.1
In parent bank (solo)[f]	4,304	685	15.9	43.8	4,142	758	18.3	39.5
Balance of equity; total net income[f]	9,820	1,132	11.5	100.0	10,494	1,392	13.3	100.0
	Discount Bank				**Mizrahi Bank**			
In commercial banks	1,255	96	7.7	24.7	0	0	–	0.0
In mortgage banks	360	41	11.4	7.1	1,171	125	10.7	49.3
In holdings, investments and others[c]	355	16	4.5	7.0	269	18	6.5	11.3
In banking and financial companies abroad	1,692	123	7.3	33.3	146	–3	–2.1	6.1
In nonfinancial and insurance companies	0	0	–	0.0	0	0	–	0.0
Total in main subsidiaries and affiliates	**3,661**	**276**	**7.5**	**72.0**	**1,586**	**140**	**8.8**	**66.8**
Not in main investments[e]	(38)	21	–54.7	–0.8	57	–2	–2.6	2.4
In parent bank (solo)[f]	1,459	26	1.8	28.7	731	128	17.5	30.8
Balance of equity; total net income[f]	5,082	323	6.4	100.0	2,374	266	11.2	100.0

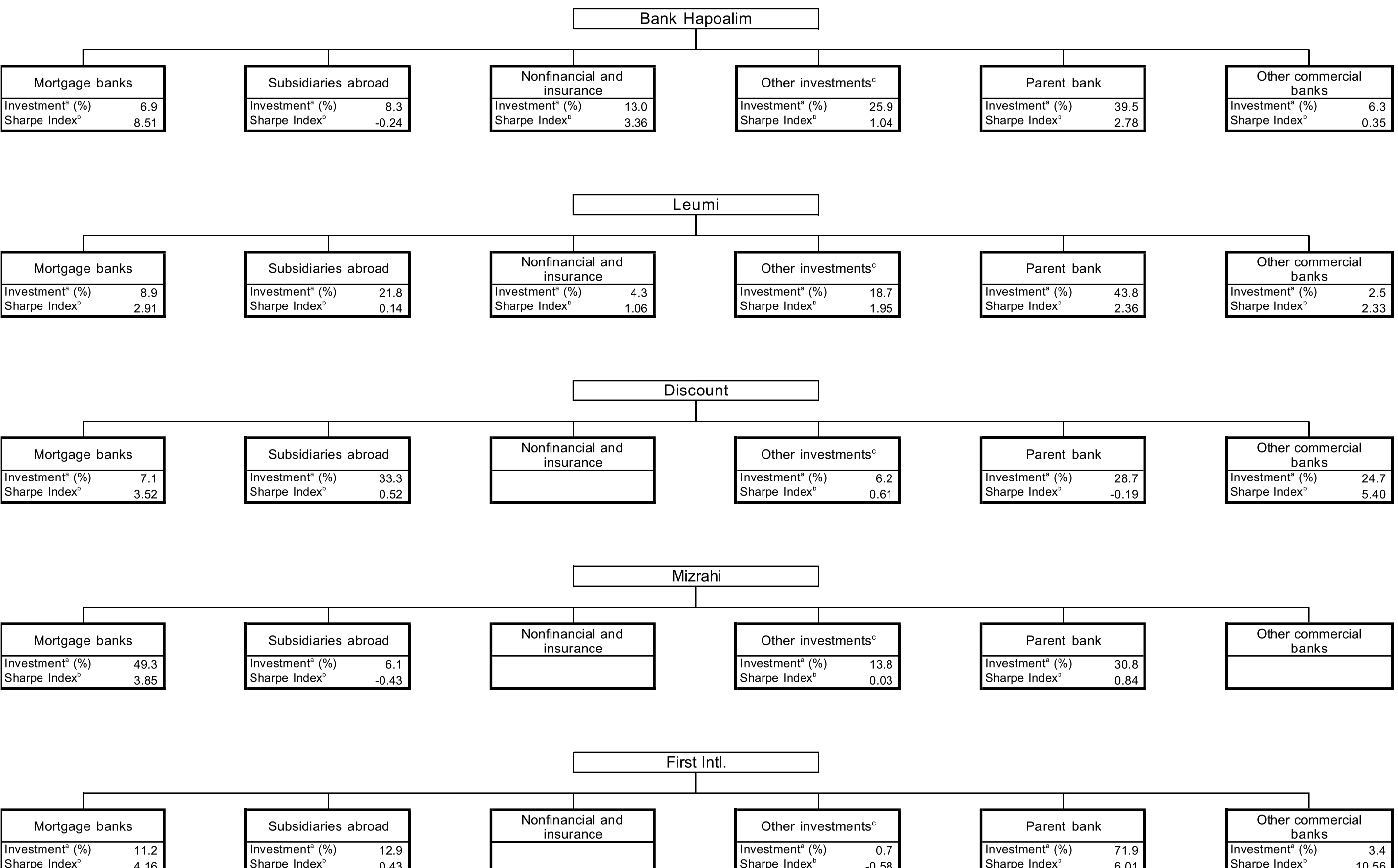
Table 4.2 (continued)

	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	88	13	14.8	3.4	2,253	187	8.3	7.4
In mortgage banks	290	37	12.8	11.2	3,426	395	11.5	11.3
In holdings, investments and others[c]	36	–64	–177.1	1.4	3,014	94	3.1	9.9
In banking and financial companies abroad	334	–1	–0.3	12.9	5,176	204	3.9	17.0
In nonfinancial and insurance companies	0	0	–	0.0	1,792	262	14.6	5.9
Total in main subsidiaries and affiliates	**748**	**–15**	**–2.0**	**28.8**	**15,661**	**1,142**	**7.3**	**51.6**
Not in main investments[e]	(18)	0.0	–	–0.7	2,201	360	16.3	7.2
In parent bank (solo)[f]	1,871	193	10.3	71.9	12,507	1,790	14.3	41.2
Balance of equity; total net income[f]	2,601	178	6.8	100.0	30,370	3,291	10.8	100.0

See footnotes to Table 4.1.

SOURCE: Published financial statements.

Figure 4.2
Activities of Subsidiaries, the Five Major Banking Groups, 1993–99



[a] Percentage of equity invested.

[b] This index is defined as the surplus risk-adjusted return on a sphere of activity: $S_i = \frac{R_i - R_f}{\sigma_i}$, where S_i is the Sharpe Index of activity i, R_i is the real average return on investment in activity i, R_f is the average real riskless interest rate for the period, and σ_i is the standard deviation of the return in the field of activity i. This index is best suited for measuring performance in a well-diversified portfolio.

[c] Including 'Holdings, investments, and others' as well as other investments not included in Note 6 of the financial statement.

SOURCE: Based on published financial statements.

2. MORTGAGE BANKS

a. Construction industry activity

The level of activity of mortgage banks in Israel, their financial results, and the risks to which they are exposed are affected by the general level of economic activity, developments in the construction industry, and apartment prices—both actual and expected.

The slowdown in construction output evident since 1996 persisted in 1999, alongside signs of recovery in the second half of the year in economic activity in general and housing demand in particular. The slowdown in the industry's output was expressed in the decline in building starts and completions and total area of apartments under construction (Table 4.3). In the second half of the year, in contrast, demand picked up, as expressed in the greater volume of mortgages extended during the year to both eligible (directed and supplementary credit) and non-eligible persons (nondirected credit).

