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**Israel: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on the following topics:
Monetary and Financial Policy Transparency; Banking Supervision; Securities
Supervision; and Payments Systems**

The Financial System Stability Assessment on Israel was prepared by a staff team of the International Monetary Fund and the World Bank 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 July 11, 2001. 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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ISRAEL

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Stefan Ingves and Michael Deppler

July 11, 2001

This Financial System Stability Assessment is based on work under the joint IMF/World Bank Financial Sector Assessment Program (FSAP). An IMF-led mission visited Jerusalem and Tel Aviv from September 5–19, 2000. The mission held discussions with the Governor David Klein and management and staff of the Bank of Israel (BOI); Commissioner of Insurance Ms. Tsipi Samet, and management and staff at the Ministry of Finance (MOF); Chairwoman Miri Katz, and staff of the Israel Securities Authority (ISA); staff in charge of risk management in the five largest bank groups; and officials of several insurance companies, mutual funds, pension funds, KPMG Somekh Chaikin, Israel Association of Actuaries, and Maalot Rating Company. The findings and analysis of the mission were discussed and banking sector data updated during the Article IV mission in May 2001. The FSSA report is presented in two parts: Staff Report on Financial Sector Issues and Observance of Financial System Standards.

The FSAP team was led by Warren Coats (MAE), and included Liliana Schumacher, Mark Stone, Charmion O'Connor (administrative assistant), and Vanya Etropolska (research assistant) (all IMF/MAE); Mario Mesquita (IMF/EU1); Rodney Lester and Melinda Roth-Alexandrowicz (both World Bank); and the following consultants: Wayne Byres (Australian Prudential Regulation Authority); Mark Robson (Bank of England), Simon Kappelhof (De Nederlandsche Bank), and Göran Lind (Sveriges Riksbank). Gil Mehrez (EUI) participated in the Article IV discussions of the report.

The financial system in Israel is robust and not prone to major vulnerabilities that could endanger macroeconomic stability. The mission identified some areas for improvement in the supervision of the bank and nonbank financial sectors, which are particularly needed in the design and oversight of the major payment systems.

The principal authors of this report are: Warren Coats, Liliana Schumacher, and Mark R. Stone. World Bank staff also contributed to both sections of the report.

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GLOSSARY

BCC:	Banks' Clearing Center
BCHC:	Banks' Clearing House Committee
BCH:	Banks Clearing House
BLL:	Banking (Licensing) Law 1981
BMI:	Bodily Injury Automobile Insurance
BO:	Banking Ordinance 1941
BOI:	Bank of Israel
BOI Law:	Bank of Israel Law
BSD:	Bank Supervisory Department
CFI:	The Commissioner for Insurance
CMIS:	Capital Markets, Insurance, and Savings Division of the MOF
EET:	Refers to a tax structure in which contributions, investment income and benefits (in that order) are not taxed.
FATF:	Financial Action Task Force on Money Laundering
IAIS:	International Association of Insurance Supervisors
ISA:	Israel Securities Authority
LTCM:	Long-Term Capital Management
LVTS:	Large-Value Transfer System
Makam:	Government securities used for monetary control
MBI:	Motor Bodily Injury insurance
MOF:	Ministry of Finance
n.a:	Not Available
NIS:	New Israeli Shekel
NPLs:	Nonperforming loans
OTC:	Over-the-counter (trading)
POS:	Point of sale
TACT:	Tel Aviv Continuous Trading
ROA:	Rate of return on assets
ROE:	Rate of return on equity
RTGS:	Real-Time Gross Settlement system
SIPS:	Core Principles for Systemically Important Payment Systems
SOB:	Supervisor of Banks
TASE:	Tel Aviv Stock Exchange

SECTION I: STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. OVERVIEW OF CURRENT VULNERABILITIES AND ISSUES

- 1. Until the slowdown in late 2000, the Israeli financial system had been growing strongly in the wake of a twin process of disinflation and structural transformation that started in the mid-1980s and intensified in the last decade.** Inflation has declined to rates similar to those observed in other advanced economies; large banks have been privatized; directed credit has been phased out; and most restrictions on international capital mobility have been lifted. Completion and consolidation of these reforms should follow.
- 2. These achievements reflect the determination of recent government administrations and the Bank of Israel (BOI) to obtain and preserve a stable currency and macroeconomic environment, in addition to deepening the financial sector.** The BOI in particular has led the quest for stable prices. Actual practice has been more successful than the laws on which it has been based. In the long run, this is a weakness in the system that needs to be addressed. Financial deepening has been driven by stabilization and liberalization. Deeper financial markets also bring new risks for financial intermediaries, and additional challenges for the various supervisory authorities.
- 3. The Israeli financial sector satisfactorily provides most of the economy's financial services and product needs.** Financial assets have grown to about 240 percent of GDP, divided about equally between claims on banks, institutional investors (insurance and pension funds), and equities (which have grown rapidly in importance in recent years). However, the development of financial markets is unbalanced, in part because of the large role of the state in underwriting insurance and pension fund risks (with nontradable, indexed government bonds) and of banks in providing corporate financing and liquidity management. First, bank concentration and control of the financial sector is high and foreign bank presence is quite low. Second, capital market development is uneven: equity and derivative markets are well developed, whereas corporate bond and money markets are nearly nonexistent.
- 4. The authorities have been concerned with bank concentration.** Though banks are rather concentrated and dominate many financial services that might have developed elsewhere, the FSAP team found little evidence of monopoly market power, and did not believe that further specific measures to restrict banks (other than for prudential reasons) were justified. The team felt that policy should aim at a level playing field and removing barriers to the development of other financial products. The recent entry of two foreign banks is very welcome. A rationalization of the tax regime as it relates to savings and collective investments will also be needed to support long-term savings and hence economic growth, and financial sector development. In fact, bank profit margins have been squeezed in recent years, which may force the consolidation or exit of some smaller, less efficient banks. The BOI will need to develop efficient exit mechanisms.

5. **Israel's primary macroeconomic risks arise from the uncertainties over security issues.** Its next most important potential risk is that progress in reducing its high public sector debt in recent years could be reversed if the government's budget deficit and social programs are not kept under tight control. Most important in this regard are its implicit and explicit commitments under older pension plans and the unfinished work to properly define the financial structure of new pension programs (see paragraphs 13 and 14).

6. **The FSAP team found no major systemic weaknesses in the banking system.** Israeli banks are conservative in their management of risks and banking supervision by the Bank of Israel is strong. Based on estimates of losses from potential shocks (stress tests) calculated by the BOI, the banks themselves, and the team, Israeli banks seem to have sufficient capital (in the Basel sense) to cover potential losses due to credit and market risks (i.e., inflation, currency and interest rate risks).

7. **Credit risk is, by far, the main source of risk for Israeli banks.** However, like most banks in the world, the methodology and technology used by Israeli banks and by the BOI to measure market risk is more advanced than the methodology and the technology used to measure credit risk. Israeli banks are aware of this gap and are making efforts to refine their credit risk procedures and to link market and credit risk assessments in an integrated framework. In general, however, banks have conservative credit exposures and risk management guidelines.

8. **The BOI plays a key role in liquidity management and absorbing liquidity shocks owing to the uneven development of financial markets.** Banks maintain adequate domestic and foreign currency liquidity to cover even large unexpected withdrawals. External public sector debt is modest and declining as a share of GDP. Foreign currency liquidity management is somewhat constrained by remaining capital controls, which should be gradually phased out. However, money and interbank markets, as well as securities markets more generally, are thin and illiquid, and thus financial institutions rely on actions of the BOI for liquidity management. The uneven development of financial markets makes it likely that significant portfolio shifts or other shocks to the economy would result in larger interest rate and/or exchange rate fluctuations than otherwise. The BOI appears to have the instruments and the experience in using them to contain liquidity shocks and to preserve the smooth functioning of Israel's financial markets under foreseeable circumstances.

9. **However, the design of the BOI's policy instruments could be improved.** Secondary money and securities market development and the transmission of monetary policy could be strengthened by switching from deposit auctions to repos and reducing the frequency of market interventions. Refinements in the reserve requirement and the BOI's standing (lending and deposit) facilities would serve the same purpose.

10. **Payment systems are not adequately supervised and interbank payments are organized on the presumption that the BOI would cover the risk of any bank failing to settle.** The BOI has recognized these weaknesses, and has taken positive initial steps to address them. The Bank intends to develop a Large-Value Transfer System (LVTS) and has

already established a payment system oversight function in the Comptrollers Office. It is also discussing with the banks in the system the establishment of a National Payments Council to advise on this and other payment systems. While it is laudable that BOI now recognizes the inherent risks of payment systems, the Central Bank must realize that the experience of other countries suggests these risks could nevertheless persist for a long time to come until a new system is in place.

11. **Crisis management capabilities are generally strong, but there is no deposit insurance scheme in place; also, a moral hazard problem is implicit in a banking system with a history of consistent bailouts of problem institutions.** The existing legal provisions for bank exit are not adequate. A new modern banking law that incorporates provisions for the administrative take over and resolution of insolvent banks or of banks that for whatever reason have their licenses revoked would improve crisis management and address the moral hazard problem inherent in the present system.

12. **Transparency is reasonably high throughout the Israeli banking system, but there are important areas that warrant improvement.** Excessive secrecy provisions constrain cooperation and coordination among regulators. The prohibition on any disclosure of lender-of-last-resort (LOLR) activity reduces the BOI's accountability for its use. The lack of public information in securities industry regulation could inhibit market development. Finally, the conditions for dismissal of the BOI governor are unclear.

13. **The insurance and pensions sectors are well developed but their growth and forms have been heavily influenced by past communitarian approaches.** Both sectors now face significant transition issues as a more disciplined and market-oriented economy emerges. In particular, the private pension system is based on a multi-employer model and is dominated by union fund managers whom in the past had close links to the government. Until new plans were introduced in 1995, private pensions had never been fully funded. The pre-1995 plans are currently showing a sizable actuarial deficit: at least one major fund is illiquid and suffering from negative cash flows. The public sector pension system is unfunded and has accumulated substantial liabilities. While economic and demographic factors are not currently a problem, there is a concern that pension increases can be too easily traded off for wage increases, thus leading to generational inequity and future fiscal strains. As with the pension system, there is a need to support the desire of the Ministry of Finance (MOF) to liberalize the investment rules (in parallel with strengthened supervision and governance) both in the interests of policyholders and to encourage the development of securities markets.

14. **The capital market challenge is to add breadth, depth, and liquidity to the Israeli markets.** On the demand side, the Tel Aviv Stock Exchange (TASE) should actively market itself as a world-class emerging market in order to attract portfolio investment. The internet revolution (and a growing economy with increased domestic savings) should help Israel to increase retail investor participation. Domestic institutional investors, addressed above, should develop a stronger presence on the domestic market. Regarding the supply side of securities, the TASE should also continue to attract local high tech companies, perhaps as a

stepping stone to the NASDAQ exchange. The revised regulations should allow the TASE to encourage future growth companies to list. However, given the general international globalization of markets, the TASE may wish to consider a merger or joint venture with other exchange(s) in order to not become marginalized.

15. All key financial sector activities except payment systems are satisfactorily supervised, though coordination among sectors should be improved. The structure of supervision might be improved by consolidating the supervision of all collective investment schemes in the Israeli Securities Authority (ISA), thus moving supervision of nonretirement-related provident funds from the MOF to the ISA. The most significant shortcoming and source of risk in the coordination of supervision arises from the legal restrictions on the ability of supervisors to share information on individual firms and financial conglomerates. This is a serious weakness.

16. The team made a number of recommendations to cover some shortfalls from best practice and to strengthen the soundness and efficiency of the financial system. These are briefly summarized in Box 1.

Box 1. Summary of Recommendations

To the Bank of Israel:

Monetary Policy

- adjust the design and use of monetary policy instruments to improve the implementation of monetary policy and to boost money market development (standing facilities, reserve requirement, open market operations)

Banking supervision and policies

- allow banks to broaden scope but with prudential and customer protection restrictions
- improve bank reporting on collateral
- encourage banks to adopt uniform credit rating categories
- adopt explicit deposit insurance

Payment system

- establish clear BOI oversight of payment systems
- develop a LVTS compliant with the Core Principles
- establish a National Payments Council

To the Ministry of Finance:

Securities

- remove limits on issuance of "Makam" monetary policy bills

Capital controls

- phase out remaining controls

Insurance and pension supervision

- transfer supervision of provident funds for short to medium term savings to ISA
- phase out use of non-tradable fixed real return government securities and liberalize investment options
- strengthen supervision staff and capabilities
- give Commissioner of insurance more independence and more flexible intervention powers
- separate the governance overview and management of pension funds

To the Israel Securities Authority:

- obtain the authority to impose civil sanctions
- stop providing financial support for class action suits

To the Government:

- establish a council to coordinate financial sector supervision
- relevant laws should be amended to allow sharing of supervisory information among supervisors
- adopt tax reforms leveling the playing field in financial instruments
- strengthen BOI independence and accountability by adopting a new central bank law that reflects

Mastricht principles as recommended by the Levin Committee report of December 1998

- strengthen legal basis of banking supervision and bank exit
- adopt a modern payment law

