

**Israel: Report on the Observance of Standards and Codes—Monetary and  
Financial Policy Transparency, Banking Supervision, Securities Supervision,  
and Payment Systems—Update**

This update to the Report on the Observance of Standards and Codes—Fiscal Sector Modules for Israel was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **February 14, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Israel or the Executive Board of the IMF.

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**Report on the Observance of Standards and Codes  
Israel—Financial Sector Modules: Factual Update**

Prepared by European I and Monetary and Exchange Affairs Departments

February 14, 2003

As part of the IMF's financial sector surveillance work, the 2002 Article IV mission made an update on the facts and regulations underlying the 2000–01 Israel Financial Sector Assessment Program (FSAP) findings, related to the observance of financial sector standards.<sup>1</sup> This factual update provides information on the most relevant changes introduced by the authorities since the FSAP.

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<sup>1</sup>For the details of the findings, see *Israel: Financial Sector Stability Assessment, including the Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency; Banking Supervision; Securities Supervision; and Payment Systems*, IMF Country Report No. 01/140, August 2001. The report is available on the IMF website <http://www.imf.org/external/np/rosc/rosc.asp>.

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## **I. TRANSPARENCY PRACTICES OF THE CENTRAL BANK IN MONETARY POLICY**

### **A. Summary of FSAP Conclusions**

1. The 2000–01 FSAP mission assessed the consistency of monetary policy in Israel with the Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Code) approved by the IMF Executive Board on July 9, 1999 and its three supporting documents. The assessors concluded that Israel fully observed most of the principles in the MFP Code, while there were minor shortcomings related to the clarity of roles, responsibility and objectives of monetary policy. Specifically, the assessors concluded that the inflation target and the exchange rate band raised the possibility of potential policy conflicts and that the need for government approval for the use of some instruments could infringe the *de facto* independence currently enjoyed by the Bank of Israel (BoI). The assessors recommended that a new central bank law be adopted that removes the potential conflict between objectives by clearly stating the BoI's price stability objective, protects the governor from removal over policy disagreements, and provides the BoI with full instrument autonomy.

### **B. Factual Update**

2. No new central bank law has been enacted. An amendment approved by the government in 2002 was sent to the Knesset, but it did not address the current Law's most important problems identified by the FSAP. So far the government has chosen not to bring the amendment to the first reading. There were some proposals by individual members of the Knesset that passed the first reading, but these proposals were cancelled after the Knesset dissolved. Therefore, currently, it is unclear whether any change will be enacted and, if so, what will be the precise nature of the change.

## **II. OBSERVANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

### **A. Summary of FSAP Conclusions**

3. The 2000–01 FSAP mission assessed Israel's compliance with the Basle Core Principles for Effective Banking Supervision. The mission concluded that Israel complied with most of the principles, but material noncompliance was found in the principles related to money laundering and disclosure of supervisory information. With respect to money laundering, a complete stand-alone ROSC was carried out by an MAE mission that visited Israel November–December 2002 and the corresponding report will be issued as a separate document.

4. With respect to information disclosure, Israel was found materially noncompliant because of secrecy provisions that prohibit the BoI from disclosing supervisory information to other supervisors, both domestic and international. Israel was also found not fully compliant in some other areas including: objective, autonomy and powers; loan evaluation and loan loss provisioning; investment criteria; country and transfer risk; remedial measures; and bank management contact.