On the supply side, there was a decline in building starts, whether initiated by the government or the private sector, and this was far more marked than in previous years (Table 4.3). The fall in private-sector building starts, area under construction, and building completions is explained by contractors' expectations that the economic slump would continue in the short run, by contractors' high financing costs, and by the adjustment of apartment stocks to lower demand. On the other hand, the pace at which the government sold land for residential construction, which served to delay residential construction in the past, accelerated in 1999, as did contractors' responses to tenders for the sale of

Table 4.3
Characteristics of the Construction Industry,[a] 1996–99

					Real change (%)	
	1996	1997	1998	1999	1998	1999
Total building starts	57,190	52,030	43,700	37,210	–16.0	–14.9
of which Government-initiated	19,440	15,700	9,970	9,120	–36.5	–8.5
Total area (mill. sq. m.)	20.9	19.2	17.2	15.9	–10.4	–7.6
Total building completions	52,280	65,580	52,510	43,150	–19.9	–17.8
of which Government-initiated	16,020	22,160	17,490	16,100	–21.1	–7.9
No. of property tax files opened	117,780	96,643	88,674	101,462	–8.2	14.4
Housing loans taken						
Total by eligible persons	54,990	45,580	41,060	40,250	–9.9	–2.0
of which New immigrants	21,360	14,800	9,990	9,770	–32.5	–2.2
Young couples	27,000	25,450	26,100	23,630	2.6	–9.5
Real change in index of owner-occupied housing (%)	2.7	0.2	–0.8	–3.2		

[a] Preliminary data.

SOURCE: Ministry of Construction and Housing, March 2000.

land—possibly indicating contractors' expectations that the industry would recover in the medium run.

As far as demand from the public was concerned, in the second half of 1999 purchases of new and second-hand apartments rallied, as did the number of mortgages taken by eligible persons, and this was expressed in the increased number of apartments sold (Table 4.3). The following factors appear to influence demand from the public:

1. After two years of stability and even a decline in apartment prices, expectations that they would rise intensified alongside expectations of local-currency depreciation (due to the Y2K-associated problems) and assessments (as of May, following the elections) of economic recovery, serving to increase housing demand.

2. The reform of purchase tax (introduced in January 2000), under which all sales of apartments and real estate were taxed, led to a surge in demand at the end of 1999, before the reform went into effect.

3. High unemployment rates served to reduce disposable income among the non-home-owning population.

4. Mortgage interest rose in 1999, and expectations that it would decline caused purchases to be postponed, expressed in a declining yield curve on interest rates during the year.

5. Purchases were brought forward at the end of 1998 because of fears that prices would rise in the wake of the sharp depreciation of the NIS against the dollar at that time, causing demand to plummet at the beginning of 1999.

Over 1999 as a whole the effect of the demand for housing was offset by supply, so that in general real housing prices dipped slightly, by 3.2 percent. This figure may be an underestimate of actual prices, as some contractors, who in the past had offered inducements to purchasers (e.g., improved building standards, household appliances) instead of price reductions, cut these back, especially as demand increased in the second half of the year.

b. Mortgage bank activity

Total performance (amount of credit extended during the year) rose by 9.3 percent to NIS 23.6 billion. The increase encompassed both directed credit to eligible persons, nondirected credit, and other credit[4] (Table 4.4). By contrast, there was a moderate decline in loans to contractors and construction firms, after a steep drop in 1998. The development of credit during the year was not uniform; in the first half the pace at which credit was extended was similar to that in 1998, while in the second half there was a 50 percent rise. Consequently, the first half of the year can be regarded as a continuation of the slowdown in the mortgage sector in 1998, while in the second half (i.e., from May, after the elections) economic activity rallied, expressed in increased apartment purchases (both new and second-hand, Table 4.3).

[4] The data in the tables refer solely to the mortgage banks, and do not include mortgages extended by insurance firms and commercial banks.

Table 4.4
Loans Extended and Sources Raised by the Mortgage Banks, 1997–99

	Loans extended (NIS million)[a]			Real year-on-year change (%)		Distribution (%)		
	1997	1998	1999	1998	1999	1997	1998	1999
Loans extended								
Total credit extended during the year	24,746	21,553	23,436	–12.9	8.7	100.0	100.0	100.0
of which To home-buyers	20,834	18,321	19,835	–12.1	8.3	84.2	85.0	84.6
Directed	5,215	4,712	5,232	–9.6	11.0	21.1	21.9	22.3
Nondirected	15,619	13,609	14,602	–12.9	7.3	63.1	63.1	62.3
To contractors and construction companies	1,469	896	856	–39.0	–4.5	5.9	4.2	3.7
Other	2,443	2,337	2,746	–4.3	17.5	9.9	10.8	11.7
Sources raised								
Total indexed sources raised[b]	16,703	16,672	20,578	–0.2	23.4	100.0	100.0	100.0
of which Deposits of the public	8,884	8,143	8,354	–8.3	2.6	53.2	48.8	40.6
Deposits from banks	7,819	8,529	12,224	9.1	43.3	46.8	51.2	59.4
Difference between credit and deposits	2,828	170	–2,374					

[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.

The balance of nondirected credit extended to home-buyers by mortgage banks rose by some 11 percent and stood at NIS 75 billion at the end of 1999 (Table 4.5). At the same time, and in spite of the increase in the extent of loans, the number of borrowers rose only moderately (by 2.3 percent). The average amount of credit at the bank's responsibility to a single home-buyer rose by 13 percent to NIS 248,000. The following factors explain the increase in the extent of credit and outstanding credit despite the stability in the number of borrowers and in apartment prices:

1. The ratio of loan size to the value of the asset (LTV) serving as collateral for the loan has been rising in the last few years, and this trend has intensified with the entry of a credit insurance agency into the mortgage sector.

2. The mortgage banks extend credit for all purposes if the property concerned serves as collateral, and this is not expressed directly in apartment prices. This credit has indeed risen considerably in the last decade.

3. According to Ministry of Housing data, demand for large apartments as well as for housing in the central areas has grown in recent years. Thus, for example, some 70

Table 4.5
Assets and Liabilities of the Mortgage Banks, 1997–99

	End-year balances (NIS million)[a]			Real change (%)		Distribution of balances (%)		
	1997	1998	1999	1998	1999	1997	1998	1999
Cash and deposits in banks	224	257	419	14.9	62.8	0.3	0.3	0.5
Loans to government	679	411	209	–39.4	–49.2	0.9	0.5	0.2
Nondirected credit to the public	61,203	67,273	74,761	9.9	11.1	78.7	79.3	80.4
Loans to construction firms and contractors	3,802	3,257	2,859	–14.3	–12.2	4.9	3.8	3.1
Other loans and assets	11,108	13,650	14,755	22.9	8.1	14.3	16.1	15.9
Total assets	**77,814**	**84,826**	**93,003**	**9.0**	**9.6**	**100.0**	**100.0**	**100.0**
Deposits of the public	40,438	43,006	44,957	6.4	4.5	52.0	50.7	48.3
Deposits from banks	27,489	31,706	37,635	15.3	18.7	35.3	37.4	40.5
Government deposits	890	797	828	–10.4	3.8	1.1	0.9	0.9
Other liabilities	4,643	4,693	4,589	0.1	–1.9	6.0	5.5	4.9
Total liabilities	**73,489**	**80,185**	**88,008**	**9.1**	**9.8**	**94.4**	**94.5**	**94.6**
Equity	4,324	4,641	4,995	7.3	7.6	5.6	5.5	5.4
Total liabilities and equity	**77,814**	**84,826**	**93,003**	**9.0**	**9.6**	**100.0**	**100.0**	**100.0**
Balance of directed credit	**39,901**	**40,201**	**41,117**	**0.8**	**2.3**	**51.3**	**47.4**	**44.2**

[a] At December 1999 prices.
SOURCE: Returns to Supervisor of Banks.

percent of new apartment sales in the private sector in 1999 were of 4–5-room apartments, and most of them were in the central areas. This contrasts with the smaller apartments (3 rooms or less) sold in the first half of the 1990s, and mainly outside the central conurbation, where prices are lower. There is, in addition, a rising trend in the level of construction, which also increases the cost of the average apartment.