II. OVERVIEW OF THE ISRAELI FINANCIAL SYSTEM AND MACROPRUDENTIAL ENVIRONMENT

A. Main Characteristics of the Financial System

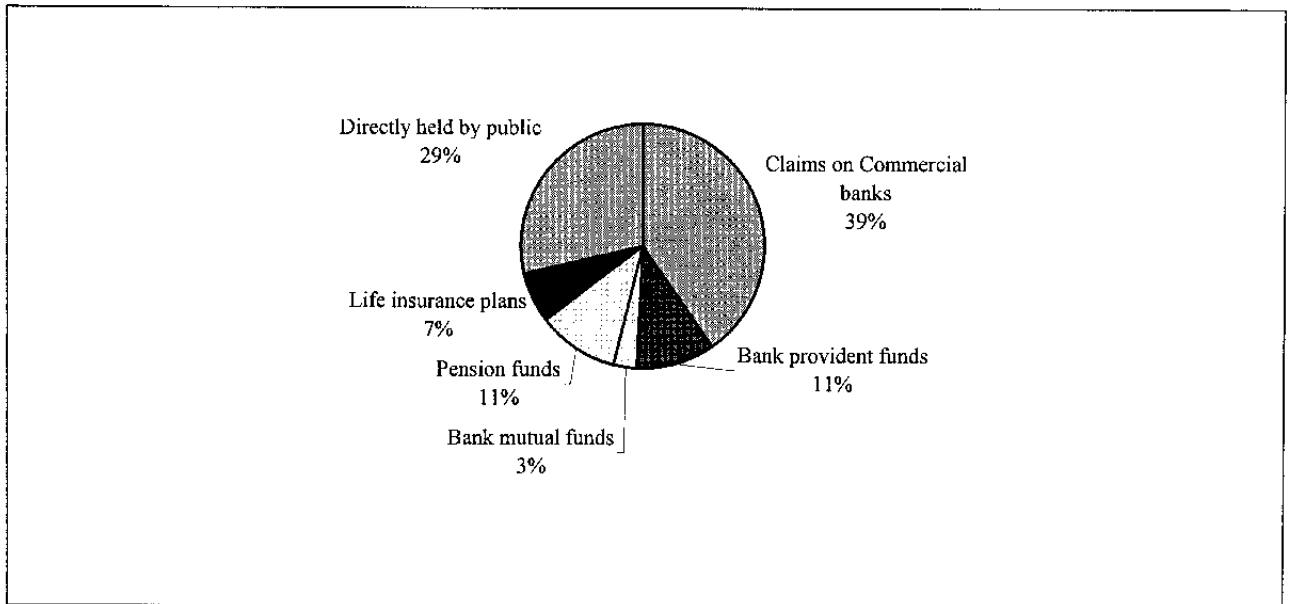
17. **In addition to fast growth, the 1980s and 1990s were a period of intense structural changes, as Israel evolved from a state-led, high inflation economy toward an increasingly market-oriented and stable economy.** In the financial sector, the most important changes included: abolition of quantitative credit ceilings, maturity restrictions, and special credit arrangements; the reduction of reserve requirements from very high levels; liberalization of foreign exchange controls; and, privatization of government-owned banks. The reform effort also helped improve development of the stock market and some derivative markets.

18. **The amount of financial assets held by the public has increased and their composition has shifted in response to policies and exogenous shocks during the 1990s.** At the end of 1999, the financial assets of the public were equivalent to 237 percent of GDP. Several factors have been behind financial deepening—disinflation, the series of financial reforms initiated in 1988, the surge of immigration in the mid-1990s, rapid economic development, and, more recently, the surging stock market. Disinflation has sharply reduced the share of total financial assets indexed to the CPI from 73 percent of total assets in 1989 to 39 percent in 1999. The share of assets indexed to foreign currency remains about 10 percent of total assets.

19. **Five banks dominate the financial sector.** Banks control the majority of financial sector assets, either directly or indirectly through their management of provident funds and mutual funds (Figure 1). The presence of foreign banks is relatively small in Israel. While banks are permitted to engage in a very wide range of financial activities, they are subject to a few restrictions as a result of the government's concerns over the high degree of bank concentration. The size of Israel's banking sector measured by broad money to GDP is higher than comparable countries, while bank credit to GDP is somewhat lower than in comparable countries.¹

¹ The comparable countries are: Austria, Belgium, Chile, Denmark, Finland, Greece, Iceland, New Zealand, Portugal, and Sweden.

Figure 1. Israel: Institutional Composition of Assets Held by the Public, 1999



Sources: Bank of Israel; and staff estimates.

20. **While claims on banks accounted for 39 percent of all financial assets held by the public at the end of 1999, institutional investors provided about a quarter of these financial assets, down from half in 1990, reflecting the growing role of equities.** The equity market in Israel is quite developed: capitalization rose to 62 percent of GDP as of end-1999 from 38 percent three years earlier. This is in line with the surging high technology sector and opening of the capital account. A major change in the last five years is the dramatic increase in the number of firms—mostly of the high tech variety—that raised capital abroad in the United States and Europe. Pension funds accounted for 11 percent of institutional investor products and are invested mostly in nontradable, indexed government bonds with a guaranteed rate of real return, which enjoy substantial tax benefits. About half of total insurance industry assets is in dedicated to earmarked bonds, which are subject to relatively strict investment rules. Mutual funds' share of financial assets rose to 3 percent in 1999. In addition, tax incentives are provided for several "long-term" household savings schemes held at banks.

21. **Financial markets in Israel are unbalanced, however.** A wide variety of non-tradable guaranteed-return and tradable government securities dominate the fixed income markets, while corporate bond markets are barely developed at this point. No municipal bonds are traded, nor are there proper markets for short-term uncollateralized loans (other than interbank transactions), repos, or commercial paper. In contrast, a wide variety of

derivative instruments are available in Israel, largely provided by banks, and turnover in derivatives is growing steadily.

22. **The design and use of monetary policy instruments and of the large-value transfer system (LVTS) by which interbank payments are made have undercut the development of the money market.** The lack of money markets seems to reflect the ease with which banks can manage liquidity within the BOI's facilities and primary markets for government securities, the thin secondary bond market, which precludes development of a repo market, and the dependence of corporations on banks for their financing and liquidity management. The FSAP team recommended making adjustments to the design and implementation of monetary policy instruments both to improve the implementation of monetary policy and to boost money market development.

23. **Because the authorities' concern regarding the high degree of bank concentration,² they have restricted a number of banks' activities in an effort to reduce their influence over the industry.** In 1985, a financial reform created firewalls between the areas of underwriting, fund management, and commercial banking activities. Israeli banks can enter the areas of securities underwriting and trading through bank subsidiaries. However, they can neither underwrite nor distribute insurance except in the case of fire insurance related to mortgages, in which case they can act as an agent for an insurance company. Banks may not own more than 20 percent of a nonfinancial entity which an insurance company is designated.

24. **The high degree of bank concentration and unbalanced financial market developments raises two policy questions.** First, what explains Israel's unusual financial structure (large equity market development and lack of a debt market), and are there policy measures that can be taken to address any shortfalls? Second, does the high degree of bank concentration impair the financial sector from providing its proper functions to a degree that warrants a policy response?

25. **The view of the FSAP team was that the unusual financial structure primarily reflects tax incentives and guaranteed-return government bonds.** There are numerous tax incentives that are aimed at boosting savings for retirement and education or that tax different financial assets differently. Some of these measures have encouraged the public to save in banks rather than more directly in market instruments. Guaranteed-return government bonds are aimed at enhancing the security of retirement savings; however, these bonds are having an adverse impact on the broad functioning of the financial system. By limiting the participation of pension funds and insurers in secondary capital markets, they undermine their development. In addition, the guaranteed rates of return discourage the development by

² Although the degree of concentration in Israel's banking industry has declined recently, it is still high—the Herfindahl Index (H-Index) is about 0.22 percent, one of the highest among industrialized countries, according to the Bank of Israel, *Israel's Banking System*, 1998).

institutional investors and households of portfolios designed to manage risk, which thus falls on government and is larger than optimal.

26. **The team felt that the high degree of bank concentration does not impair the financial sector from providing its proper functions to a degree that warrants a direct policy response.** The team found no evidence of market power that could thwart the development of alternative instruments and markets. Equity markets are providing an increased share of corporate financing. Bank margins are low. Moreover, two foreign banks recently established branches in Israel. Thus, the threats posed by a large concentration of bank assets are waning naturally. This evolution implies that a policy response may not be needed. At the same time, banks' important role in derivative markets are providing new risk management services. Further, the team's assessment was that all important financial functions are provided, although there are also distortions that reduce the efficiency of the financial sector that cannot be addressed by regulations aimed at directly limiting bank activities.

27. **The most effective approaches to removing potential costs of bank assets concentration would be to remove impediments to the development of other markets.** Reforms of the tax system and of the government's past approach to social safety net concerns, the elimination of guaranteed return government bonds and the further liberalization of the capital account, all of which are justified more generally, should be sufficient for this purpose.

28. **While Israeli banks have made important gains, from product expansion (e.g., insurance underwriting) owing to economies of scale and scope and synergies, there are prudential concerns and customer protection issues that should be addressed by the regulators.** In order to counteract the potential negative impact of nonbank activities undertaken by banking groups on bank soundness, and to avoid conflicts of interests, the team suggested the following measures:

- a. New nonbank activities should be undertaken by bank subsidiaries and not directly by the banks.
- b. Minimum capital requirements should be established on the nonbank affiliate, the bank, and the consolidated entity.
- c. Transfers from banks to nonbank companies in the same conglomerate should be carefully monitored.
- d. Nonbank affiliates should choose a name, location and management that allows them to be distinguished from the bank affiliate in order to avoid contagion issues in case of the failure of a nonbank affiliate.
- e. Customers should be given the opportunity to review at a later date (and cancel at no cost) their decisions regarding purchases of nonbank services made in the course of a related bank transaction.

B. Regulatory Framework

29. **There are three major financial sector supervisory authorities in Israel, the Banking Supervisory Department (BSD) at the BOI, the Israel Securities Authority (ISA) and the Capital Markets, Insurance and Savings Department of the Ministry of Finance, which includes the Commissioner for Insurance (CFI).**

30. **The BSD of the BOI is responsible for the soundness of individual Israeli banks, and the banking system as a whole.** The ISA is responsible for the oversight of capital markets, particularly the stock exchange, and the supervision of mutual funds, brokers, securities firms, investment advisors and portfolio managers. The CFI is responsible for, among other things, the supervision of insurance (both life and general), pension funds and provident funds. There is no official or systematic oversight of the payment system.

31. **In addition to a division of responsibilities that may be somewhat inefficient (pension and provident fund supervision by the CFI), comprehensive and effective supervision of the financial sector is more seriously impeded by legal secrecy requirements that prevent effective sharing of information among the supervisory organs. To correct this problem, the team recommended amendments to the relevant laws to permit such information sharing among appropriate officials.**

32. **In order to facilitate further cooperation among financial sector regulators, the team also recommended the establishment of a “Council of Financial Supervisors,” comprising the BOI, ISA, and CFI.** This Council could be established by a formal Memorandum of Understanding agreed upon by the three agencies and should facilitate the exchange of relevant information, the identification of regulatory gaps, overlaps and inconsistencies, and encourage the harmonization of regulatory practices and requirements where the interests of agencies overlap. The Council could also explore the concept of a “lead regulator” for conglomerate financial groups.

C. Macroeconomic Environment, Risks and Exposures

33. **Mostly as a result of a large immigration wave (roughly an increase of 20 percent in the country’s population) the economy experienced very fast growth in the mid-1990s, which led to incipient overheating and an increase in the current account deficit by 1995–96.** As a result of a policy tightening and the tapering off of immigration, growth decelerated to about 2.3 percent in 1998–99. Since the third quarter of 1999, led by a buoyant high-tech sector, the economy grew at an impressive rate of above 8 percent. However, in the fourth quarter of 2000 following the fall in the NASDAQ and the deterioration in the security situation, GDP declined substantially. Overall, GDP still increased by 6 percent in 2000, but is projected to grow by less than 2 percent in 2001. The economic slowdown between 1996 and 1999, and the tightening of monetary and fiscal policies, contributed to significant disinflation, consolidating the transition to a more stable macroeconomic environment, and marking the final step in the decline in inflation in Israel’s very protracted path toward price stability that began with the 1985 stabilization program.

34. **Under the new institutional arrangement, financial intermediaries are faced with: (a) exchange rates that are allowed to fluctuate within very wide bands; and (b) flexibility to set interest rates and allocate credit under the overall liquidity conditions established by the BOI in order to meet the inflation target.** Against these positive developments, many distortions remain (primarily associated with the indirect approaches still used for social safety net purposes) that have thwarted the development of money and securities markets and artificially enlarged the banking sector. These distortions do not enhance the financial sector's resilience to shocks.

35. **Financial institutions may face increased exchange and interest rate volatility, and the possibility of sharp contemporaneous shifts in asset prices, as happened in the fall of 1998 in the wake of the Russian and Long-Term Capital Management (LTCM) collapses.** Uncertainties associated with Israel's political situation and reversals in the Oslo peace process are a potentially important source of shocks, but capital flows in the past have been quite insensitive to these factors. However, the current "break" in the peace process may be more significant and lead to more significant economic spillover effects.

36. **The likelihood that external and domestic shocks would lead to increased exchange and interest rate volatility depends on many factors, including foreign exchange reserves adequacy and indebtedness.** Based on several indicators (Table 1), Israel appears to be less vulnerable to an exchange rate crisis than in the past. In particular, government debt is smaller and declining. Export growth has rebounded in 1999 and 2000 after a temporary period of slow growth between 1996 and 1999. Although the recent global slowdown in the high-tech sector and the security situation are likely to result in a much smaller export growth in 2001, exports are likely to recover in 2002 and continue its rapid growth pattern. The current account deficit is small and has been declining. Furthermore, due to the switch in financing from loans in the 1980s and early 1990s to non-debt creating equity and FDI capital inflows in the late 1990s, net external debt as a share of exports has declined, as has short-term debt. Foreign reserves have been large and stable since 1996, and are now adequate to meet short-term debt liabilities. Turning to microstructure, the ratio of business sector exposures to exchange rate volatility has declined following the volatility of the exchange rate in 1998, while the growth rates of broad money and private sector credit have been stable and seem sustainable.

37. **Public debt is one area of potential vulnerability. Although still high, it has been declining for over a decade and is expected to decline farther.** The reduction in public debt has been a result of declining expenditures and budget deficits as well as of a high GDP growth rate. If the government's social commitments (such as pensions) are not properly structured or contained, this progress could be reversed. The share of public debt to GDP has been of about 95 percent in 2000 compare to 132 percent in 1990. In 2000, domestic debt amounted to 70 percent of GDP and external debt amounted to 24 percent of GDP. Most of the domestic debt is indexed to the CPI, but nonindexed issues for a period of up to five years are becoming very popular. Importantly, the foreign debt service burden is moderate and stable, as is the ratio of short-term to total debt. This is discussed further below in the context of foreign currency liquidity.