## B. Factual Update

- (i) On information disclosure. The BoI received irrevocable consent from all the Israeli banks that operate abroad with banking offices to let the BoI disclose to foreign host supervisors supervisory information that is necessary for them to perform effective consolidated supervision. The authority to disclose information to host country supervisors will be enforced via Amendment No.13<sup>2</sup> to the banking ordinance.
- (ii) On loan evaluation and loan loss provisioning. The BoI enhanced the scrutiny over problem loans by requiring a quarterly reporting of the problem loan exposure to be included in the Board of Directors' statement in the financial reports. In addition, a team has been set up internally to devise a methodology for a loan classification based on credit ratings, and its first draft report has been drawn up. The BoI also drafted a position paper regarding the commonly accepted definitions of problem loans based on the practice abroad. In regard to loan security, the BoI has instituted a quarterly reporting requirement of non-recourse loans that are extended in highly leveraged transactions, which includes data on the collateral offered by the borrower.
- (iii) On criteria for investments. The BoI has instituted a requirement that banks report within 7 days an investment in a non-financial company that exceeds 2 percent, and a 45-day pre-notification requirement regarding an investment that exceeds 5 percent, of their capital (cumulative).
- (iv) On country risk. The BoI has recently expanded the disclosure of banks' activity by country distribution in the annual financial reports. A draft report has been drawn up to introduce disclosure of country risk exposure and to incorporate a methodology for managing country risk that is practiced in the United States.
- (v) On bank management contact. The BoI and the Ministry of Finance have proposed an amendment to the banking ordinance which, in the case of banks that have no controlling shareholders, makes the appointment of key positions, including division heads, internal auditors and compliance officers, conditional on the Supervisor of Bank's consent ("fit and proper" test). For banks that have a controlling shareholder, this prerogative will be limited to the directors, CEO and the Chair of the Audit Committee.
- (vi) On operational independence and resources. The BOI and the Ministry of Finance have proposed an amendment (Amendment no.13) to the banking ordinance that will upgrade the BoI's independence twofold. The Governor of the BoI will be

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<sup>2</sup>Amendment No.13 has been approved by the Government but not yet by the Knesset.

empowered to suspend and nullify the votes of shareholders who act without a permit from the BoI when such a permit is required. The Supervisor of Banks will have the authority to dismiss directors, managers and signatory persons if the bank does not undertake corrective action.

### **III. TRANSPARENCY OF BANKING SUPERVISION PRACTICES**

#### **A. Summary of FSAP Conclusions**

5. The 2000–01 FSAP mission assessed the consistency of bank supervisory practices with the MFP Code and its three supporting documents. The FSAP found that Israel was noncompliant with respect to payment system oversight, and recommended that explicit responsibility for the oversight be given to a separate division of the BoI. The FSAP also found less than full compliance in the following areas: clarity of objectives of the Bank Supervision Department (BSD); effective disclosure of relationship between the BSD and other agencies; use of public consultation; disclosure of information on emergency financial support given to banks; existence of explicit exit policies and depositor protection rules; and transparency of information on the expenditure of the BSD.

#### **B. Factual Update**

- (i) On the role of the BoI with respect to payment systems. The Comptroller of the Bank has been made explicitly responsible for the oversight of the payment and settlement systems in Israel.
- (ii) On the existence of explicit exit policies and depositor protection rules. The BoI Governor recently announced his intention to introduce a deposit protection scheme. A special task force in the BoI is studying methodology and practice, and will propose legislative steps for government approval. The framework to be proposed will be similar to the generally accepted one in developed countries. The BoI is also in the process of reviewing exit policies for weak banks.

### **IV. OBSERVANCE OF CPSS DRAFT CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS**

#### **A. Summary of FSAP Conclusions**

6. The 2000–01 FSAP assessed the compliance of the NIS payment system operated by the BoI with the BIS/CPSS Core Principles for Systemically Important Payment Systems (SIPS). The assessors found Israel's observance of the SIPS core principles mixed. They thought that the NIS settlement for various clearing processes involved de facto credit risk for the BoI, because the BoI was unable to check the availability of funds at the moment when it officially or unofficially accepted the outcome of the clearing. Banks seemed to

assume that the BoI accepted the risk. Furthermore, the assessors considered that the BoI had limited its oversight of the payment system to its supervision of banks.

### **B. Factual Update**

7. The Comptroller of the Bank has been made explicitly responsible for the oversight of the payment and settlement systems in Israel. The Comptroller has proposed a two-part reform in the payment and settlement system in Israel. First, the adaptation of the existing systems to international core principles. For this purpose the Governor appointed four teams, which examined the disadvantages of and required adjustments to the existing clearing systems. Their report was submitted to the Governor in August 2002. Second, the establishment of a new settlement system of the RTGS type. According to the Action Plan that was approved by the Governor, the new system will start working in 2006.