Outstanding credit to contractors and construction companies, which includes off-balance-sheet credit, rose slightly. Notwithstanding, outstanding on-balance-sheet credit fell (due to redemptions) by some 12 percent (Table 4.5), continuing the trend of the last few years.[5] The decline is explained by the tightening of criteria for extending credit to contractors by the mortgage banks as well as by the aforementioned fall in building starts.

The amount of credit (directed and nondirected) extended to home-buyers rose during the year, but its share in total outstanding credit remained constant, due to the 17.5 percent

[5] These data do not include off-balance-sheet activity, especially in the framework of guarantees under the Sale (Apartments)(Assurance of Investments of Persons Acquiring Apartments) Law, 5735–1974. Total off-balance-sheet exposure to the construction industry at the end of 1999 was NIS 7 billion.

increase in ‘other credit,’ incorporating credit for all purposes, credit to *kibbutzim* and *moshavim*, and particularly large mortgages (Table 4.4). In the last few years this kind of credit has accounted for a growing share of total credit, reflecting the trend for some customers of mortgage banks to borrow for various purposes using their apartment as collateral. This is partly explained by the expansion of credit, as borrowers who refrained from taking credit in the past because of lack of collateral can now do so. The rise in ‘other credit’ also contributes to the increase in banks’ activity, and the interest on it is generally higher than that on nondirected housing loans.

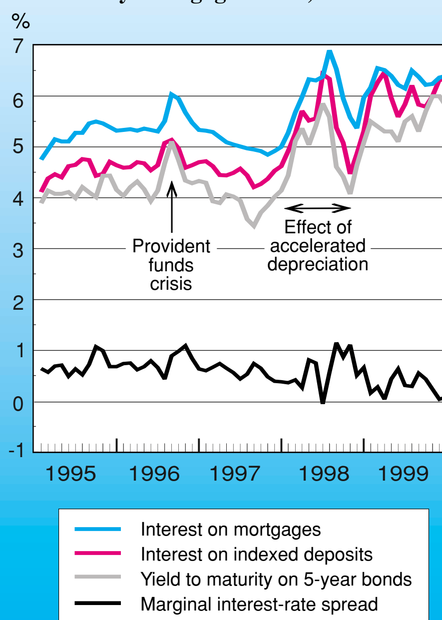
Continuing the trend of recent years, the share of variable-interest nondirected credit (*less* renewed credit) in total credit rose slightly in 1999, and reached 39 percent (Table 4.8). The picture was not uniform, however: in some banks the share of this kind of credit in total credit fell because customers assessed that the relatively high interest on it would persist, and might even rise further.

On the sources side, the trend of the last few years persisted, and the extent of deposits from banks—especially the parent-bank—grew at the expense of deposits of the public. Thus, deposits of the public rose slightly during the year, while deposits from banks surged by 43.3 percent (Table 4.4). The smaller share of deposits of the public in total deposits is attributed to the continuing withdrawals from provident institutions and the regulation restricting the proportion of deposits of each provident fund (which are included in deposits of the public) in a single entity to 5 percent of its total assets. As a result of the moderate increase in the supply of deposits of the public, which in recent years has preferred more liquid and short-term assets, and in view of the more rapid increase in credit, the mortgage banks raised the extra capital they needed to finance their activities from the commercial banks—generally at a higher interest rate. This shift in the composition of sources led to an increase in the share of deposits from banks in total liabilities in the last few years, and it has grown from 35 percent in 1997 to about 41 percent in 1999, at the expense of deposits of the public (including savings schemes), which declined from 52 percent to 48 percent respectively (Table 4.5).

Concerning interest rates, yields on CPI-indexed bonds rose to a ten-year peak of 6 percent. Most of the changes in yields were short-term in nature and were the result of monetary policy, whose main effect is short-term, while yields on long bonds remained stable at between 5 and 5.3 percent. The slope of the yield curve was negative in most months of the year, expressing expectations that the interest rate would fall and explaining to some extent the moderate increase in the share of variable-interest credit. CPI-indexed bonds have a marked effect on the level of interest on the sources of mortgage banks as they constitute a substitute for investment by the public, which operates in this market via institutional investors. The yields on these bonds were influenced primarily by tight monetary policy in 1999 as well as by redemptions from provident funds (net withdrawals of NIS 5.2 billion in spite of the rise in the market value of their assets as a result of the surge in the stock market) and from CPI-indexed savings schemes. These withdrawals led to an increased supply of bonds used to hedge against liabilities to depositors

and savers, thereby causing their yields to rise, mainly in the short term. Consequently, the mortgage banks raised the interest rate on both deposits and mortgages. The interest on total nondirected indexed credit also increased, from 6 percent in 1998 to 6.4 percent in 1999, compared with a rise, from 5.3 to 6 percent, of the interest on total deposits (Figure 4.3). The average interest-rate spread (on all active assets) remained steady at 0.72 percent, similar to its level in 1998. On the other hand, the marginal interest-rate spread between CPI-indexed nondirected housing credit and total CPI-indexed deposits contracted from 0.45 percent in 1998 to 0.25 percent in 1999 (Table 4.8). Note that these data on marginal interest rates are biased downward as they express only the interest rate set when the contract for a variable-interest loan is signed (and is generally lower than the later rate), and do not take into account credit that is not for housing, housing loans extended in nominal local currency, and foreign-currency credit. Consequently, the actual marginal interest-rate spread is higher than that given here, especially in banks where the share of variable-interest credit is relatively high.

Figure 4.3
Interest on Credit Extended and Sources Raised by Mortgage Banks,[a] 1995–99



[a] Credit includes nondirected mortgage credit. Sources include total CPI-indexed deposits of the public and banks.
SOURCE: Returns to Supervisor of Banks.

Alongside mortgage banks, which extend housing loans in accordance with the terms of their license, in recent years other entities which are not mortgage banks (and hence are not included in the tables and figures in this chapter) have entered this field. The commercial banks which have been operating in this sector for several years (Union and Mercantile-Discount banks), whose outstanding housing credit rose by 11 percent in 1999 (about NIS 1.4 billion), have recently been joined by Otsar Hahayal Bank, whose outstanding housing credit was NIS 299 million at the end of 1999. The entry of additional new entities in the future, together with the need for independent mortgage banks to expand their activities into the field of commercial banking (as Bank of Jerusalem, for example, has done), in view of the competition in the sector, may obscure the distinction between commercial and mortgage banks in the future.