38. **Macroeconomic shocks can also be magnified if they result in bank distress and failures.** Israeli banks appear to be well capitalized, and, despite the economic deceleration of the late 1990s, loan performance has not deteriorated severely. Banking sector soundness is discussed more extensively in the next chapter.

39. **Monetary policy in Israel is aimed at meeting inflation targets set by the government after consultation with the BOI (subject to an exchange rate band).** Recently, targets have been set in conjunction with the discussion of the budget deficit for the following year. Current targets are 2.5–3.5 percent in 2001, 2–3 percent in 2002, and 1–3 percent from 2003. The present arrangement is the product of a gradual, and as yet incomplete, shifting of the objective of monetary policy from a nominal exchange rate target to an inflation target. This process has been characterized by a progressive widening of the exchange rate band since December 1991.

40. **Because of the underdevelopment of money and securities markets, monetary policy instruments are more typical of those found in developing economies.** Moreover, the continued use of such instruments perpetuates the underdevelopment of these markets. The team recommended that the MOF remove the limit on the BOI's use of Makam securities (government securities used for monetary control), and that the BOI switch from deposit auctions to repos, in addition to reducing the frequency of its interventions. The team also recommended that the BOI review the design of its standing facilities and reserve requirement following the adoption of an LVTS.

D. Systemic Liquidity Arrangements

41. **In a small open economy such as Israel's, liquidity is best assessed in terms of both domestic currency and foreign currency liquidity.** Banks and other financial institutions in Israel are very liquid. Banks currently maintain liquid assets significantly in excess of their liquid liabilities. In the event of unusually large deposit drains, the BOI would be able to provide sufficient liquidity support.

42. **Bank liquidity is managed to a very large extent through the use by banks of the BOI's monetary policy instruments—currently deposit auctions, averaging of required reserves, and the BOI's standing deposit and lending facilities.** The BOI intervenes in the domestic market daily. In addition, government securities are auctioned several times a week and significant quantities mature every week. The BOI has sufficient instruments, which it uses effectively, to preserve relatively reliable liquidity conditions in the market. If, for example, an unexpected conversion of bank deposits into cash occurs, forcing banks to liquidate an unusual quantity of its government securities or other tradable assets, there is little doubt that the BOI would supply sufficient liquidity to the system to avoid dramatic swings in interest rates inconsistent with good monetary policy.

43. **The payment systems through which liquidity is managed are technically efficient, but as currently designed, they depend, implicitly at least, on the assumption that the BOI will absorb the risk of any bank not settling its payments.** Key systems lack

back up capabilities. Thus the technical failure of one or more systems could paralyze payments and liquidity management for relatively long periods.

44. Money and secondary securities markets are thin. Bond markets are particularly underdeveloped. These facts seem to reflect the ease with which banks can manage liquidity within the BOI's facilities and primary markets for government securities and the ease with which corporate liquidity management and other financing needs are satisfied by banks. Nonetheless, if financial institutions need to liquidate unusual amounts of their assets (as occurred in 1996 when the public shifted large amounts of its deposits with Provident funds to other investment products), it might be difficult to do so without significant losses in the absence of some liquidity support from the BOI.

45. Though systemic liquidity management seems to function satisfactorily in Israel, the team recommended a number of reforms that would streamline the implementation of monetary policy while at the same time contributing toward the development of money and securities market. In connection with the introduction of an LVTS, and in order to improve monetary policy implementation and further development of the money market, the team recommended refinements in the reserve requirement and the BOI's standing lending and deposit facilities.

46. With regard to foreign liquidity, the standard indicators of Israel's external debt burden have improved in recent years (see Table 1). This improvement has occurred despite a persistent current account deficit. The switch in financing from loans in the 1980s and early 1990s to nondebt-creating equity and FDI capital inflows in the late 1990s has financed the current account deficit without increasing aggregate exposure to foreign exchange liquidity risk. Greater exchange rate volatility in 1998 seems to have led the corporate sector to reduce its exposure to the associated risks, thus improving its foreign exchange liquidity.

47. In addition, public sector debt management has been conducted carefully. External public sector debt is modest and has been declining as a share of GDP. External reserves (of the BOI) are large in relation to the usual indicators. Israel should be able to withstand temporary shocks to foreign exchange flows without difficulty. Furthermore, while the foreign currency market in Israel is relatively modest compared to other countries of its size, it is efficient and well organized. Banks face no significant payment system risks in connection with their foreign currency transactions.

48. Foreign currency liquidity management is somewhat constrained by remaining capital controls. The team recommended the phased removal of the few remaining capital controls and another step in this direction was taken in late 2000.

III. THE BANKING SYSTEM

A. Scope, Size, and Structure

49. **Banks in Israel are able to offer a wide range of financial services to their customers.** Apart from the traditional deposit and lending activities, Israeli banks manage about 84 percent of the mutual and 91 percent of the provident funds, trade in derivatives and control subsidiaries that specialize in underwriting, brokerage activities, and mortgage origination. Banks also own shares of manufacturing and insurance firms, in some cases up to 20 percent of a single firm's equity, but are not permitted to "control" insurers. Banks were recently allowed into the pensions market, although only as third party service providers. Banks are not allowed to underwrite insurance products. In line with trends elsewhere, they have evidenced a desire to provide in house insurance products to their clients.

50. **The ratio of bank assets to GDP was 1.64 as of end-2000. The growth in assets and credit to the public has been high over the recent years.** However, since the growth of deposits is also high, the banks remain very liquid. A specific feature of Israeli banks is that assets may be nonindexed, indexed to a price index or foreign currency, or in foreign currency. At the end of 2000, the three categories had about one-third each of the portfolio of banks' financial assets.

51. **There are 45 credit granting institutions in Israel, of which 23 are commercial banks, 8 are mortgage banks, two are merchant banks, and the rest are other types of entities, licensed as banks.** These numbers have been more or less unchanged over the last five years. Israeli banks are well represented abroad, having 59 branches and representative offices and 34 subsidiaries. In addition, there are three branches of foreign banks (HOB, Citibank and Standard Chartered) and three subsidiaries (Invested, Polka Kasha and Ozark).

52. **A small number of banks continue to dominate the financial sector, even considering more than a decade of important structural reforms undertaken with a view to reducing these banks' leading role in the financial sector.** The five leading banks continue to provide the bulk of financial services, either directly or indirectly through ownership of other institutions. Within the banking sector itself, the five largest groups³ control 93.7 percent of bank assets and the three largest banking groups control 75.6 percent. There have been no formal restrictions on the entry of foreign banks and nonbank financial institutions into the Israeli markets since the mid-1990s. However, there has been little interest until recently in the Israeli market when Citigroup and HSBC started branch operations.

³ The five largest banking groups are: Bank Hapoalim, Bank Leumi, Discount Bank, Bank Mizrahi and First International Bank of Israel.

53. **By the end of 2000, the government held 60 percent of the equity in Discount Bank, 43.6 percent in Bank Leumi, and 0.02 percent in Bank Hapoalim, three of the five largest banks.** The government has during 1999 divested its share holdings in Bank Mizrahi and the Union Bank. The privatization process continues, via tenders and via equity sales on the stock exchange. However, the results have lately been disappointing, for example, due to the lack of qualified purchasers.

54. **Bank dominance has effected financial sector development.** The dominant role of banks and their relative success in providing many of the financial services needed by the economy have contributed to the small size of Israel's corporate bond market, as credit and liquidity management are readily available from banks on currently reasonably good terms.

B. Regulatory and Supervisory Framework

Supervision

55. **Israel has a competent and professional supervisory staff and a satisfactory legal and regulatory framework to supervise banks.** Accounting and financial disclosure standards are broadly in line with international standards.

56. **The BOI is the sole supervisor of banks.** The net skills of its staff is reasonably adequate, with many staff having extensive supervisory experience. Salaries and other benefits within the BOI are sufficient to prevent any significant attrition to the private sector. There are no indications of significant governmental interference in the implementation of supervisory policy in recent years.

57. **The legal framework applying to the supervision of banks, and to banking activity more generally, appears adequate, but is somewhat outdated and in places unclear.** For example, the relationship between the Governor (of the Central Bank) and the Government, and between the BOI's objectives, could be clearer.

58. **Weaknesses in the applicable laws have not significantly hindered the supervision of problem banks, including the application of remedial action.** However, the responsibility of the BOI for bank exit is compromised by the requirement to have the agreement of the Government for certain key actions. In one very important respect (the appointment of an administrator to take over a problem bank), the Banking Ordinance explicitly requires the approval of the Government for an action that the BOI should have the independence to undertake. Although in practice the system appears to have worked well for quite some time (except in the area of failed bank resolution), without firm statutory foundations, such an arrangement cannot be guaranteed under all political and economic circumstances.

59. **The statutory boundaries between the three different financial regulators [the other two being the Capital Markets, Insurance and Savings Division of the Ministry of Finance (CMIS) and the Israeli Securities Authority (ISA)] are not entirely clear. It is difficult to be sure that there are no gaps or overlaps in the regulatory coverage, or that**

the current allocation of responsibilities is efficient. The Banking Supervision Department (BSD) of the BOI has difficulty in exchanging information with these agencies and with its overseas counterparts, due to the strength of the over-arching privacy and secrecy laws. This is especially noteworthy given the financial conglomeration in Israel. Proposals have been made to amend these laws to allow for the necessary exchange of information between supervisory agencies, but it is not yet clear when, or if, these changes will be implemented.

Failed bank resolution

60. **The team expressed concern that the provisions for bank exit are inadequate. In general, bankruptcy procedures work satisfactorily for liquidating the remaining shell of a closed bank.** Before getting to that point, the supervisor needs the power to take over a failing bank, to protect its assets in the interest of its creditors, and to sell its valuable assets without disruption to its operations.

61. **The BOI's policy of depositor protection in the event of a bank failure is also unclear.** Israel has no deposit insurance, but in the past, the depositors (and in one crisis, the shareholders) of failing banks have been guaranteed by the BOI to ensure an orderly resolution. As an alternative, an insolvent and nonviable bank should be dealt with in several ways—by taking it from its owners and selling the bank to new owners, merging it with another bank, or closing it.

62. **At this point, the Governor has the authority to revoke a bank's license, but must seek the government's approval before replacing management and/or appointing an administrator.** The Administrator in accordance with directions received from the Governor of the BOI, may transfer some or all of the assets of the bank to another bank but only if it assumes all the liabilities of the administered bank. This aspect of the Banking Ordinance unduly limits the scope of the Administrator's powers to resolve the bank in an efficient way (for example, it would preclude the use of a "purchase and assumption" transaction) unless all claims (other than by owners) are guaranteed (as has been the past practice).

63. **The team noted that the current legal arrangements regarding failed banks have worked satisfactorily because all creditors have always been bailed out.** If, because of the moral hazard involved, this practice is abandoned in the future (perhaps by adopting explicit deposit insurance), existing legal regulations will not permit an efficient failed bank resolution.

Payment systems

64. **A particular weakness pertains to the BOI's role in the payment system and its policies with regard to the settlement of payments through its books.** It is not clear how the BOI would deal with the failure of a bank to provide the funds needed after the system has implicitly settled its payments. Although in theory the BOI is able to reverse a transaction for which insufficient funds are available, in the event of a major bank failure, it appears unlikely that it would be able to do so without the risk of a collapse of the system because of

the "domino" effect of consequential unwinding. In practice, therefore, system participants assume that the BOI will bear all of the credit risk arising from delayed settlement. This moral hazard is undoubtedly currently giving rise to mispricing of credit within the payment systems.

65. The BOI's recent establishment of a payment system oversight function in the Comptroller's department and its intention to oversee the development of a modern LVTS should go a long way toward overcoming these deficiencies.

Money laundering

66. Israel is listed by the Financial Action Task Force on Money Laundering (FATF) as one of 15 noncooperating countries because of deficiencies in its anti-money laundering framework. Its status was reviewed by FATF in June 2001. Israel is now well advanced toward correcting this problem. It adopted modern legislation on anti-Money Laundering in August 2000, and on the basis of the new law, the Governor of the BOI signed the Anti-Money Laundering Order on January 16^t, 2001. The order dictates identification and reporting requirements adherent to the FATF standards. The BOI is in the process of drawing up a working plan to ensure the implementation of the Order issued by the Governor which includes ongoing monitoring and reviewing the bank's readiness, introducing procedures in accordance with the Order, mandatory training for employees to increase conscientiousness, setting guidelines for the different bank functions, and preparing the operational and computer systems for reporting compliance. During 2001, the Governor will establish in accordance with section 13 of the Order a committee, which will be empowered to impose financial sanctions for noncompliance. The Supervisor of Banks also plans to revise Israel's "know your customer" directive (No. 411) to reflect the new legislation and Basel committee criteria on this issue. The anti-money laundering legislation will be fully implemented by February 2002.

C. Vulnerability Assessment and Issues

67. There are several sources of vulnerability within the Israeli banking system. An analysis of the combined balance sheets for the five largest banking groups reveals some of the trends that have characterized the Israeli banking system between 1995 and 1999. Specifically: (i) Asset growth was very large with an annual rate of 10 percent in 1998 and 12 percent in 1999; (ii) credit to the public has outgrown asset growth (with annual rates of 14.2 percent in 1998 and 11.8 percent in 1999); (iii) specific provisions for bad loans decreased in real new sheqalim and by about a third as a percentage of total assets ; and (iv) on the liability side, deposits became a more important source of funding, substituting all the other sources, including equity (Table 2).

68. However, the recent slowdown in the U.S. economy, the large drop in high-tech stock prices, and the Palestinian conflict deteriorated the credit quality of some bank clients during the last quarter of 2000, with the result that Israeli banks became more cautious about their lending practices. This was reflected in lower annual rates of growth

in bank assets and bank loans (8 percent and 9.5 percent, respectively) and an increase in provisions (although their loan loss reserves⁴ as a percent of total assets, still declined in 2000).