## **V. OBSERVANCE OF IOSCO PRINCIPLES OF SECURITIES SUPERVISION**

### **A. Summary of FSAP Conclusions**

8. The assessment was based on the Principles of Securities Regulation adopted by IOSCO in September 1998. The assessors found most of the principles fully implemented. However, inadequate implementation was found in the following areas: regulators should have authority to share information with domestic and foreign counterparts; regulators should establish information sharing mechanisms with domestic and foreign counterparts; there should be initial and ongoing prudential requirements for market intermediaries that reflect their risk; and market intermediaries should be required to comply with standards for internal organization and operation conduct that aim to protect the interest of clients.

### **B. Factual Update**

- (i) On information sharing and cooperation among supervisors. Coordination and information sharing among agencies have not been implemented formally. However, in recent months there seems to be an increasing collaboration among the Israeli Securities Authority (ISA), the BoI and the Tel Aviv Stock Exchange (TASE) regarding the financial stability of, primarily but not exclusively, the TASE members.

An MOU was signed with the U.S. Securities and Exchange Commission (SEC). The Government of Israel and the ISA are close to signing an MOU with the Government of France and the French Banking and Finance Commission (CBF).

The ISA has not yet considered signing other MOUs nor has it considered signing the multilateral MOU offered to all members of IOSCO.

- (ii) On prudential requirements for market intermediaries. During the last few months, the ISA has taken an initiative that requires the TASE to take extra steps aimed at monitoring the market, especially the financial stability of its members. A new amendment to the Securities Law has been implemented that is aimed at facilitating an enhancement of the ISA's enforcement powers. However, no new prudential requirements have been introduced with respect to derivatives trading.

## **VI. TRANSPARENCY OF SECURITIES SUPERVISION POLICIES**

### **A. Summary of FSAP Conclusions**

9. The assessment was based on the MFP Code and its three supporting documents. While the assessors considered many of the principles observed, they thought that the requirement that securities supervision agencies should establish and maintain public information services was not met. They also found less than full observance in the following areas; the relationship between securities supervision and other financial agencies should be publicly disclosed; the conduct of policies by security supervision agencies should be transparent and clear to the public; significant changes in policies should be announced and explained in a timely manner; agencies should issue a periodic report on the major developments of the sector; agencies should ensure timely public reporting of aggregate data under their jurisdictional responsibilities; laws and regulation should be publicly available.

### **B. Factual Update**

10. The ISA improved its website. It now provides a general description of, as well as detailed information about, the ISA's activities. It publishes the decisions of the ISA and research related information. The ISA spokesperson is now responsible for making all of the ISA decisions transparent to the general public.

## **VII. OBSERVANCE OF IAIS CORE PRINCIPLES OF INSURANCE SUPERVISION**

### **A. Summary of FSAP Conclusions**

11. The assessment was based on the draft Insurance Core Principles Methodology dated June 24, 2000 of the International Association of Insurance Supervisors (IAIS). The assessors found Israel's observance of the IAIS core principles mixed. Material nonobservance was found with respect to the following principles: coordination and cooperation among supervisors; corporate governance (the insurance supervisors in Israel do not have the authority to require boards of directors to have in place risk management functions); internal controls (the insurance supervisors in Israel do not have the authority to require directors to exercise internal controls on organizational matters, make specific requirements of the audit function, and provide suitable prudential oversight); cross-border operations (the licensing process does not require consultation with the insurance supervisor of a parent insurer in another jurisdiction). Moreover, the following principles were found to be less than fully



observed: organization (including the need to strengthen the supervisors' life insurance actuarial skills); licensing; prudential rules and liabilities; capital adequacy and solvency; derivatives and off balance principles; on-site inspection and access to information.