Box 4.1
Variable-Interest Loans

In the framework of variable-interest housing loans, the interest rate rises or falls in accordance with a reference rate determined in the contract between the bank and the borrower. There are several kinds of reference rate on the basis of which the interest on these loans may change—the average interest rate published by the Bank of Israel, the interest rate of the lending bank, and the scheduled interest of that bank (the tariff). With regard to the last category, borrowers do not know how it is determined, as it is set solely at the bank's discretion and may be raised unilaterally. A shift of this kind affects primarily veteran customers; consequently, even if the mortgage interest rate in the economy as a whole has not altered at all, veteran borrowers may find themselves having to pay a higher rate than new ones, especially if because of competition the bank inclines to extend reductions to new borrowers (only for the initial period, from the time the loan is taken to the first interest-rate shift). It is important, therefore, to ensure full disclosure of the criteria for changes in the scheduled and effective interest rates throughout the life of a loan extended at variable interest.

c. Business results of mortgage banks

The net profit of the mortgage banks grew by 25 percent in 1999, due mainly to the increase in net interest income. Net interest income before loan-loss provision rose by some 14 percent, and stood at NIS 1,088 million (Table 4.6), as a result of the surge in all the kinds of loans extended in the second half of the year. The price effect was limited, however, because the average interest-rate spread remained stable.

Annual loan-loss provision rose slightly (Table 4.6). Provision for housing credit, which is calculated on the basis of the extent of arrears[6] and is not affected by the bank management's assessment of credit risk, has increased steadily since 1996 as a result of the economic slowdown and high unemployment rate. The ratio of specific annual loan-

[6] The extent of arrears is calculated as the ratio of the accrued balances of arrears (including related payments and interest on arrears) to the last payment made, as registered by the Clearing House (including related payments).

Table 4.6
Main Items in the Profit and Loss Statement of the Mortgage Banks, 1997–99

	End-year balance (NIS million)[a]			Real change from previous year (%)	
	1997	1998	1999	1998	1999
Net interest income before loan-loss provision	1,005	951	1,088	–5.4	14.5
Loan-loss provision	148	212	218	43.2	2.9
Total non-interest income	853	845	877	–1.0	3.8
of which Fee income	819	815	842	–0.4	3.2
Total operating expenses	759	763	801	0.7	5.0
of which Salaries and related expenses	399	395	441	–1.0	11.6
Ordinary before-tax income	951	821	946	–13.7	15.3
Provision for taxes	424	404	424	–4.8	4.9
Net income	**523**	**413**	**517**	**–21.1**	**25.1**

[a] At December 1999 prices.
SOURCE: Published financial statements.

loss provision to outstanding credit at the bank's responsibility has also risen—from only 0.12 percent in 1996 to 0.25 percent in 1999 (Table 4.8). Provision against credit to contractors and construction companies, on the other hand, which is determined on the basis of the management's own considerations, fell in 1999 even though the extent of their arrears rose (from 11 percent in 1998 to 17 percent in 1999).

The additional provision for industry concentration (determined on the basis of the proportion of outstanding credit to a specific industry in total credit at the bank's responsibility) declined significantly, once Discount Mortgage Bank reduced its exposure to the construction and real estate industry, after this had been high in previous years.

The non-interest income of mortgage banks, which grew moderately in 1999, is affected principally by the insurance business—life and home insurance—which accounts for 41 percent of non-interest income, and by collection fees on directed credit, which constitute 37 percent of this income (Table 4.7). Insurance income rose slightly because larger loans were extended in 1999. Non-interest income also increased to some extent because of increased arrears, on which borrowers are fined. The discussion of the legality of mortgage banks' involvement in insurance, and the Supreme Court's ruling on the arrangement with the various supervisory authorities, may impact on the non-interest income—and possibly also on the profits—of the mortgage banks. Furthermore, in July 1999 a new agreement between the government and the mortgage banks concerning the reduction of fees on new loans from state funds went into effect. Under this agreement, which will end in July 2000, collection fees on new loans to eligible persons are reduced from 6.5 to 5.65 percent. The increase in collection fees on loans extended in 1999 to eligible persons is offset by that reduction, so that altogether they rose only marginally (Table 4.7). The

Table 4.7
Distribution of Operating Fees, Other Income, and Operating and Other Expenses of Mortgage Banks, 1997–99

	NIS million[a]			Year-on-year change (%)		Distribution (%)
	1997	1998	1999	1998	1999	1999
Operating fees						
Life insurance fees	196	214	223	9.4	4.2	25.9
House insurance fees	150	132	135	–12.6	2.6	15.7
Government credit commissions	305	311	315	1.9	1.5	36.6
Rent commissions	70	45	48	–35.6	6.9	5.6
Preparation of files	55	65	85	17.4	31.7	9.9
Other	42	46	31	8.9	–33.2	3.6
Total fees and commissions	**819**	**812**	**838**	**–0.8**	**3.1**	**97.2**
Other income						
Provident fund management fees	13	11	12	–17.3	9.5	1.4
Rent	8	7	6	–14.5	–16.6	0.7
Other	10	8	6	–16.0	–25.0	0.7
Total	31	26	24	–17.5	–6.7	2.8
Total non-interest income[b]	**850**	**838**	**862**	**–1.4**	**2.8**	**100.0**
Operating expenses						
Salaries and related expenses	393	386	405	–1.9	4.9	50.5
Amortization and deductions	43	49	45	12.4	–6.9	5.7
Maintenance of buildings and equipment	73	75	74	2.6	–1.3	9.2
Marketing and advertising	45	37	41	–16.5	8.3	5.1
Management fees, related companies	64	62	54	–4.1	–12.2	6.8
Professional services	23	28	25	24.4	–10.8	3.2
Communications	15	18	19	17.6	4.9	2.3
Computers	35	42	46	22.6	8.4	5.7
Business services and insurance	16	16	17	–1.9	5.0	2.1
Other	51	51	76	–0.4	51.1	9.5
Total operating and other expenses	**759**	**763**	**801**	**0.6**	**4.9**	**100.0**

[a] At December 1999 prices.

[b] Including management fees on insurance collected by means of subsidiaries, and salaries paid to employees of these companies. Consequently these figures differ from the summary of the profit and loss statement in Table 4.6.

SOURCE: Published financial statements and returns to Supervisor of Banks.

Ministry of Finance has issued an auction for mortgage banks which will result in a more significant reduction in the fees on government loans to eligible persons in the future.

Income from management fees and the preparation of files has risen by a cumulative 50 percent in the last two years (Table 4.7), and may reflect a price-increase compensating the mortgage banks to some extent for the erosion of their margins and fall in fees and other income in recent years.

Operating and other expenses rose more than non-interest and other income, the most prominent categories being sales and marketing, communications, and information technology (Table 4.7). The increase in sales and marketing, together with the decline in the net interest margin and rise in marketing campaigns, in which framework brand-names have proliferated in the mortgage field in the last few years, apparently indicate increased competition in the sector. Expenditure on information technology rose relatively moderately in comparison with previous years, reflecting the completion of some banks' preparations for the year 2000 (including the solution of Y2K-associated problems) and intensified use of computers, both vis-à-vis customers (expanding the range of on-line transactions) and for internal purposes of increased efficiency and monitoring.