69. Analysis of the off-balance sheet items revealed that the notional value of financial derivatives represented around 50 percent of bank assets as of end-2000 (Table 3), most of which (70 percent of the notional value of all contracts) was OTC-traded.

70. The combined income statements for the five banks for the period 1995–2000 (Table 4) shows that banks have managed to keep income increasing at the pace of assets, and as a consequence the before-tax ROA has been very stable (0.96 percent in 2000). However, an analysis of the different components of the income statement as a proportion of total assets shows that the stability of the ROA was achieved through a decrease in provision expenses by 50 percent (between 1995 and 2000),⁵ while the sources of income (net interest margins and fees) decreased their contribution to total returns. The before-tax return on equity (ROE) has grown during the same period (19.3 percent in 2000).⁶

71. Thirty-seven out of the total of 43 domestic credit institutions control less than 6 percent of total assets. This fact in the context of modest returns seems to predict a high probability of mergers and acquisitions in the immediate future.

72. The team assessed the soundness of the five largest Israeli banking groups on the basis of (i) the banks' internal systems to measure and manage risks; (ii) risk indicators such as the Basel capital ratio, profits, problem loans, and provisions; (iii) the vulnerability analysis of the BOI; (iv) stress tests conducted by the banks themselves, and (v) stress tests conducted by the team. On the basis of all of these sources of information, and banks' good record of compliance with the BOI's stringent prudential regulations, the team concluded that Israeli's major banks' resilience to shocks is likely to compare very favorably with those of other developed countries. The team did not identify any major weaknesses in the soundness of the Israeli banks.

73. Risk management at the banks. Israeli banks have had credit and market risks control systems for several years. Like most banks in the world, the methodology and

⁴ Loan loss reserves measure the stock of accumulated loan loss provisions made each year.

⁵ However, it should be noted that loan loss provisions increased from 0.32 percent of total assets in 1999 to 0.35 percent in 2000 (Table 4).

⁶ Israeli banks before tax returns are somewhat low when compared with U.S. and U.K. banks. For U.S. banks, the before-tax ROA and ROE in 1999 were 2 percent and 23.9 percent, respectively. For U.K. banks, the before-tax ROA and ROE in 2000 were 1.4 percent and 26.8 percent, respectively.

technology used by Israeli banks to measure market risk is more advanced than the methodology and the technology used to measure credit risk. However, Israeli banks are aware of this gap and are making efforts to refine their credit risk procedures and to link market and credit risk assessments in an integrated framework.⁷

74. **Risk indicators and stress tests.** As of end-2000 the combined capital to risk-weighted assets ratio of the largest five banking groups was slightly lower than in 1999 (9.5 percent vs. 9.7 percent). However, all five largest Israeli banking groups remained strongly capitalized with a total capital ratio above the required 9 percent, with Tier 1 representing almost 72 percent of all capital (Table 5). Four of the five largest banking groups made profits during 2000.

75. **The ratio of Nonperforming Loans⁸ (NPLs) to total loans for the aggregate five largest banking groups has been reduced from 6.7 percent in 1997 to 5.5 percent in 2000 (Table 6).** When loans to the agricultural sector and municipalities are excluded, the NPL ratio becomes 2.3 percent.⁹ Loan loss reserves covered 53 percent of all NPLs as of end-2000. The individual NPL ratio for the five largest banks was between 8 percent and 2.7 percent as of end-2000. Loan loss reserves covered, depending on the bank, between 60 percent and 47.5 percent of total NPLs.

76. **Loan concentration.** While in most cases Israeli banks seemed to be well diversified, some banks had large exposures (i.e., one in excess of one percent of its loan portfolio) to high-leveraged clients.

77. **For its own stress tests, the team quantified the potential losses that each of the five largest banking groups could suffer under crisis scenarios, due to changes in interest rates, inflation, foreign exchange, and credit risks.** The sum of those potential losses were then related to the available capital (Tier 1 + Tier 2) and to Tier 1 capital to

⁷ High asset and credit growth rates often indicate a worsening in credit risk management on the part of the banks. However, in the case of Israel, banks do not seem to have lowered their standards in spite of the recent high rates of asset and credit growth.

⁸ The definition of problem loans in Israel covers more than the definition of nonperforming loans used in the United States. In order to work with similar measures, the mission defined NPLs in the Israeli case as problem loans minus loans in the special mention category. Total problem loans (in the Israeli sense) to total loans ratio for the five largest banks was 10.9 percent and 8.6 percent as of end-1999 and end-2000 respectively.

⁹ The problem loans to the agriculture sector represent a long existing problem in the Israeli banking sector. These loans were ones to the Kibbutzin and Moshavin that became difficult to repay in the mid-1980s. At the end of 1989, the first of a series of agreements and arrangements were signed between seven banking groups, the Government, and the Kibbutz movements in connection with those debts.

assess banks' ability to survive such shocks. Table 7 reports the results of the stress tests for the aggregate five largest banking groups.

78. The tests attempted to measure the potential effects that the slowdown in the U.S. economy, in particular in the high-tech sector, and the lack of resolution of the Palestinian conflict could have on the healthiness of Israeli banks. Based on discussions with the banks, the mission concluded that the corporate sectors that are more likely to deteriorate under the present circumstances are: (i) the domestic high-tech sector, which exports its main products to the United States. It is also now less able to raise equity abroad and should then fund its activities with bank loans, increasing therefore its leverage and becoming riskier; (ii) the construction sector, affected by the reduction in the demand for office space by the domestic high-tech sector and by a lower expansion in the tourism-related activities such as new hotels, restaurants, stores; (iii) tourism services. Based on available classification of bank loans by sectors, the mission defined the following sectors as more likely to deteriorate: construction and real estate; commerce; restaurants and hotels; transportation and storage; and communications and computer services.

79. Market volatility, after increasing in October 2000, has come back to previous levels. Citibank and HSBC have recently entered the Israeli banking sector. These facts seem to indicate that the market expectation is that neither of the recent shocks can disrupt the Israeli economy completely. However, if the slowdown in the sectors indicated above expand to other sectors, the impact on bank solvency could be larger.

80. Based on the analysis made above, the mission chose two worst case scenarios: (i) The first scenario assumes that the deterioration in credit quality affects only the loans in the sectors directly influenced by the recent episodes and the loans that are classified as problem loans in those sectors default; (ii) The second scenario assumes that there is a larger deterioration in the credit quality of bank loans and all problem loans default. The reasoning behind assumptions (i) and (ii) is that during a slowdown, the riskier borrowers are those that are likely to suffer higher deterioration. This is the case of those loans that are already nonperforming or in a watchful status (special-mention category) both of which are included in the definition of problem loans.

81. Given the lack of data on collateral value, the mission assumed that the recovery rate in case of default is zero. This is a very strong assumption.

82. The worst case scenarios were also characterized by losses due to interest rate, inflation and exchange risk based on adverse conditions that have a probability of occurrence of 1 percent or less.¹⁰

¹⁰ The mission used the calculations made by BOI in its Banking Report 2000, as its own estimates of market risk for each individual banking group. Based on five years of observations, the worst case interest rate changes estimated by the BOI were: 1.9, 0.69 and
(continued)

83. **For the five largest banks on an aggregate basis, the team found that losses in the first scenario represent 42.8 percent of Tier 1 and 31.2 percent of Tier 1+ Tier 2.** Losses that would take place under the second scenario represent 89.8 percent of Tier 1 and 65 percent of Tier 1+ Tier 2. When the stress tests are applied to each of the five largest groups, the potential losses under both scenarios are always lower than each bank's Tier 1+Tier 2. Under scenario 2, in one case, potential losses exceed the banking group's Tier 1 capital by 10 percent. Compared with similar tests conducted in September 2000 on the basis of end-1999 data, Israel's major banks' resilience to shocks remains strong and has slightly improved.

Conclusions and recommendations

84. **The team's conclusions on the health of the Israeli banks are as follows:**

- Israeli banks seem to have enough capital to cover potential losses due to credit and market risks (i.e., inflation, currency and interest rate risks) under very extreme scenarios.
- The team was concerned about the declining net interest rate margins and fee income as a proportion of total assets. Bank assets and credit have grown at very high rates, but the contribution of those assets to total profit has not kept the same pace. Shrinking margins and modest return seem to be behind that behavior. Although large banks have found ways to maintain stable return on assets, the situation may give rise to problems in the smaller banks, in particular if the recent entry of foreign banks encourage still more competitive banking practices.
- Credit risk is, by far, the main source of risk for Israeli banks. However, the methodology and technology used by Israeli banks to measure market risk is more advanced than the methodology and the technology used to measure credit risk.

0.44 percentage points for the nonindexed interest rate, the real interest rate, and the dollar interest rate. The worst case inflation and exchange rate changes, based on five years of observations, were 1.59 and 5.68 percentage points respectively. The worst case was defined as a case with a probability of occurrence of 1 percent or less. The difference between the stress tests undertaken by the mission and the ones undertaken by the BOI lies in the explicit inclusion by the mission of potential losses due to credit risk in the worst case scenarios.

85. Based on these conclusions, the team recommended that the BOI should:

- Improve its own credit risk assessment by requiring banks to report the amount, types and value of collateral. Discussions between the BOI and the banks of such an improvement are now under way.
- Examine carefully the situation of the smaller banks in the system. It is likely that consolidation of the banking industry will need to take place in the future due to increased competition.
- Encourage the incorporation of methodologies that address the non-linear risk in derivatives portfolios.
- Encourage the improvement in credit risk measurement and management. Specifically, the BOI could encourage the use of uniform credit rating categories for banks. Based on this uniformity, and given the large amount of data that is necessary to have estimates of client risk, and the positive externality involved in estimates that can use the information available to all banks, the BOI could centralize the information available to all banks in order to measure the sensitivity of the credit quality of banks' clients to different specific and general risk factors.

86. More generally, the legal framework in which banks operate and are supervised should be strengthened. The team recommended adopting a new modern banking law that would incorporate provisions for the administrative takeover and resolution of insolvent banks or of banks that for whatever reason have their licenses revoked. In addition, the law should provide for:

- More explicit statement of supervisory objectives and powers;
- Sharing of relevant bank data and information among domestic and foreign supervisors; and
- Authority for the Governor to appoint an administrator to a failing bank without the need for specific Government authorization.

IV. INSURANCE AND PENSIONS

A. Structure and Ownership

87. Recently pension funds, life insurers and provident funds have accounted for about 27 percent of the financial assets held by the public, down from a peak of 49.2 percent in 1990, but still stronger relative to long-term deposit style products. The major causes for the decline have been a flight from medium-term savings vehicles (mainly nonretirement provident funds) to short-term deposits because of interest rate differentials (and possibly an increased desire for liquidity), and increased direct holdings of shares and convertible bonds. These institutional investors are well developed, but regulations and distortions in the industry limit financial market development.

88. **The industry is highly concentrated.** Four groups control over three-quarters of the gross insurance premiums. One pension fund manager controls approximately half of both old and new fund assets.

89. **The industry as a whole is in transition from a solidarity-based approach to product design and pricing to a more entrepreneurial, competitive, and individualistic market environment.** While basically sound reform programs have and continue to guide the transition, conflicts remain to be resolved between vested interest groups. Government liabilities for long-standing commitments place a burden on the budget, and new risks will become increasingly important. Supervisory capabilities for the new environment are not yet fully developed.

B. The Regulatory and Supervisory Framework

90. **Insurance, pensions, and other long-term savings plans are regulated by the Capital Markets, Insurance and Savings Division of the Israeli Ministry of Finance (CMIS).** The Division is headed by a Commissioner of Insurance, a statutory appointment under the 1981 Insurance Business Supervision Law. A Deputy Commissioner for Pensions, reports to the Commissioner. The supervisor has 32 professional staff members, who are all civil servants. Most of the senior officers have special contracts, which provide higher than standard incomes but which are still not competitive with the private sector.

91. **Activities relating to insurance and contractual savings are governed by a number of laws.** These include approving savings plans, regulating and examining the investment rules of provident and pension funds, licensing insurers and insurance agents, monitoring the reserves and capital adequacy of insurance companies, regulating insurance products and plans and protecting the rights of the insured. As a matter of pragmatic policy, the regulator tends to operate through regulations, circulars and persuasion rather than attempting to achieve changes to the written law (the MOF has been attempting for 10 years to generate a Provident Funds statute).

Insurance

92. **The Insurance Business Supervision Law provides substantial powers to the supervisor, either directly or through the Minister of Finance.** In addition, the supervisory body is well structured and has a core of capable and committed officers who are engaged in reforming the market and in particular the introduction of genuine competition for the benefit of consumers and the economy at large. The main limiting factor is a lack of actuarial and on-site inspection capacity.¹¹ In addition, the roles of the Minister and the Israeli Parliament (Knesset) Finance Committee appear in some cases to impinge on the

¹¹ The MOF Actuary is a senior professional with internationally accepted qualifications; however, his specialty is pensions, not insurance.

legitimate supervisory role of the Commissioner.¹² Examples include specification of contract forms and some of the response mechanisms when an insurer shows signs of distress. Israel is unusual by industrial (and many developing) country standards in continuing to allow the licensing of composite insurers offering both life and non-life insurance and not completely sealing these functions from one another.

93. **In practice, insurance supervision is fairly well defined, although there is room for improvement.** Although the 1981 Act appointing the Commissioner of Insurance does not specify objectives for insurance supervision. Meantime, what has happened is that various objectives (currently not prioritized) have been developed, all with a view to protecting the interests of policyholders. There is a pressing need for more staff to strengthen insurance supervision and for more on-site inspections in insurance and securities.

Pensions

94. **The reforms introduced following the 1995 agreement have gone a long way to bringing Israel up to best practice in terms of pension supervision.** The major deviations from best practice reflect history and the difficulties of changing embedded structures that have created their own constituencies. These revolve around the lack of investment freedom available to boards and managers because of a historical symbiotic relationship between the government and all long-term savings mechanisms (and which has carried over for pension funds), the lack of a legal separation of the old funds and managers from the new ones, a chronic tendency to create unfunded liabilities and limited capacity for the supervisor to conduct on-site inspections.