## **B. Factual Update**

12. The Insurance Commissioner's Office recently released a position paper for public comment: "The Role of the Appointed Actuary of an Israeli Insurer, and Qualification Requirements for Israeli Actuaries—Proposed Principles of Legislation, Regulation and Standards of Professional Practice." This paper is a first step to address many of the issues related to the IAIS principles that were found to be less than fully observed by the FSAP. Specifically,

- (i) On corporate governance.
  - The paper proposed rules on the appointment of the actuary by the board of directors. According to the Commissioner's Office, this rule seeks to recognize the fact that the actuary has duties for which the board is responsible and which may conflict with some of the responsibilities of senior managers, such as how to balance risks and returns.
  - The paper discussed the advisory role of the actuary. This role would require the board to receive regular advice concerning the risk management of the insurer.
- (ii) On internal controls. The paper on the role of the actuary discussed rules that, according to the Commissioner's Office, intend to enhance internal oversight. Specifically, the rules cover: the role of the appointed actuary in the valuation and reporting of insurer liabilities; monitoring and reporting by the appointed actuary of the financial conditions of the insurer by means of dynamic capital adequacy testing; the right of the appointed actuary to receive the information he/she requires; and his/her obligation to report problems affecting financial conditions to senior management.
- (iii) On prudential rules and liabilities. The paper on the role of the actuary discussed the qualification requirements for the actuary, including education, professional experience, and continuing professional development; professional discipline; and the supporting standards for professional practice. In addition, the Commissioner's Office indicated that they expect that the valuation and advisory roles described above will induce the actuarial profession to develop formal technical guidelines for establishing insurance policy liabilities. Such guidelines would have the force of law, except where overridden by Insurance Commissioner directives.

- (iv) On-site inspection and access to information. The paper on the role of the actuary also discussed the content of annual reports to be submitted to the Insurance Commissioner, including the statement of actuarial opinion. According to the Commissioner's Office, these reports would describe the process by which reserves are determined and would indicate the extent to which the appointed actuary is well versed in recent industry developments. The Commissioner's Office expects that these reports would support a more formal risk-based approach to supervision and onsite inspection.

Other developments related to the IAIS principles were as follows:

- (i) On derivatives and off-balance sheet items. Since April 2001, investment regulations for insurance companies have included prudential restrictions on the use of derivatives and other off-balance sheet items.
- (ii) On coordination and cooperation. The authorities have made steps to introduce changes to the Israeli insurance legislation that would permit mutual assistance agreements with regulatory authorities in other countries. According to the Commissioner's Office, such agreements would enable cooperation between the Israeli Insurance Commission and foreign regulators on insurance-related legal violations. The changes in legislation await final approval by the Knesset.
- (iii) On prudential rules and liabilities. In March 2001, the minimum capital requirements were amended. The most significant change was the elimination of the capital ceiling, previously set at approximately NIS 100 million. In some cases, the changes in regulation doubled the minimum required capital.

A recent Insurance Commissioner regulation requires the appointment, by each insurer, of an actuary to certify the non-life reserves. Draft regulations have been prepared that require a build-up of minimum reserves against the exposure to catastrophes resulting from natural disasters (primarily earthquake exposure) and new levels of minimum reserves against the life insurance exposure to major disasters (war, epidemic, etc.)

- (iv) On on-site inspection and access to information. The Insurance Commissioner's Office is interested in developing a more formal risk-based approach to insurance supervision. To that end, the chief actuary recently completed a three-day training visit to the Canadian Office of the Superintendent of Financial Institutions.

## **VIII. TRANSPARENCY OF INSURANCE AND PENSION SUPERVISION POLICIES**

### **A. Summary of FSAP Conclusions**

13. The assessment was based on the MFP Code and its three supporting documents. The assessors found most of the principles fully observed, but they considered the observance of the following principles as not fully satisfactory: clarity of roles (no objectives for the supervisors are specified in the insurance law and, in the case of pension funds, the historical roles of the supervisors have not been to ensure solvency); public availability of information (there is not enough information for less sophisticated users); the relationship between insurance and pension supervision and other financial agencies (the relationship of supervisors should be clarified in legislation).

### **B. Factual Update**

14. No changes have been introduced with respect to this assessment.