Wages and related expenses, which are the largest component of expenditure, grew by 11.6 percent in 1999, compared with an increase of 3.3 percent in the commercial banks (Table 4.6). On the other hand, the number of employees declined by 1 percent, within the framework of the reorganization and early retirement schemes introduced by some mortgage banks, and several branches were closed as part of the effort to enhance efficiency. The total number of temporary and other employees grew substantially in 1999, as it had in 1998 (a cumulative rise of 45 percent). This may be the result of the wider variety of activities, flexibility in deploying employees in accordance with changing needs, and technological developments requiring skilled workers. The cost of the latter, if they are employed on the basis of personal contracts, is often higher than the average cost of permanent employees. This might partly explain the increase in the number of temporary and other employees compared with the decline in the number of permanent ones, and the rise in the average wage per post (including temporary and other employees) in mortgage banks. Wages and related expenses per post rose from NIS 186,000 in 1998 to NIS 197,000 in 1999—*inter alia* also due to provision against voluntary retirement schemes—compared with an increase from NIS 231,000 in 1998 to NIS 241,000 in 1999 in the commercial banks.

According to several indicators there has been an improvement in operating efficiency, largely as a result of the expansion of activity. The ratio of operating costs to the balance sheet declined from 0.90 percent in 1998 to 0.86 percent in 1999 (Table 4.8). Value added per employee post also rose in 1999, as did the efficiency ratio, which was 2.45, similar to its level in 1996 and 1997.

Due to the increase in net interest income, net profit grew by 25 percent, to stand at NIS 517 million in 1999—reflecting a return on equity (ROE) of 11.2 percent. This represents a rise over 1998, but a decline of over 2 percentage points from 1996 and 1997 (Table 4.8).

Table 4.8
Principal Data on the Mortgage Banks, 1995–99

	1995	1996	1997	1998	1999
Nondirected credit extended during year (NIS million)	13,756	14,931	15,619	13,609	14,602
of which At variable interest (percent)	16.0	32.0	35.0	38.0	38.9
Value added per employee post (NIS '000)[a]	559	640	683	596	638
Percent					
Return on equity (ROE)[b]	12.7	13.6	13.3	9.4	11.2
Efficiency ratio[c]	2.28	2.41	2.45	2.35	2.45
Operating expenses/assets	1.16	1.03	0.97	0.90	0.86
Marginal interest-rate spread[d]	0.69	0.67	0.57	0.45	0.25
Margin on active assets	1.16	1.12	1.16	0.98	1.01
Duration gap[e]		1.5	1.5	1.3	1.2
Loan-loss provision	0.19	0.15	0.19	0.25	0.24
Total arrears[f]	1.47	1.46	1.32	1.42	1.59
To home-buyers	0.86	0.77	0.80	0.83	0.88
To contractors and construction companies	3.44	6.13	6.95	11.04	17.20
Other[g]	4.14	3.71	2.25	2.11	2.17
Risk-weighted capital ratio[g]	11.5	12.0	12.0	10.6	10.6
Deferred liabilities/tier 1 capital	23.9	31.9	36.7	42.5	38.3

[a] 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.

[b] Ratio of net income to capital at the beginning of the year, *plus* offerings weighted by date of issue.

[c] Ratio of total non-interest income *plus* net interest income before loan-loss provision to operating expenses.

[d] The difference between nondirected indexed credit for housing and deposits of the public at banks received during the year.

[e] The weighted gap between the duration of assets and the duration of liabilities in terms of years (Dgap).

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

[g] Reclassified.

SOURCE: Based on published financial statements.

The effect of the increase in net profit and issues of subordinated notes during the year were offset in part by the distribution of dividends, so that total equity grew by 7.6 percent and stood at NIS 5 billion.

d. Risks and capital in the mortgage banks

The economic environment in which the mortgage banks operated in 1999 and assessments regarding the future appear to indicate a rise in the level of business risk. The economic

slowdown—and the high unemployment rate in particular—the shortage of long-term sources, and the entry of additional entities into the sector, which may intensify competition on the uses side, as well as uncertainty regarding income from insurance and collection fees on directed credit, may all lead to a deterioration in the profits of mortgage banks. Consequently, it is understandable that some of them, especially those that are independent, seek to diversify their sources of income by engaging in commercial banking activities.

The continued rise in the extent of credit at the banks' responsibility in total credit and on the balance sheet exposes the banks to greater credit risk (quantity) than in the past. The quality of credit, which is measured by total arrears (including loan-loss provision) *divided by* outstanding credit in the last month, was down from 1998 among both home-owners and contractors and construction companies, as well as in other credit (Table 4.8). This ratio reached its highest level for several years in 1999, and reflects the economic slowdown, increased unemployment rate, and difficulties encountered by real estate developers. Both the specific annual provision against home-buyers and the balance of specific loan-loss provision have risen significantly in the last two years, apparently indicating the deterioration of the quality of the mortgage banks' credit portfolio, but also an increase in the specific provisions intended to remedy this.

The extent of nondirected variable-interest credit rose moderately in 1999, accounting for 39 percent of the total extent of credit, after growing substantially for several years. The main reason for this was the shortage of long-term sources, which forced the mortgage banks to prefer extending loans at variable interest in order to reduce the duration gap. The latter remained stable during 1999 (1.2 years), due to the stability of the duration of assets (4.5 years), of liabilities (3.7 years), and the share of variable-interest loans (Table 4.8). The rate of exposure of net worth to interest-rate risk (assuming early repayment of 3 percent of the portfolio) was about 7 percent in 1999. While extending variable-interest loans reduces the duration gap, it may increase exposure to credit risk as home-buyers' income is not generally adjusted in line with prevailing interest rates. On the other hand, extending loans at variable interest alongside raising sources at variable interest reduces the interest-rate risk involved in early repayment of these loans, which often occurs when the interest rate declines. Note that the rate of early repayment of outstanding credit to home-buyers declined slightly in 1999, and even more so in 1998—apparently due to the rise in mortgage interest in these years.

The new products that have been added in recent years, and serve as an indication of competition, embody various risks. Giving borrowers of variable-interest mortgages the possibility of setting interest without penalty could increase the extent of early repayment if interest rates fall, while the bank will have difficulties raising appropriate sources to hedge against the exposure. Furthermore, increasing the share of deposits from banks—which are less stable than deposits of the public (received via institutions)—in total deposits apparently increases liquidity risk. Extending mortgages in which the principal is paid in full and in a one-off payment at the end of the period exposes the bank to credit risk because of the possibility that the borrower's economic situation will deteriorate near the end of the period. This is particularly the case if the bank has no mechanism for

continually monitoring the flow of repayments which should warn of the worsening of the borrower's financial situation.