95. **Complicating the picture are a number of side issues, including the desire of the non-union fund managers to break the union cartel with regard to new funds and possible mis-selling of manager's pension contracts.** These are relatively minor compared to the issues listed in the previous paragraph and should be resolved as soon as possible so that the major reform program which begun so auspiciously could be allowed to move on.

96. **With regard to transparency of supervisory policies, the objective of supervision is not clear given continuing political controversy arising from the 1995 reform program.** In its comprehensive annual reports and increasingly through its web site [double check spelling; you have it both as one word and two words; I have changed it to two words throughout], the CMIS Division provides the public with a great deal of information of high quality on its policies and activities and on the financial results of the government traded bond market, life and general insurance, provident and pension funds, and savings plans.

¹² Where fundamental change, such as the introduction of more competition to the Motor Bodily Injury (MBI) market, is concerned these authorities continue to have a legitimate role.

C. Overall Assessment and Issues

Insurance

97. **The market is growing relative to the economy with gross premiums being equal to 6.2 percent of GDP, up from 4.7 percent in 1989.** This is split roughly equally between life and non-life, but life policies are growing faster, a feature of more advanced economies. Aggregate policyholder liabilities at the end of 1999 amounted to NIS 83.2 billion, an amount equal to 19.1 percent of savings in banks.

98. **Capital and surplus (NIS 5.3 billion at the end of 1999) is low by international standards, but has been adequate to date (earthquake risk aside) because of low risk.** Until 1991, the government underwrote the market risk of insurers by providing guaranteed real return nontradable bonds up to 85 percent of total assets and the current product range passes market risk to the insured. Mortality assumptions have been set at very conservative levels and are well out of date. They are due to be revised in the next round of filings following the commencement of a class action and the issue of a directive by the Commissioner. Overall solvency at 6.6 percent of policy liabilities is up compared to previous years, but risk will go up as investment choice increases, the industry issues new contract styles, and more Motor Bodily Injury (MBI) risk is transferred to insurance company balance sheets. Rules of thumb for minimum solvency in normal markets are 5 percent of policy liabilities for life and 20 percent for non-life.

99. **The key issue that needs to be addressed as the risk level of the industry increases is balance sheet integrity, requiring in turn the development of a life insurance policy reserve standard and an appropriate solvency and capital adequacy regime.** These will need to be backed up by enforceable corporate governance requirements and proper support from the actuarial and accounting professions, including whistle-blowing responsibilities.

Pensions

100. **While the pension regime introduced in 1995 is an excellent start to a necessary transition, there are a number of major outstanding matters to be dealt with.** These include the conditions under which fund managers may invest in a wider range of capital market instruments, ensuring the independence and accountability of fund managers and boards (including greater competition) and explaining the nature of the new plan benefits to new plan members. This latter problem will require resolution of the question of where responsibility for extreme longevity improvement lies. Overriding all of these considerations is the need to formulate the next step of the transition strategy to deal with the unfunded liabilities in the old pension arrangements and the public sector system and to reinforce fiscal responsibility by making the costs of wage/ pension benefit tradeoffs more transparent.

101. **Fiscal implications aside, the heavily regulated pension system places limits on the scope for balanced financial development.** Non-tradable government bonds account for the overwhelming majority of fund assets. These earmarked bonds constrain capital market

development by crowding out equity, bonds and other securities from pension fund balance sheets.

Provident funds

102. **Provident funds account for total assets under management in excess of NIS 160 billion, however, those covering medium- to long-term savings objectives (that is a minimum of 15 years) amounted to NIS 116 billion at end, 1999.** A majority of the members in these latter funds have satisfied the conditions to retain tax immunity and are thus able to switch at short notice. As short-term interest rates have risen and equity markets have become deeper they increasingly have done so and this vehicle is rapidly losing its share of market.

103. **These unique characteristics of provident funds in Israel also impede broad financial market development.** The mix of savers—some locked in and interested in solid long-term yields, others interested in high short-term yields—creates a structural contradiction in the management of the funds' portfolios that prevents the funds from serving as important long-term institutional players in the capital markets. Moreover, competition is quite limited, with banks controlling 91 percent of fund assets (on which they take an average management fee of 1 percent) owing to their control of the distribution system. Much of the money switching out of provident funds has gone to short-term bank deposits.

104. **On balance, there appear to be strong grounds at the supervisory level for placing provident funds with a retirement objective under the Pensions unit and moving other types of so-called provident funds to the Securities supervisor.** For this to happen, the recommendations of the two recent reports on tax reform will need to be at least partially implemented.¹³

V. PAYMENT SYSTEM

A. Main Payment Systems

105. **The Israeli payment system comprises a number of clearing and settlement systems provided by the Bank of Israel and by the private sector.** The BOI operates a system for settling interbank liquidity trading, clearinghouse positions, and other interbank transactions. The BOI also requires banks to maintain current accounts in both new sheqalim and U.S. dollars for fulfillment of reserve requirements, which are used by banks to settle transactions with the BOI and with other banks. The Banks Clearing House (BCH) is a unincorporated body that organizes the physical exchange and clearing of all paper-based

¹³ The May 2000 "Report of the Public Committee for Income-Tax Reform", chaired by Prof Ben Basset. The earlier report of the "Committee for Examination of Structural Changes in the Capital Market", chaired by David Brodet.

instruments. The Tel Aviv Stock Exchange Clearing House offers clearing and settlement services for securities.

106. **All processes are well organized, both technically and in terms of the procedures that apply, but a basic problem stems from the fact that the NIS settlement for the different clearing processes involves de facto credit risk for the BOI, which is not able to check the availability of funds on the moment that it officially or unofficially accepts the outcome of the clearing.** Moreover, banks seem to assume that the BOI accepts the risk. As a consequence, banks have not really prepared themselves, either in terms of setting appropriate counterparty limits for the NIS settlement process or in terms of having systems for measuring exposures in the payment system. In addition, the clearing processes themselves do not provide the proper information to the participants for managing the risks.

B. Regulatory and Supervisory Framework

107. **The BOI has limited its oversight of the payment system to its supervision of banks.** In the past, it has not taken the lead in developing its settlement systems and private sector clearing systems. More recently the BOI has recognized the weaknesses pointed out by the September FSAP mission, and has taken positive initial steps to address them. The Bank has established a payment system oversight function in the Comptrollers Office, and intends to establish a National Payments Council to advise on payment systems issues and development. The Bank is studying the development of an LVTS, which will, due to the nature of its function, allow more satisfactory management of payment risk.

C. Specific Sources and Degree of Vulnerabilities

108. **The payment system in Israel has evolved without any systematic oversight. As a result, each is technically sound but was designed without the core principles in mind.** The efficient and timely functioning of these systems are based on the assumption that the BOI will cover any losses that may result after the fact from the settlement of customer, bank, or clearinghouse net payments. This situation would either expose the BOI to potentially large losses, or the payment systems to considerable disruption in the event of the failure of a large bank. In the team's judgment, the high quality of banking supervision makes the prospect of such an outcome rather low.

109. **The team endorsed the BOI's intention to develop an LVTS linking banks to their reserve accounts at the BOI.** Several options are available for the Central Bank. A major consideration for making the choice relates to the liquidity implications of the different systems in the context of the monetary instruments used. Since this will also have an impact on the banks as the users of the system, they should be consulted on these issues.

110. **A second reason for consulting the banks stems from the fact that any choice will have major information systems implications for the banks.** For this purpose, the BOI intends to establish a National Payments Council, which will typically deals either at the level of the main committee or through subcommittees with all payments related policy issues.

111. **The introduction of a new settlement system probably requires legislative changes as well.** Since that may take considerable time to develop, this part of the work should be started rather soon.

VI. FINANCIAL SAFETY NETS

A. Deposit Insurance

112. **While there is no formal deposit insurance in Israel, the BOI law gives its governor considerable authority and discretion to guarantee deposits and other claims on banks.** In practice, in the last isolated bank failure (in 1985), all depositors were fully compensated by the BOI. In the deepest financial crisis in Israeli economic history, the 1983 banking-share crisis, almost the entire system was taken over by the government, and depositors did not suffer losses since no bank was actually allowed to fail.

113. **The team noted that the implicit guarantee was likely to reduce market discipline and bank soundness.** To the extent that there was really any uncertainty (ambiguity) about deposit protection, this would not necessarily prevent deposit runs. To correct this problem, the team suggested that the authorities consider introducing an explicit deposit insurance scheme.

B. Lender of Last Resort

114. **The BOI law gives considerable flexibility to the BOI's lender-of-last-resort (LOLR) operations.** The Governor has the power to establish rules governing BOI credit to banks, deciding on the nature and amount of collateral required, and on whether a certain episode of banking distress does or does not constitute an emergency situation. According to the authorities, the practice is to inject liquidity only into solvent institutions and against collateral. However, the authorities are prohibited by Article 65 of the BOI Law (on secrecy) to inform the public, even with a lag of many years, about its lender-of-last-resort operations.

115. **The ability of the BOI to provide LOLR support seems adequate.** However, the team recommended that the law be changed to permit disclosure (at an appropriate time) of any such lending by the BOI, in order to help discipline its use of this authority.

C. Contingency planning

116. **Although episodes of bank distress have apparently been rare in recent Israeli financial history, bank supervisors indicated that there are contingency plans in place for dealing with problems in two classes of institutions: the top-five banks, and the smaller banking institutions.**

VII. ASSESSMENT AND MEDIUM-TERM OUTLOOK

117. **Israel's financial sector is well positioned to weather any possible shocks.** However, the financial sector's development has been distorted to some extent by the manner in which certain social safety net programs have been designed, tax distortions, and restrictions on institutional investors. For these and historical reasons, the banking sector is highly concentrated and a large share of financial services are provided by banks or by institutions under the control of banks. One result of these and some other factors is the lack of development of money and bond markets, the thinness of which increases the costs and risks of liquidity management and long-term financing.

118. **To address these weaknesses, Israel should proceed with its long-held and somewhat stalled plans to reform the tax system, adopt new central bank and banking laws, continue with the reform of pension schemes, remove remaining capital controls, and continue the never ending task of maintaining or strengthening its market-oriented supervisory capabilities.**

119. **The medium-term challenges for pension supervision** include dealing with unfunded liabilities, fully explaining the nature of the new funds to their members, and coping with the increased risks resulting from the likely introduction of increased investment freedom recommended above.

120. **Medium-term challenges for insurance supervision** include developing a viable on-site inspection capacity, building up actuarial capacity, developing key actuarial standards (including life insurance policy liabilities), producing a workable model for controlled competition in the MBI market, enforcing boards of directors' accountability for risk management, developing an information exchange capacity with other financial sector supervisors and continuing the current market reform program. In addition, a number of specific issues need to be dealt with, including earthquake reserves and annuity conversion options.

121. **Medium-term challenges for securities markets mainly concern more even development.** Measures needed include enactment of tax reforms effecting financial instruments and creation of a commercial paper market and municipal bond market as well as an increase in the corporate bond market. Independent brokerages, fund managers, and advisors would provide an alternative and thus competition to bank provided services in these areas. the ISA will need to stay abreast of best international security regulatory practices. Technology, globalization and financial conglomeration all serve to challenge the ISA.

122. **The team's view was that the above measures—tax reform to level the playing field, full liberalization of the capital account, and phasing in market investments for defined benefit pension and other savings schemes** (thus phasing out the special non-traded, guaranteed real return, government securities)—would result in a more complete development and deepening of securities markets. It was also the team's view that such

developments, combined with increased foreign competition (domestically and abroad), would be sufficient to ensure a competitive banking sector in the medium term.

123. **Thus in the medium term, the team expects that banks' current dominance would be diminished** by the removal of the above impediments to the development of other markets and products. A profit squeeze following achievement of price stability and increased foreign competition may be expected to lead to some consolidation in the banking sector. Improved bank resolution tools in the banking law (an entirely new banking law and central bank law are needed) are needed for this process to proceed smoothly.

Table 1. Israel: Macroeconomic Environment, 1995–2001
(In percent)

	1995	1996	1997	1998	1999	2000
GDP growth	6.5	5.0	3.3	2.4	2.3	6.0
Fiscal balance / GDP						
General government 1/	-4.4	-5.6	-4.0	-3.6	-4.7	-2.8
Central government 1/	-4.0	-3.8	-2.7	-2.3	-2.5	0.0
Inflation (e.o.p.) 2/	8.1	10.6	7.0	8.6	1.3	0.0
Unemployment rate	6.9	6.7	7.7	8.6	8.9	8.8
Real effective exchange rate (change in percent, CPI based) 3/	0.8	5.9	7.0	-3.0	-3.8	8.0
Bilateral U.S. dollar exchange rate (percent change, e.o.p.) 4/	3.9	3.7	8.8	18.0	.0	-1.6
Interest rates						
Bank of Israel discount rate (e.o.p.) 4/	14.2	15.2	13.4	13.5	11.2	8.2
Deposit interest rate (e.o.p.)	12.9	13.8	12.1	12.2	9.9	6.9
Lending interest rate (e.o.p.) 5/	19.9	20.5	18.1	17.6	15.1	11.5
Real yield to maturity on 5-year indexed bonds 6/	4.1	4.6	4.1	5.1	5.6	6.0
One-month T-bill yield (Makam; nominal) 6/	14.5	15.5	13.4	11.3	11.8	8.8
Public debt (gross, e.o.p.)/GDP	109.0	107.0	106.0	109.0	103.0	94.6
Net private savings/GDP 7/	16.4	16.7	10.1	10.3	9.6	4.4
Current account balance/GDP	-5.4	-5.6	-3.7	-1.0	-1.9	-1.9
Stock price Index (General share-price index, end-1991=100) 4/	191.0	188.0	256.0	257.5	423.4	424.7
Exports of G&NFS (percent change, average in US\$) 8/	13.7	6.2	7.8	6.3	10.1	23.3
Gross official reserves (in US\$ billions; e.o.p.) 8/	8.3	11.6	20.3	22.7	22.5	23.2
Central Bank short-term foreign liabilities (in US\$ billions) 8/	0.2	0.1	0.1	0.1	0.0	0.0
Business sector exposure to depreciation (in US\$ billions e.o.p.) 8/	9.8	10.3	14.3	13.3	11.3	6.2/
Business sector exposure to depreciation (in percent of reserves) 8/	117.8	88.7	70.3	58.7	50.2	26.3
Total gross external debt to exports GNFS (in percent) 8/	165.7	173.9	177.9	181.0	172.0	151.2
Spread of foreign bonds relative to U.S. Bonds (in basis points) 8/	40	30	40	100	50	120
External Government Debt/GDP 8/	26.8	26.2	26.2	27.2	27.2	25.1
Foreign Deposits in Banks (in US\$ millions) 8/	15014	15478	17520	19170	21217	22056

Sources: Bank of Israel; and Fund staff estimates and projections.