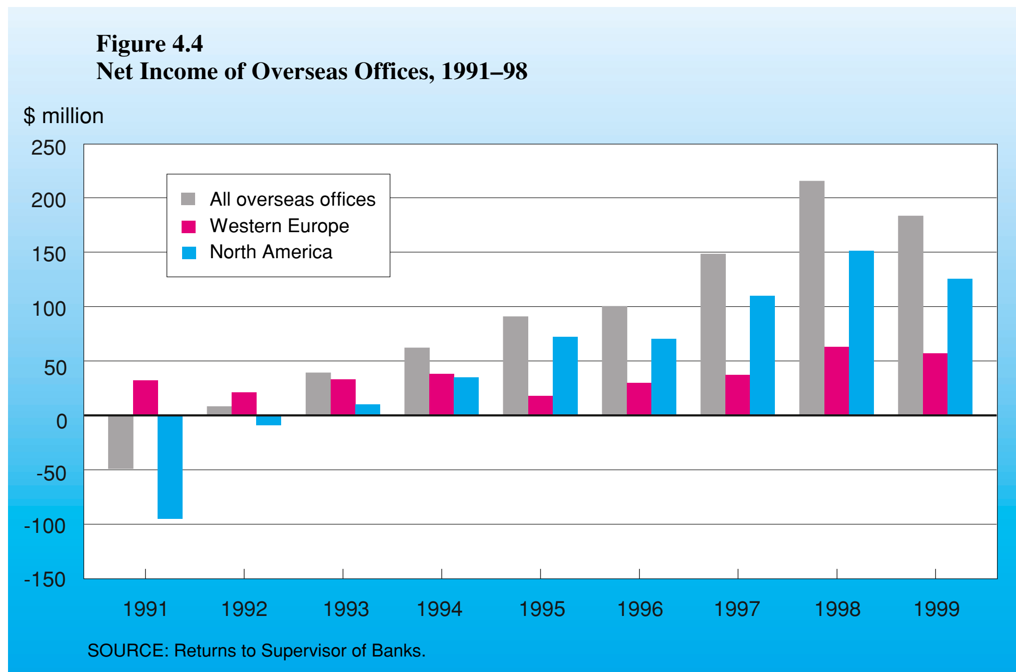
The risk-based capital ratio of the mortgage banks has remained at its 1998 level of 10.8 percent (Table 4.8). The increase in credit at the responsibility of the bank and in dividends paid out served to reduce the minimal capital ratio, while accrued profits and issues of subordinated notes serving as quasi-capital reserve) offset the decline in this ratio. Issues of subordinated notes increase supplementary capital, thereby enlarging the less stable component of equity, as subordinated notes are 'quasi capital,' and expire after a given period. Nonetheless, the ratio of subordinated notes to primary capital declined in 1999, contrary to the trend of the last few years, to stand at 38 percent (Table 4.8).

3. OVERSEAS OFFICES

a. Introduction

The activity abroad of the five major banks is conducted by means of 73 overseas offices, 15 of which are subsidiaries, 20 branches and agencies, and 38 representative offices. The subsidiaries and branches, in which most of the activity is conducted, are situated primarily in the US and western Europe (Switzerland and the UK). The representative offices are distributed more widely, across Germany, Canada, South America, and Australia.

Figure 4.4
Net Income of Overseas Offices, 1991–98



SOURCE: Returns to Supervisor of Banks.

The major banks in Israel maintain branches abroad in order to obtain foreign-currency deposits and provide financial services to the Jewish communities and Israeli customers which are active there, to increase and diversify their activities abroad in the context of the relatively limited banking market in Israel, and to diversify risk on a geographical basis.

The dollar balance sheet of all the overseas offices (subsidiaries and branches) increased by 16 percent in 1999, while net profit shrank by 15 percent, to stand at $ 183 million (Figure 4.4). Return on equity (ROE) on investment in banking subsidiaries abroad was 9 percent in 1999. The contraction of net profit is due mainly to exceptional activities, such as tax refunds and profits from the sale of some overseas offices in 1998, and in fact ordinary before-tax profit rose by 17 percent in 1999.

The overseas offices are influenced *inter alia* by the economic situation in the countries in which they are located, even though some of their activities are not connected with their physical location. In the US, the UK, and Switzerland—the countries in which most of the overseas offices are found—the economic boom and capital-market surge persisted and even intensified. The continued trend of mergers and acquisitions, the permit enabling American banks to engage in activities hitherto forbidden to them, and the development of bank technology (automated branches, branches in supermarkets, and on-line bank services) should improve operating efficiency, on the one hand, while increasing competition in all spheres of banking activity, on the other.

The banks in the US maintained a high level of profitability in 1999 too. The ROE of the banks in the peer group[7] reached a record level of 15.34 percent, as did the ROA (return on assets), which rose to 1.31 percent. Most of the rise in profitability in 1999 was the result of a steep increase in non-interest income, as capital-market activity intensified, compared with a moderate rise in operating expenses.

b. Extent of activity in overseas offices

The extent of the balance sheet of all the overseas offices rose by 16 percent in 1999, reflecting an increase in all balance-sheet items, both in North America and in western Europe (Table 4.9). The balance of assets grew—mainly due to the expansion of deposits in banks and investments in securities—more than in the peer group. The balance sheet of the North American offices grew by more than that of the western European ones (in dollar terms) in 1999, *inter alia* as a result of the strengthening of the dollar against the European currencies, and against the Swiss franc in particular.[8]

[7] The peer group comprised the commercial banks in the US, whose average assets in 1999 were about $ 5 billion, so that the comparison is appropriate mainly for offices operating in the US. The source of the data is FDIC, Quarterly Banking Profile, March 2000.

[8] Because the dollar strengthened against the European currencies, the cash and balance-sheet data of the west European offices, which appear in dollar terms, are an underestimate of data denominated in local currencies. Nonetheless, a large part of the activity of the west European offices is also conducted in dollars.

Table 4.9
Assets, Liabilities, and Spreads of the Overseas Offices, 1998–99

($ million)

	North America			Western Europe			Total		
	1998	1999	Change (%)	1998	1999	Change (%)	1998	1999	Change (%)
Credit to the public	5,783	6,215	7.5	2,814	2,978	5.8	8,699	9,305	7.0
Cash and bank deposits	2,674	3,440	28.6	1,373	1,624	18.3	4,107	5,115	24.5
of which In banks owned by group	507	517	2.0	496	599	20.7	1,051	1,149	9.3
Securities	4,303	5,415	25.8	894	1,092	22.1	5,204	6,513	25.2
Total assets	**13,025**	**15,367**	**18.0**	**5,283**	**5,865**	**11.0**	**18,481**	**21,408**	**15.8**
Deposits of the public	9,182	11,458	24.8	2,735	3,060	11.9	12,051	14,657	21.6
Deposits from banks	2,731	2,338	–14.4	1,481	1,729	16.8	4,238	4,092	–3.4
of which From banks in group	1,789	1,477	–17.4	896	960	7.2	2,708	2,461	–9.1
Total liabilities	**12,253**	**14,594**	**19.1**	**4,730**	**5,332**	**12.7**	**17,148**	**20,094**	**17.2**
Equity	**772**	**773**	**0.2**	**553**	**533**	**–3.6**	**1,333**	**1,314**	**–1.4**
Interest-rate spreads[a] (*percentage points*)									
On: Credit to and deposits of the public	2.98	2.77		1.84	1.86		2.66	2.49	
Cash and deposits in banks in the group	1.34	1.30		–0.14	–0.67		0.67	0.34	
Cash and deposits in banks not in the group	–0.57	0.76		–0.42	–0.02		–0.48	0.39	
Net interest margin on total assets & liabilities (incl. off-balance-sheet items)	**2.15**	**1.77**		**1.86**	**1.60**		**2.06**	**1.73**	

[a] On balance at bank's responsibility.
SOURCE: Returns to Supervisor of Banks.

Credit to the public extended by all the overseas offices rose by 7 percent, continuing the expansionary trend of recent years. This increase is noteworthy in view of the sale and closure of some of the overseas offices in the last few years and the transition to private banking. Nevertheless, the increase in activity vis-à-vis business firms and participation in international syndicates at the expense of retail activity explains part of the growth of credit, as on average commercial loans are larger than retail loans.

The composition of credit in the North American offices differs from that in the west European ones, and it reflects activity of a slightly different nature: in the North American offices most credit is extended to three industries: manufacturing, financial services, and commerce (in that order, together accounting for 65 percent of all credit), while the west European offices extend most of their credit to five categories: financial services, households, commerce, real estate, and manufacturing (together accounting for 82 percent of all credit). The difference in the nature of activity is explained by strategic shifts in the North American offices, namely, an increase in wholesale activity (commercial banking and international syndicates) and in private banking at the expense of labor-intensive and less profitable retail banking, which has caused heavy losses in the past. This trend is expressed in the average extent of credit, which rose from $ 119,000 in 1998 to $ 139,000 in 1999. The west European offices engage in private banking to a greater extent than the North American ones, explaining the high share of credit to households in total credit and the low level of average credit—only $ 62,000 in 1999. This credit, which is often used to fund purchases of securities and other transactions, is merely a supplementary activity to private banking.

Cash and deposits in banks grew by 25 percent in all the overseas offices, in the context of the surge in deposits of the public and relatively moderate rise in the demand for foreign-currency credit in Israel. The additional sources not utilized for extending credit were diverted to deposits in banks and investments in securities.

The extent of the securities portfolio held by the banks in both the North American and west European offices rose by 25 percent in 1999, and it accounted for more than a third of the balance sheet—far more than its share in the peer group (about one fifth of the balance sheet). The increase derived from securities purchases during the year, while the value of the existing portfolio (comprising mainly riskless bonds) was eroded in the wake of the rise in interest rates. The trading assets as well as the available-for-sale assets, whose balance-sheet value is determined by the rates prevailing in the various markets at the end of the year (as opposed to assets held to maturity, whose balance-sheet value is not affected by market fluctuations), account for over three-quarters of the total securities portfolio.

The marked rise in the balance of deposits in banks and of investments in securities in the last few years may indicate a declining trend of yield as well as risk in the overseas offices' assets portfolio; this is because these two uses, which account for a larger share of the credit portfolio than they do in the peer group, are characterized by low yield and risk.

On the sources side, deposits of the public surged, most of the increase being concentrated in the North American offices (Table 4.9). This feature is notable in the

context of the sale and closure of retail offices there in recent years and the relatively moderate growth rate of deposits in the peer group. The contraction of retail banking is also expressed on the sources side: the size of the average deposit in the North American offices has risen from $ 78,000 in 1996 to $ 91,000 in 1999.

The trend in deposits from banks has been mixed. In the west European offices they have risen by 17 percent, while in the North American ones they have fallen by 14 percent (Table 4.9). Since deposits from banks are generally regarded as being supplementary to deposits of the public, which are usually cheaper, these differences may stem from variations between these two regions as regards the public's demand for credit and the supply of deposits from the public. In the North American offices deposits of the public met and even exceeded the public's increased demand for credit, while the moderate rise in deposits of the public in the west European offices obliged the offices to make up the difference from deposits from banks. As on the uses side, the cost of deposits from banks that belong to the same group was not lower on average in 1999 than that of the other sources, so that the group's share in deposits from banks and offices' receipts declined.

The extent of off-balance-sheet activities increased markedly in 1999, and this, together with the use of derivatives, constitute a trend that has been evident for several years and reflects *inter alia* the expansion of private banking and risk-hedging activity—especially against interest and exchange-rate risk, similar to the rise in the peer group. There was a steep increase (49 percent) in the extent of derivatives used to hedge interest rates in all the overseas offices—in view of the interest-rate shifts in Europe and North America. The use of derivatives to hedge against currency speculation fell, however, partly because of the introduction of trading in the euro and the greater resort to it.

The financial margin on total active assets (yielding net interest income, including off-balance-sheet activity) declined in 1999, a trend that has been evident for several years and reflects increased competition in all the regions in which overseas offices operate (Table 4.9).

c. Financial results of overseas offices

The net profit of overseas offices declined from $ 215 million in 1999 to $ 183 million in 1999 (Figure 4.4). This 15 percent reduction, constituting a trend shift from the rise evident since 1991, is the result of the tapering off of two factors not connected with the customary economic activities of the overseas offices, and which made a significant contribution to net profit in 1998, namely, the sale of offices in North America and tax refunds against past losses.

Net interest income before loan-loss provision is a function of the financial margin on total active assets (including off-balance-sheet activity) and the average extent of activity during the year. This income contracted in both the North American and west European offices for the following reasons: (i) greater competition, which served to reduce margins in 1999, as was the case in the peer group; (ii) the increased share of cash and deposits in

banks, the margin on which is relatively low, at the expense of credit to the public, the margin on which is the highest among all uses; (iii) a steep fall in income from investment in securities, which also shrank drastically in the peer group; (iv) the sharp drop in hedging activities and speculation between European currencies by customers in the west European offices after the introduction of the euro, reducing income commissions on financing transactions, which is included in net interest income.

The average balances of active assets rose considerably in the North American offices, compared with a moderate increase in the west European ones. Consequently, net interest income in the North American offices, in which the volume effect exceeded the price effect, grew while in the west European offices, where the price effect was stronger, it declined. Since the North American offices account for a larger share of all overseas offices than the west European ones, the net interest income of all the overseas offices rose.

In line with the uniform development of interest-rate spreads, margins, and the composition of uses in the North American and west European offices, loan-loss provision in all overseas offices fell steeply in 1999 (Table 4.10). The switch to extending credit in the framework of international syndicates to large firms, private banking, and the economic boom in Europe and the US may have enabled the overseas offices to improve the quality of their credit portfolios relative to extending retail credit and credit to small businesses, as was the case in the past. Income from fees and commissions grew markedly in the North American offices, as it did in the peer group. In the west European offices, on the other hand, this item remained stable, despite the surge in the stock markets of the developed countries in 1999 and the commissions-intensive private-banking activity vis-à-vis wealthy individuals that is more characteristic of the west European offices. 'Other income' was affected primarily by the decline in this item in the North American offices of Bank Leumi, after recording one-off profits in 1998.

Salaries and related expenses rose in the North American offices, but fell in the west European ones against the backdrop of the decline in the number of positions in both these regions. The trend of cutting back on personnel reflects increased efficiency, similar to the tendency evident in the peer group and in banks all over the world, and is made possible by technological developments (direct and online banking, etc.). In contrast to this, however, the average salary rose in the North American offices, in light of the tight labor market—which explains the increase in salaries and related expenses there. Annual salaries in west Europe is still higher than that in North America (Table 4.9), reflecting *inter alia* the higher cost of living and average salary in the former, as well as the nature of activity (private banking and foreign trade), which requires the employment of more expert (and therefore more costly) personnel. Nonetheless, as a result of the switch by the North American offices from retail to wholesale and private banking, as well as of the large demand for employees in general and experienced employees in particular, the difference between the average annual salary in the two regions has fallen, from $ 16,000 in 1996 to $ 9,000 in 1999 (Table 4.11).