1/ Operational concept, excludes the nominal component of interest on shekel-denominated government debt. Fiscal policy has targeted the central government balance.

2/ Overall CPI. The current inflation target is 3–4 percent in the year to December 2000.

3/ Increase (decline) indicates appreciation (depreciation).

4/ For 2001, end-May.

5/ Overall cost of nonindexed credit.

6/ For 2001, end-April.

7/ National private savings less gross private investment.

8/ For 2000, preliminary data.

Table 2. Israel: Five Largest Banking Groups. Main Balance Sheet Items 1995–2000
as a percentage of total assets, end of year

Assets	12/31/95	12/31/96	12/31/97	12/31/98	12/31/99	12/31/00
Cash and deposits with banks /1	14.1	14.7	16.5	16.10	16.9	16.4
Securities	14.8	15.4	13.4	13.06	13.4	11.9
Gross Credit to the public	60.9	61.9	63.8	66.09	66.8	68.6
total provisions	3.0	2.9	2.6	2.43	2.2	2.1
- specific provisions	2.5	2.4	2.1	1.97	1.8	1.7
- general	0.3	0.3	0.3	0.26	0.2	n.a.
- supplementary	0.1	0.2	0.2	0.20	0.2	n.a.
Net Credit to the Public	58.0	59.0	61.2	63.66	63.9	66.4
Credit to the government	9.6	7.3	5.4	3.68	2.6	1.8
Investments in companies included on an equity basis	1.0	1.0	0.9	0.64	0.6	0.5
Buildings and equipment	1.5	1.4	1.4	1.36	1.3	1.2
Other assets	1.0	1.1	1.2	1.51	1.3	1.6
Total assets	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities & capital						
Deposits of the public	78.2	80.2	81.2	82.0	83.1	84.0
Deposits of banks	4.1	3.3	3.2	3.1	2.8	2.8
Deposits of the government	3.7	3.4	3.0	2.6	2.3	1.8
Bonds and subordinated notes	6.9	5.5	4.8	4.6	4.2	4.0
Other liabilities	1.3	1.7	1.9	2.2	2.3	2.3
Total liabilities	94.1	94.2	94.0	94.4	94.7	94.8
Minority interests	0.3	0.3	0.3	0.3	0.3	0.3
Equity	5.6	5.6	5.7	5.3	5.0	5.0
Total liabilities and capital	100.0	100.0	100.0	100.0	100.0	100.0
Memo:						
Assets (NIS million)	460.9	489.3	518.9	571.0	638.0	689.8
Assets (USD million)	147.0	150.5	146.8	137.3	153.6	170.7
Exchange Rate (NIS/USD)	3.1	3.3	3.5	4.2	4.2	4.0
Growth in Total Assets	-	6.2	6.1	10.0	11.7	8.2
Credit to the Public (NIS million)	278.7	300.3	328.3	374.7	418.6	458.3
Growth in Credit to the Public	-	7.7	9.3	14.2	11.7	9.5
Deposits to the Public (NIS million)	360.2	392.3	421.3	468.1	530.1	579.1
Growth in Deposits to the Public	-	8.9	7.4	11.1	13.3	9.2

Sources: Bank of Israel; and Fund staff estimates.

1/ Including deposits with banks earmarked for credit to the government.

Table 3. Israel: Five Largest Banking Groups. Notional Value of Financial Derivatives (NIS billion)
1998–2000

	Interest Rate	Exchange Rate	Others	Total	Total (% of total bank net assets)	Growth rate with respect to previous year
1998	71.9	166.6	25.3	263.7	46.2	n.a.
1999	109.1	171.7	48.9	329.7	51.7	25.0
2000	103.1	226.1	20.2	349.4	47.5	6.0
Of which:						
Exchange-traded as percent of total	8.7	4.4	68.5	29.5		
OTC-traded as percent of total	69.5	37.8	6.9	64.7		
Other-traded as percent of total	21.8	57.8	24.5	5.8		

Sources: Bank of Israel; and Fund staff estimates.

Table 4. Israel: Five Largest Banking Groups. Income Statement 1995–2000
As a percentage of total net average assets (*)

		1995	1996	1997	1998	1999	2000
Net interest income before loan-loss provision	(1)	2.6	2.5	2.5	2.2	2.2	2.3
Loan-loss provision	(2)	0.7	0.6	0.5	0.4	0.3	0.4
Net interest income after loan-loss provision	3=(1)-(2)	2.0	2.0	2.1	1.8	1.9	1.9
<u>Operating and other income</u>							
Operating commission	(4)	1.3	1.3	1.3	1.2	1.1	1.2
Net profit from investment in shares	(5)	0.0	0.0	0.0	0.0	0.0	0.0
Other income	(6)	0.3	0.3	0.3	0.2	0.2	0.2
Total operating and other income	(7)=(4)+(5)+(6)	1.6	1.5	1.5	1.4	1.4	1.4
NIM + Operating and other income	(8)=(3)+(7)	3.6	3.5	3.6	3.3	3.3	3.4
<u>Operating and other expenses</u>							
Salaries and related expenses	(9)	1.7	1.7	1.7	1.5	1.4	1.5
Depreciation and maintenance		n.a	n.a	n.a	n.a	n.a	0.4
Depreciation and amortization	(10)	0.2	0.2	0.2	0.2	0.1	n.a
Maintenance of buildings and equipment	(11)	0.3	0.3	0.3	0.3	0.2	n.a
Other expenses	(12)	0.6	0.6	0.5	0.5	0.5	0.6
Total operating and other expenses	(13)=(9)+(10)+(11)+(12)	2.8	2.7	2.6	2.5	2.3	2.5
Ordinary before-tax profit	(14)=(8)-(13)	0.8	0.8	0.9	0.8	1.0	0.9
Provision for taxes on ordinary profit	(15)	0.4	0.4	0.5	0.3	0.5	0.4
Ordinary after-tax profit	(16)=(14)-(15)	0.4	0.4	0.5	0.5	0.5	0.5
Bank's share in ordinary after-tax profit of subsidiaries and affiliated companies	(17)	0.1	0.1	0.1	0.1	0.1	0.1
Minority interests in net ordinary profit of consolidated subsidiaries	(18)	0.0	0.0	0.0	0.0	0.0	0.0
Ordinary net profit	(19)=(16)+(17)+(18)	0.4	0.4	0.5	0.5	0.5	0.5
Extraordinary net profit	(20)	0.0	0.0	0.1	0.0	0.0	0.1

Table 4. (continued) Israel: Five Largest Banking Groups. Income Statement 1995–2000
As a percentage of total net average assets (*)

		1995	1996	1997	1998	1999	2000
Before Tax ROA	(21)= (14)+(20)	-	0.86	1.06	0.79	1.03	0.96
Memo							
Before Tax ROE		-	15.6	18.9	15.2	20.1	19.3
Total net assets (NIS million)		460.9	489.3	518.9	571.0	637.6	689.8
Average net assets (NIS million)		-	475.1	504.1	545.0	604.3	663.7
Total equity (NIS million)		25.7	27.2	29.4	30.4	32.0	34.2
Average equity (NIS million)		-	26.4	28.3	29.9	31.2	33.1
(*) Total net average assets = Average of end-of -period total net assets and the previous end- of- period total net assets							

Sources: Bank of Israel; and Fund staff estimates.

Table 5. Israel. Five Largest Banking Groups. Capital Ratio
1997–2000

	1997	1998	1999	2000
Tier 1	8.9	7.4	7.3	6.9
Tier 2	1.1	1.7	2.4	2.6
Total Basel capital ratio	10.0	9.2	9.7	9.5

Sources: Bank of Israel; and Fund staff estimates.

Table 6. Israel: Five Largest Banking Groups. Nonperforming Loans and Loan Loss Reserves 1997–2000

	1997	1998	1999	2000
NPLs to total loans ratio	7.3	6.7	6.5	5.5
NPLs (excluding loans to the agriculture and municipalities) to total loans ratio	4.0	4.8	4.7	2.4
Loan Loss Reserves to NPLs ratio	56.2	55.1	50.8	53.1

Nonperforming Loans (NPLs) correspond to the Israeli classification "Problem Loans net of adjustments: (i) loan loss reserves were added in order to obtain a gross measure; (ii) loans in the special mention category were removed in order to make the measure closer to the definition used in the United States for NPLs.

Sources: Bank of Israel; and Fund staff estimates.

Table 7. Stress Tests for Five Largest Banking Groups as of December 2000

DATA (NIS billion)	
Tier 1 capital	36.2
Tier 2 capital	13.6
TOTAL	49.8
All problem loans net of specific provisions	31.5
Problem Loans net of provisions in the Construction and Real Estate Sectors	9.5
Problem Loans net of provisions in the Commerce Sector	2.5
Problem Loans net of provisions in the Restaurants and Hotels Sector	1.7
Problem Loans net of provisions in the Transportation and Storage Sectors	0.4
Problem Loans net of provisions in the Communications and Computer Services Sectors	0.3
Sum of all Problem Loans net of provisions in the sensitive sectors indicated above	14.5
Var due to inflation and exchange rate risk	0.1
Var due to interest rate risk	0.9
SCENARIO 1	
Banks suffer losses due to a shock to changes in interest rates, inflation and the exchange rate that have a probability of occurrence of 1 percent or less (based on changes in those variables over the last 5 years). Holding period is one month. At the same time all the problem loans in the sectors that are sensitive to the recent shocks fail. It should be noticed that due to the lack of information on collateral, the recovery value of defaulted loans is assumed to be zero.	
Total losses in NIS billion	15.5
As a % of Tier 1	42.9
As a % of Tier 1 + Tier 2	31.2
SCENARIO 2	
Banks suffer losses due to a shock to changes in interest rates, inflation and the exchange rate that have a probability of occurrence of 1 percent or less (based on changes in those variables over the last 5 years). Holding period is one month. At the same time all problem loans default. It should be noticed that due to the lack of information on collateral, the recovery value of defaulted loans is assumed to be zero.	
Total Losses in NIS billion	32.5
As a % of Tier 1	89.8
As a % of Tier 1 + Tier 2	65.3

Sources: Bank of Israel; and Fund staff estimates.

SECTION II: OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information for the Financial System Stability Assessment for Israel on compliance and consistency with international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework have been adequate to address the potential risks in the financial system; and has also provided a source of good practices in financial regulation and supervision in various areas.

As part of the FSAP, the following detailed assessments of standards were undertaken: Basel Core Principles for Effective Banking Supervision: Wayne Byres (Australian Prudential Regulation Authority) and Göran Lind (Sveriges Riksbank); the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies: Mark Stone (IMF) and Mark Robson (Bank of England); the International Organization of Securities Commission (IOSCO) Objectives and Principles of Securities Regulation: Melinda Roth-Alexandrowicz (World Bank); the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems (CPSIP): Simon Kappelhof (De Nederlandsche Bank); and the International Association of Insurance Supervision (IAIS) Supervision Procedures: Rodney Lester (World Bank). These assessments were prepared by drawing on the authorities' self-assessments, answers to questionnaires, and field work during September 2000.

Israel has relatively well developed, capable, and transparent financial sector supervision and monetary policy formulation, especially in the area of banking supervision which has developed over a longer period. Two areas of particular weakness concern the design and lack of oversight of payment systems, and inadequate coordination of supervision among different regulators because of legal impediments to information sharing. Steps are underway to address these deficiencies. As a general matter, supervision in all areas seems to be of better quality than the laws on which it is based. The exception is securities supervision, which has both good supervision and a modern law.

VIII. INTRODUCTION AND SUMMARY

124. **This section contains summaries of the team's assessments of Israel's observance of financial sector supervision standards and codes.** The detailed assessments for each of these standards and codes formed an integral part of the FSAP and an input into the FSSA. Some of the standards were still in draft form at the time of the assessment, while some did not have a complete methodology on which the assessment could be based.

125. **Israel has relatively well-developed, capable, and transparent financial sector supervision** and monetary policy formulation, especially in the area of banking supervision which has grown over a longer period. Two areas of particular weakness concern the design and lack of oversight of payment systems, and inadequate coordination of supervision among different regulators because of legal impediments to information sharing. As a general matter, supervision in all areas seems to be of better quality than the laws on which it is based. The exception is securities supervision, which has both good supervision and a modern law.

126. **Israel should modernize its laws governing the BOI and the supervision of banking, pensions, and insurance.** A new central bank law should clarify the objectives of monetary policy, protect the Governor from dismissal; and should also should clarify the purpose of supervision, the relationship between the Supervisor of Banks and the Governor of the BOI, and strengthen the provisions on bank exit. Relevant laws should be amended to allow supervisors to share relevant information with other supervisors domestically and abroad.

127. **Supervision of different financial sector products and firms should be better coordinated.** In addition to changes in the law to permit information sharing, existing mechanisms of coordination should be strengthened. The FSAP team also recommended the establishment of the "Council of Financial Supervisors," comprising the BOI, ISA, and CFI. This proposed Council should facilitate the exchange of relevant information, the identification of regulatory gaps, overlaps and inconsistencies, and encourage the harmonization of regulatory practices and requirements where the interests of agencies overlap.

128. **The BOI should take explicit responsibility for oversight of payment systems.** Existing systems are generally technically efficient but function as if the BOI will accept the risk of settlement. The FSAP team welcomed the BOI's recent establishment of a payment system oversight function in the Comptrollers Office and its intention to develop an LVTS.

129. **The reform of the insurance and pension areas is not yet complete.** The investments of both remain relatively restricted. Furthermore, all long-term savings programs (including pensions) continue to be highly protected by the government (e.g., via the provision of non-marketable, fixed real yield bonds), which implicitly underwrites the unfunded liabilities of whatever benefit levels are created. New Pension funds, founded on

more financially sound foundations, continue to be too closely controlled by the old union dominated funds. On-site capabilities remain inadequate.

IX. BANKING SUPERVISION

A. Observance of Basel Core Principles for Effective Banking Supervision

130. **As part of the joint IMF-World Bank FSAP program, the BOI was assessed for its compliance with the Basel Core Principles for Effective Banking Supervision.** The team conducting the FSAP was led by Warren Coats (MAE). Göran Lind (Central Bank of Sweden) and Wayne Byres (Australian Prudential Regulation Authority) conducted the Core Principles assessment, using the Methodology contained in the Basel Committee paper dated October 1999. The assessment team based its assessment on extensive discussions with representatives of the Supervisor of Banks and the BOI's Banking Supervision Department (BSD). The team also discussed compliance with representatives of two commercial banks and a major audit firm, as well as gathering information from the Ministry of Finance and Securities Authority. The assessment is based on these discussions, as well as written material, primarily the *Banking Ordinance 1941* (BO), amended 1996, and the *Banking (Licensing) Law 1981*(BLL), as well as the *Bank of Israel Law 1954* (BOI Law) and several of the BOI's Directives dealing with various aspects of banking activity, risk management and reporting and disclosure.

Main findings

131. **Israel has a competent and professional supervisory staff and a satisfactory legal and regulatory framework in which to supervise banks.** Accounting and financial disclosure standards are broadly in line with international standards. More broadly, macroeconomic conditions have improved in recent years, with inflation considerably reduced.

132. **The BOI is the sole supervisor of banks.** The number and skills of its staff are adequate, with many staff having extensive supervisory experience. Salaries and other benefits within the BOI are sufficient to prevent any significant attrition to the private sector. There are no indications of significant governmental interference in the implementation of supervisory policy in recent years. However, a detriment to effective supervision is that the BOI is subject to **strict secrecy provisions, which prevent an appropriate level of information sharing** with domestic and foreign supervisors. Proposals have been made to amend these laws to allow for the necessary exchange of information between supervisory agencies, but it is not yet clear when, or even if, these changes will be implemented.

133. **The legal framework applying to the supervision of banks, and to banking activity more generally, appears adequate.** There have been no significant hindrances to the supervision of problem banks, including the application of remedial action. Israel has no deposit insurance. In the past, failing banks have been guaranteed by the BOI to ensure an orderly resolution. However, the **laws on money laundering currently are behind best practices in other industrial economies.** New legislation, which will significantly improve

the ability of the authorities to detect and track money-laundering activities, was adopted in August 2000. However, this will take some time to be fully implemented.

Compliance with the principles

134. **Traditionally the Basel Core Principles are grouped into seven major categories: (i) preconditions for effective banking supervision; (ii) licensing and structure; (iii) prudential regulations and requirements; (iv) methods on ongoing supervision; (v) information requirements; (vi) formal powers of supervisors; and (vii) cross-border banking.** The results are summarized here and in Table 8 by these groups.

135. **Preconditions for effective banking supervision and CP 1.** All sub-divisions of CP 1 are in compliance, with the major exception of the secrecy laws within the Banking Ordinance, which prevent the BOI from discussing problems within an individual Israeli bank with other supervisors (domestic or foreign). The BOI has approached the Ministry of Justice about the amendment of these provisions to allow for information exchange with other supervisory bodies, but these proposals have not yet been put forward to the Knesset Finance Committee.

136. **Licensing and structure, CPs 2–5.** The BOI complies with these Principles, with minor exceptions. There is a general prohibition of deposit taking that prevents significant abuses by unlicensed institutions, although this could be tightened further. The BOI also needs to consider implementing arrangements that ensure all material investments and acquisitions, covering both financial and nonfinancial and domestic and foreign investments, are conveyed to the Bank Supervisory Department (BSD) in advance. Such arrangements should be structured in such a way that the BOI can satisfy itself that the bank has the organizational and financial capacity to handle the acquisition, but does not need to take responsibility for the “soundness” of the acquisition itself.

137. **Prudential regulations and requirements, CPs 6–15.** Israeli banks are required to maintain a risk-weighted capital ratio, calculated in accordance with the broad framework of the Basel Capital Accord, of at least 9 percent at all times (including a market risk capital charge). In some instances, the BOI has adopted tighter requirements, providing some additional comfort. There are comprehensive rules for granting credit and for the evaluation of loans and of loan-loss provisions (CPs 7 and 8). However, the present BOI directive on problem loans uses a classification system that is somewhat unique to Israel, including the reporting of problem debts solely on a net basis (i.e., after deducting provisions). Reporting to the supervisor on problem loans according to classification is also limited to an annual return, although there is a quarterly collection that gathers some data broken down by industry.

138. **Large and related party exposures (CPs 9 and 10) are tightly defined and require Board approval in accordance with BOI directives.** However, the Core Principles recommend additional scrutiny for related party exposures over and above the normal credit management process; in particular, the BOI should encourage independent scrutiny of related

party exposures on an on-going basis. More work is also required to develop a more systematic framework for the assessment of country and transfer risks (CP 11). The BOI should set out explicit requirements for these risks, including a requirement for banks to create and maintain adequate policies and procedures. For market risks (CP 12), the BOI's compliance is high, reflecting a strong research effort in recent years. The requirements for the supervision of other risks and internal control systems (CPs 13 and 14) are also in compliance.

139. **On money laundering, existing laws are recognized as inadequate.** However, new legislation, which will significantly improve the ability of the authorities to detect and track money-laundering activities, was adopted in August 2000 and an implementing Governor's Order was issued in January 2001. The new regulations include not just "know your customer" and account opening rules within banks, but also reporting requirements to a new database of large or suspicious transactions located in the Ministry of Justice. These new arrangements will take some time to fully implement.

140. **Methods of ongoing supervision, CPs 16–20.** This group of principles relates to the supervisory methods that should be applied, both on-site and off-site, and the necessity to evaluate these methods qualitatively and on an ongoing basis. The group includes the necessity of supervising banks on a consolidated basis. The framework for on-site and off-site supervision at the BOI complies with CP 16. BSD management are highly conscious of the need to ensure off-site and on-site supervision is closely integrated, particularly given the former is located in Jerusalem and the latter in Tel Aviv (where the major banks are headquartered). Nevertheless, to aid on-going improvements, the BOI is encouraged to consider the development of a quality assurance function. In assessing bank management (CP 17), the BOI has begun to use the issuance of new licenses as the opportunity to impose a "fit and proper" regime. However, this needs to be expanded to cover all banks and extended to all directors and key members of management. The BOI is compliant with CPs 18, 19 and 20, although it could usefully explore closer relationships with banks' external auditors. The BOI meets the requirements for consolidated supervision. This reflects the fact that, notwithstanding the lack of coordination among supervisory agencies, the BOI itself directly monitors all banking group entities (even those that fall under other domestic supervisors, e.g., a securities trading subsidiary), and has the legal power to do so. There is no doubt that group supervision is occurring, even if it probably involves some unnecessary duplication by the BOI and the securities regulator.

141. **Information requirements, CP 21.** The BOI is in compliance with CP 21, although there may be some benefit in the BOI having the power, on an ad hoc basis, to direct the scope and standard of the work of bank external auditors.

142. **Remedial measures and exit, CP 22.** In practice, the BOI acts promptly in all cases where there are supervisory concerns, even where this is only expectation of potential problems. However, this Principle is designed to ensure that there is a clear duty on supervisors to take action when necessary, and that forbearance is prevented wherever possible. To that end, it would be helpful to have included in legislation, an explicit statutory

duty on the Supervisor of Banks (SOB) to act promptly to address supervisory issues as and when they occur, to have problems remedied as soon as is practicable. This would not restrict the options available to the SOB, but would make it clear that forbearance is not acceptable.

143. **Cross-border banking, CP 23–25.** These principles are all related to cross-border banking, such as cooperation between home and host country supervisors and exchange of information, consolidated supervision on a global basis, and equal treatment of foreign establishments. While the BOI practices consolidated supervision on a global basis, the secrecy provisions of the Banking Ordinance prevent the BOI from providing sufficient information on Israeli banks to foreign supervisors. While these provisions have been circumvented to some extent, by the use of license conditions for new banks, these provisions could be more comprehensive. As noted above, the BOI has sought an amendment to these provisions to allow for information exchange with other supervisory bodies, but it is not clear if or when these amendments will occur.

144. **When measured against the Essential and the Additional Criteria in combination, the BOI is fully compliant with 17 CPs, largely compliant with six, and materially noncompliant with two Principles.**

145. **Initiatives under way, such as the proposed changes to the secrecy provisions and the new money laundering legislation, should address the two main areas of material noncompliance.** Other areas where the BOI could improve its supervisory arrangements are all within the scope of the supervisor to implement.

Authorities' response and recommended next steps

146. **The authorities were in broad agreement with the assessment.** In the two areas in which the BOI is materially noncompliant (money laundering and information sharing among supervisors), the BOI is taking steps that should result in full compliance. It has prepared amendments to the banking law that would allow it to share supervisory information with other banking and financial sector supervisor domestically and abroad. It has issued regulations to implement the new money laundering law and is waiting for the Ministry of Justice to establish the agency that will monitor compliance.

147. **An overriding recommendation for the Israeli authorities is to make the legislation pertaining to banking more transparent.** Making the laws more explicit also increases the accountability of the BOI and the SOB.

B. Transparency of Banking Supervision Policies

148. **This assessment is of the transparency of banking supervision policies as they are currently conducted by the Banking Supervision Department of the Bank of Israel.** The assessment was made in the context of the FSAP.

149. **The assessment was conducted by Mark Robson, a Senior Advisor from the Financial Stability Area of the Bank of England, acting as consultant to the Monetary**

and Exchange Affairs Department of the IMF, under the supervision of its Assistant Director, Warren Coats. It was based mainly on a self-assessment by the Banking Supervision Department; an examination of the relevant laws (principally, the 1941 Banking Ordinance; the 1954 Bank of Israel Law; and the 1981 Bank (Service to the Public) Law and Bank (Licensing) Law); information in public reports issued by the BOI (particularly, the annual surveys of the banking system and financial statements of the Bank); and discussions with many officials of the BOI, including the supervisor of banks, his deputy, heads of units and their assistants, the senior economist of the Banking Supervision Division and the General Counsel and the comptroller of the BOI. Partners of the leading accountancy firm of KPMG Somekh Chaikin and officials of the Ministry of Finance and Securities Authority also provided helpful information. The authorities were fully cooperative.

150. **The assessment was based on the *Code of Good Practices on Transparency in Monetary and Financial Policies* approved by the IMF Executive Board on July 9, 1999, and its three supporting documents, as approved by the Executive Board of the IMF on July 24, 2000.**

Background

151. **A full summary of the structure of the banking sector and the supervisory environment can be found above, in the assessment of Israeli compliance with the Basel Core Principles for Banking Supervision.**

Main findings

152. **Banking supervision by and large is well defined, with clear and generally adequate responsibilities and powers given to the Banking Supervision Department of the BOI.** Its policies and rules are clearly communicated to the public. It provides the public with a lot of information of high quality on its activities and on the banking sector. Responsibilities are not fully transparent in several respects, however. The main law on which the BOI's supervision rests is outdated and the Bank's objectives on supervision are not explicitly defined. A particular weakness pertains to the BOI's role in the payment system and its policies with regard to the settlement of payments through its books. It is not clear how the BOI would deal with the failure of a bank to provide the funds needed after the system has implicitly settled its payments. The responsibility of the BOI for bank exit is also compromised by the requirement to have the agreement of the government to certain key actions. The Bank's policy of depositor protection in the event of a bank failure is also unclear. A more detailed summary is given in the next section in Table 9.

Compliance with the code

153. **With respect to the clarity of roles, responsibilities and objectives, the legal position of the Banking Supervision Department is somewhat ambiguous, since it derives its authority from the 1941 Ordinance, and banking supervision is not specifically included as one of the functions of the BOI in the 1954 Law.** Subsequent legislation has given the Supervisor of Banks specific responsibilities with respect to bank

licensing and services to the public. Nevertheless, the Governor appoints the Supervisor, a senior employee of the BOI, under the 1941 Ordinance as amended, and may remove him from this office at any time. The Supervisor is assisted in his functions by an Advisory Committee on banking business, whose members are appointed by the governor and which is quite separate from the Advisory Committee under the BOI, appointed by the government.

154. **In a few respects, and through no particular fault of the BSD, governance falls short of best practices because of the weakness of the underlying legislation, which might have been entirely appropriate some fifty years ago but appears inadequate for contemporary conditions.** The Knesset Finance Committee, government and official authorities are well aware of this issue, and a new BOI Law has been under active discussion for at least eight years. To date, however, little progress has apparently been made in resolving the fundamental issue of the relationship between the government and governor (and under him, the Supervisor of Banks) specifically as regards authority, independence and accountability. For the time being, therefore, the independence of the governor and the Supervisor of Banks regarding policy and its implementation is less than fully clear in law. In one very important respect (the appointment of an administrator to take over a problem bank), the Banking Ordinance explicitly requires the approval of the government for an action that the BOI should have the independence to undertake. Although in practice the system appears to have worked well for quite some time (except in the area of failed bank resolution), without firm statutory foundations, its efficient functioning can not be guaranteed under all political and economic circumstances.