In the wake of the rise in net interest income, steep drop in loan-loss provision, and relative stability of non-interest and other income as well as in operating and other

Table 4.10
Main Items in the Profit and Loss Statements of the Overseas Offices, 1998–99

($ million)

	North America			Western Europe			Total		
	1998	1999	Change (%)	1998	1999	Change (%)	1998	1999	Change (%)
Net interest income before loan-loss provision	**274.1**	**309.5**	**12.9**	**116.0**	**107.7**	**–7.2**	**395.1**	**421.6**	**6.7**
Loan-loss provision	16.9	8.1	–52.0	2.1	1.4	–32.7	19.4	9.8	–49.4
Operating fees	33.3	37.1	11.4	56.1	56.0	–0.2	91.1	94.9	4.2
Other income	16.8	13.6	–19.0	4.2	1.6	–62.2	21.6	15.7	–27.3
Total non-interest and other income	**50.1**	**50.7**	**1.2**	**60.3**	**57.6**	**–4.5**	**112.7**	**110.6**	**–1.9**
Salaries and related expenses	96.3	100.7	4.6	49.1	47.5	–3.2	147.7	150.6	2.0
Other expenses	59.4	58.9	–0.9	30.0	29.6	–1.5	92.1	91.2	–0.9
Total operating and other expenses	**184.8**	**187.4**	**1.4**	**95.0**	**93.0**	**–2.1**	**285.3**	**286.0**	**0.3**
Ordinary before-tax income	126.9	169.3	33.4	79.3	72.3	–8.8	207.6	242.3	16.7
Provision for taxes	–21.8	43.9	301.1	17.5	17.5	–0.1	–3.9	61.7	1,678.0
Net income	**151.5**	**125.4**	**–17.2**	**62.7**	**57.2**	**–8.8**	**215.3**	**183.1**	**–15.0**

SOURCE: Returns to Supervisor of Banks.

Table 4.11
Principal Data on the Overseas Offices, 1998–99

	North America		Western Europe		Total	
	1997	1998	1997	1998	1997	1998
Total assets ($ million)	13,025	15,367	5,283	5,865	18,481	21,408
Annual salary per post ($ thousand)	68	72	84	81	72	74
Financial coverage ratio[a]	1.48	1.65	1.22	1.16	1.39	1.47
Operating coverage ratio[b]	0.29	0.29	0.64	0.63	0.41	0.41
Efficiency ratio[c]	1.78	1.95	1.86	1.79	1.80	1.88
(percent)						
Credit to public/total assets	44.4	40.4	53.3	50.8	47.1	43.5
Securities/total assets	33.0	35.2	16.9	18.6	28.2	30.4
Return on assets[d] (ROA)	1.4	0.96	1.2	0.98	1.3	0.99
Return on equity[d] (ROE of subsidiaries)	18.0	9.6	12.0	8.1	15.6	8.9
Loan-loss provision/total credit at risk[e]	0.25	0.08	0.06	0.03	0.18	0.07
Problem loans/total credit at risk[e]	1.85	1.54	4.22	2.75	2.66	1.90
Charge-offs/total credit at risk[e]	0.31	0.19	0.11	0.19	0.24	0.18

[a] Net interest income before loan-loss provision/total operating and other expenses.
[b] Non-interest and other income/total operating and other expenses.
[c] Ratio of total non-interest income *plus* net interest income before loan-loss provision to operating expenses.
[d] Net income (including tax credits and extraordinary profits) *divided by* equity/assets at beginning of year.
[e] Including off-balance-sheet items.
SOURCE: Based on returns to Supervisor of Banks.

expenses, the ordinary before-tax income of all the overseas offices grew by about 17 percent (Table 4.10). These developments were expressed in the financing coverage ratio,[9] which rose in the North American offices and fell in the west European ones, as well as in the operating coverage ratio,[10] which remained unchanged in both regions (Table 4.11).

Tax provision in the North American offices rose by some $ 66 million in 1999, after Bank Leumi's North American offices, which posted losses in 1990–94, recorded considerable income against the accrued losses[11] of the last few years. As this income,

[9] Calculated as net interest income before loan-loss provision *divided by* operating and other expenses.

[10] Calculated as non-interest and other income *divided by* operating and other expenses.

[11] In some of the US offices it is intended to organize matters on a different basis (in the framework of REIT funds) in order to reduce the effective tax rate and bring it into line with that paid by other banks operating in the US.

which had enlarged net profit in previous years, had no effect in 1999, net profit was lower than in 1998, and stood at $ 183 million.

The dollar return on assets (ROA) of all the overseas offices also fell, and reached 1 percent, far below that of the peer group—1.31 percent (Table 4.11). ROE (of subsidiaries abroad) also fell, to 8.9 percent—less than that in the peer group, where it was 15.34 percent. These differences indicate that there are gaps between the performance of the overseas offices and of domestic banks operating in the same region.

d. Risks and capital in the overseas offices

The various credit risk indices reveal opposing trends. Regarding the quantity of risk, the share of balance-sheet credit to the public in total assets in the various regions declined, signalling lower credit risk. This derives from the change in the composition of uses, with a marked increase in deposits in banks and securities investments (whose risk exposure is generally low), and a more moderate rise in credit to the public. Since the risk embodied in the latter is greater than in the former, the share of risky assets declined. There was a steep increase in the use of off-balance-sheet derivatives, however, especially of those exposed to credit risk, so that the share of assets exposed to credit risk in total assets (on and off the balance-sheet) rose.

According to indices of credit quality, this appears to have improved in 1999; thus, the ratio of problem credit (excluding credit under special supervision) to total credit at the bank's responsibility, including off-balance-sheet risk, fell in all the overseas offices (Table 4.11). There were similar declines in the ratios of loan-loss provision and charge-offs to total credit in both regions. The closure of some of the offices in North America which had extended bad credit, and the economic boom there and in Europe in the last few years, may have operated to improve the quality of the credit portfolio.

The trend of reducing retail activity in the North American offices, which served to enhance the indices of credit quality in 1999, increased concentration somewhat, according to the extent of large exposure credit: average credit to borrowers taking over $ 8 million rose from $ 18 million in 1998 to $ 19 million in 1999. On the other hand, the reduction in the number of overseas offices and the concentration of their activity in defined segments and one place in which they enjoy a comparative advantage, reduced control risk, which has materialized in the past.

The nostro portfolio of the overseas offices grew substantially. As this portfolio consists primarily of securities not held to maturity, the offices' market risk on this portfolio apparently rose while their liquidity risk fell, as these assets are more liquid than credit extended to the public.

With regard to exchange-rate risk, the policy of the banks in Israel is generally to avoid opening positions on a consolidated basis, so that the exposure to exchange-rate risk is partly hedged by futures and balance-sheet transactions which are expressed in the group's net interest income in Israel (see Chapter 3).

The equity of the subsidiaries abroad fell by 1.4 percent in 1999, to stand at $ 1,314 million at the end of the year. The decline in equity, which is not a common occurrence, is the result of the distribution of dividends despite the decline in profitability, as well as of losses due to available-for-sale securities, which are imputed directly to equity, and of the translation of the equity of the overseas subsidiaries, which operate mainly in Switzerland, from Swiss francs into dollars.

Despite the narrowing of the gap between the return obtained by the overseas offices and by other banks operating in the same countries, and relative to the return on other investments abroad (such as mortgage banks and nonfinancial companies), bank managements must complete the formulation of an extensive long-term policy regarding the activities of their overseas offices. The risks implicit in these activities, and especially the credit failures of the past, exchange-rate risk, and imperfect monitoring and control activities all stress the need for the sound and cautious management of activities and risks in order to avoid repeating the mistakes of the past, particularly at a time of economic slump in the countries in which the overseas offices operate.