155. **It should also be noted that no objectives for banking supervision are specified in the original Ordinance.** In practice, the Department has developed its own objectives in addition to the specific, additional duties imposed on it by the 1981 legislation. These objectives are discussed in the annual surveys, but not prioritized.

156. **The statutory boundaries between the three different financial regulators (the other two being the Capital Markets, Insurance and Savings Division of the Ministry of Finance and the Israeli Securities Authority) are not entirely clear, so that it is difficult to be sure that there are no gaps or overlaps in the regulatory coverage, or that the current allocation of responsibilities is optimally efficient.** The Banking Supervision Department has difficulty in exchanging information efficiently with these agencies and with its overseas counterparts, due to the strength of the over-arching privacy and secrecy laws.

157. **Regarding openness in formulating and reporting policies, the Banking Supervision Department has a high public profile.** The Supervisor is frequently called upon to make statements about policies to the Knesset Finance Committee and to the press. The Department produces an annual survey of Israel's banking system, of high quality and including a large amount of information, in accessible form and style on developments in the sector, its policies and action taken during the year in pursuit of them, and recent and forthcoming regulatory changes. The only deficiency observed concerns consultation on prospective changes. These are typically discussed in secret with the Advisory Committee, and the banks and general public are not usually consulted.

158. **With this one notable exception, a large amount of information on policies is publicly available, in annual reports and on the Bank's web site.** There are only two respects in which the Code is not fully observed. The first is that, respecting the strict secrecy obligation, information on emergency financial support to banks would never be disclosed. The second is that based on past experience and the absence of explicit deposit insurance, there may be a widespread assumption that in the event of a bank failure, the government would fully compensate the depositors. This is not, however, stated policy and there remains the possibility that the government would not provide such support (often described as "constructive ambiguity"). This is patently not transparent and is likely to result in either moral hazard, or mis-pricing of retail credit risk, or both.

159. **With regard to accountability and assurances of integrity, the general approach taken is open and clear.** The only situation in which the Code is not fully observed concerns the lack of any financial or management accounting information on the cost of banking supervision in the public domain (although, in principle, it might be available under the new Freedom of Information Act, which came into force in 1999). The total overall administrative and general expenses of the BOI, the major part being salaries, are reported annually but the Banking Supervision Department is not distinguished from all other areas and activities of the Bank.

Authorities' response and recommended next steps

160. **The authorities broadly agreed with the team's assessments and recommendations.**

161. **To fully comply with best practices with regard to transparency, the relevant laws should be amended to clarify the relationship between these entities: the Governor and the Government, the Governor and the Supervisor of Banks, the different objectives of the BOI, and the three financial supervision authorities.** In addition, information on any emergency support given to banks should be provided to the public (after a suitable delay), and more detailed information should be provided to the public on the Banking Supervision Department's expenditures. Furthermore, changes to regulations should involve public consultation.

X. OBSERVANCE OF CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

162. **This assessment pertains specifically to the payment and settlement systems that are operated by the BOI.** The assessment was made in the context of the FSAP. The assessment was conducted by Simon Kappelhof, a payments expert from De Nederlandsche Bank, and was based on information provided by the BOI in the form of the Red Book prepared for the BIS, answers to the IMF questionnaire with regard to payment and securities issues, regulations for the Israeli Banks Clearing House, and the regulations for the accounting system of the BOI. These sources were supplemented by discussions held with

officials of the BOI, as well as with officials of the Tel Aviv Stock Exchange and Bank Hapoalim, Bank Leumi, Bank Mizrahi and Discount Bank.

163. **A full assessment was limited by the fact that time did not permit the examination of many of the laws that are relevant to payments, such as Israel's contract law and bankruptcy law.** A second limitation relates to the point that although it was aimed to have an impression of the soundness of the cross border payment and settlement practices of the banks, the core principles basically relate to domestic systems (except in case of a payment system that in itself has an international character). The authorities and others were fully cooperative.

164. **The principles used in the assessment are the Core Principles for Systemically Important Payment Systems (SIPS), approved by the G-10 Central Bank Governors.** There are no specific tools or criteria available for the assessment of the payment system.

A. Background

165. **The BOI and the commercial banking system form the backbone of Israel's payment system.** While the commercial banks and their affiliates provide most of the other payment and clearing services, the BOI general ledger system is the principal settlement system for new sheqalim. The banks operate, inter alia, a paper-based clearing house and an automated clearinghouse as well as an ATM network. They also own credit card companies and operate a POS network.

166. **The BOI has the power to supervise payment systems and settlement arrangements through its Banking Supervision Department.** However, the BOI generally avoids exercising its authority in matters connected with the supervision of settlement institutions, and is content to guide them indirectly by means of its representatives on the Banks' Clearing House Committee (BCHC). The BOI's basic approach is to restrict its involvement to developing and running its own payment system unless, for one reason or another, the private sector is not prepared to take the initiative. In that respect, the BOI chairs the private bank operated clearing house (at the request of the banks).

167. **Formally, it is the BCHC that sets the rules and supervises the operations of the Banks Clearing House and the Banks Clearing Center.** The Committee is appointed by the Governor of the BOI and comprises 10 members—five from the BOI (including the Chairman) and five from commercial banks, which gives the BOI adequate influence over the clearing systems.

168. **The Tel Aviv Stock Exchange (TASE), is supervised by the Securities Authority.** The BOI is a member of the Board of TASE, which does not give it the same level of influence over the process that it has over the BCHC. The Board of the TASE sets the rules for the TASE. Linked to the TASE, the Tel-Aviv Stock Exchange Clearing House offers clearing, settlement, and custody services and acts as the central securities depository. Clearing of derivative transactions takes place at the derivatives clearing house (MOF), a subsidiary of the TASE.

B. Main Findings

169. **The rule of law is well and long established in Israel. Contracts, laws, and rules are relatively efficiently enforceable.** The rules governing payment systems are clear and adhered to. Responsibilities for the operation of various systems are clearly established and defined.

170. **Oversight by the BOI, however, is not as fully or clearly developed as in most other developed countries.** Responsibilities are spread across several departments. The responsibility now in the Banking Supervision Department for developing an LVTS runs the risk of compromising its supervisory activities, which—regarding payments systems—are concerned with payment issues relating to a individual institution—and oversight activities that are oriented at the soundness of the overall system both with regard to its design and its operation.

171. **Israel's successful stabilization and entry into a stable price environment will facilitate the strengthening and further development of its payment systems.** It can be expected to gradually reduce the degree of dollarization in the economy, thus shifting more of its payments onto its domestic NIS payment systems.

172. **There is currently no oversight or systemic responsibility in the area of payment expenses.** A division of the Banking Supervision Department looks after the rules and practical arrangements for the supervised banks participating in the clearing systems for both paper-based and electronic transfer instructions. While value is almost always given on presentation date T, final settlement generally takes place on date T+1 or T+2. Although in theory the BOI is able to reverse a transaction for which insufficient funds are available, in the event of a major bank failure, it appears unlikely that it would be able to do so without the risk of a collapse of the system due to the "domino" effect of consequential unwinding. In practice, therefore, system participants assume that the BOI will bear all of the credit risk arising from delayed settlement. This moral hazard is undoubtedly currently giving rise to mis-pricing of credit within the payment systems. Further details can be found in the assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems.

173. **The Bank's officials who are most closely involved with the current arrangements recognize this deficiency.** They have been investigating the possibility of moving to a new large value transfer system, either on real time gross settlement or secured deferred net settlement basis. At the time of this assessment, the payment risk implicitly carried by the BOI was the most serious underlying policy problem with major transparency implications identified by the team with respect to the banking supervision function.

174. **Israel's observance of the core principles is mixed.** All processes are well organized, both technically and in terms of the procedures that apply, but a basic problem stems from the fact that the NIS settlement for the different clearing processes involves de facto credit risk for the BOI, which is not able to check the availability of funds at the

moment that it officially or unofficially accepts the outcome of the clearing. Moreover, banks seem to assume that the BOI accepts the risk. As a consequence, banks have not really prepared themselves, either in terms of setting appropriate counterparty limits for the NIS settlement process or in terms of having systems for measuring exposures in the payment system. In addition, the clearing processes themselves seem to be organized on the basis of the assumption that there is no settlement risk or that, if any, it will be taken by the BOI. Systems generally have no limits and no provisions like loss-sharing arrangements.

175. **The BOI has limited its oversight of the payment system to its supervision of banks.** It has not taken the lead in developing its settlement systems and the private sector clearing systems in accordance with the core principles and thus a number of core principles are non-observed in the design of these systems. The BOI will need to reorient its thinking about its role in the payment system if it is to more fully observe the core principles, and to give payment system issues the importance given by the central banks of most developed countries.

176. **The BOI is aware of the credit risk issue that is inherent in the present settlement system and is at the moment considering the introduction of a LVTS system, which may operate either on a real time gross settlement basis or a secured deferred net settlement basis.** The introduction of such a system will, due to the nature of its functioning, have a number of positive effects in this context.

C. Compliance with the Principles

177. **Israel's compliance with the Core Principles is summarized below and in Table 10.**

Principle 1: Well-founded legal basis in all relevant jurisdictions

178. Rules and regulations applicable to the payment system are based on several laws, on regulations by the Supervisor of the banks, and by contractual arrangements.

Principles 2–3: Understanding of the system's impact on risks; and procedures for the management of risks

179. The practice of the BOI in the settlement gives the banks the impression that the BOI will take care of the risks and does not give them the proper incentives to manage the risks in the system.

Principles 4–5: Final settlement; inability to settle by the participant with the largest single settlement obligations.

180. In general, settlement does not take place on the same day and, where netting takes place, the systems do not have provisions to settle the position of the largest defaulter.

Principle 6: Assets for settlement.

181. All systems settle in central bank money.

Principle 7: Security and operational reliability; and contingency arrangements

182. All systems have adequate provisions to ensure a high degree of security and operational reliability and have contingency arrangements for timely completion of daily processing.

Principle 8: Practical for the markets and efficient for the economy

183. Systems are efficiently organized.

Principle 9: Objective and publicly disclosed criteria for participation

184. The criteria for participation can be regarded as objective and are well known.

Principle 10: Governance of the system should be effective, transparent and accountable

185. Governance of the systems is in principle adequate due the involvement of the BOI under its legal authority.

Principle 11: Responsibilities of the Central Bank in Applying the Core Principles

186. The BOI approaches payment systems issues very much from a supervisory perspective, which does not properly reflect the responsibilities for the payment system that are assumed in the BIS Core Principles approach.

D. Recommended Action

187. **The team endorsed the BOI's intention to develop a new LVTS linking banks to their reserve accounts at the BOI.** As mentioned before, several options are available for the BOI. A major consideration for making the choice relates to the liquidity implications of the different systems, also in the context of the monetary instruments used.

188. **Since the adoption of an LVTS will also have an impact on the banks as the users of the system, the team advised the BOI to consult the banks on these issues.** A second reason for consulting the banks stems from the fact that any choice will have major information systems implications for the banks. A common way for consulting the banking community on general payment systems issues is through a National Payments Council, which typically deals either on the level of the main committee or through subcommittees with all payments related policy issues.

189. **As is mentioned in the context of principle 1 on the legal basis for payments, the introduction of a new settlement system probably requires legislative changes as well.**

Since that may take considerable time to develop, the team recommended that the BOI start preparing such legislation rather soon.

190. **Apart from these systems changes, the team advised the BOI to reconsider and refocus the oversight function that the central bank typically has in relation to the payment system.** In all G-10 countries there is a clear distinction between the supervisory activities and the oversight activities of the central bank (in case the supervisory function is with the central bank), even to the extent that the oversight activities are the responsibility of a senior member of management that is not the member responsible for supervision. Generally this member will also be responsible for the payment operations of the central bank and for its involvement in its role in the private sector operated systems. Subsequent to this assessment, the BOI established a payment system oversight function in the Comptroller's Office and is considering the establishment of a National Payments Council.

E. Authority's Response

191. **The BOI acknowledged the weaknesses identified by the FSAP team and has already undertaken several steps toward addressing them.** The BOI has established a payment system oversight function in the Comptroller's Office. It is also discussing with banks the establishment of a National Payment's Council to advise on the development of payment systems. The Council will be consulted with regard to the development of a LVTS to help ensure that it complies with best practice for such systems.

XI. TRANSPARENCY PRACTICES OF THE CENTRAL BANK IN MONETARY POLICY

192. **This report assesses the consistency of monetary policy in Israel with the Good Transparency Practices for Monetary Policy by Central Banks.** This assessment was made in the context of an FSAP mission. The assessment was undertaken by Mark Stone, Senior Economist in the Monetary and Exchange Affairs Department of the IMF, under the supervision of Warren Coats, Assistant Director of MAE, and was based largely in discussions with officials of the BOI, which is responsible for monetary policy, as well as with officials of the Ministry of Finance. In addition, the assessment drew on *Bank of Israel Law, 5714-1954* and on answers prepared by the BOI to questions sent prior to the mission.

193. **The Israeli authorities cooperated fully with the assessment and all required information and documents were provided.**

194. **The assessment was based on 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 the supporting document approved by the Executive Board on July 24, 2000.** No assessment methodology has been developed yet.

A. Background

195. **Monetary policy in Israel is aimed at meeting inflation targets set by the government after consultation with the BOI. Recently, targets have been set in conjunction with the discussion of the budget deficit for the following year.** Current targets are 3–4 percent in 2000, 2.5–3.5 percent in 2001, 2–3 percent in 2002, and 1–3 percent from 2003. The present arrangement is the product of a gradual, and as yet incomplete, shifting of the objective of monetary policy from a nominal exchange rate target to an inflation target. This process has been characterized by a progressive widening of the exchange rate band since December 1991.

196. **Policymaking at the BOI works as follows. BOI staff forms a view on the inflation outlook based on monitoring of inflation developments, as well as input from economic models.** Based on this outlook, the Governor meets with the Monetary Forum, an internal advisory group of relevant department heads, to decide on the stance of monetary policy needed to maintain projected inflation within the target range. The desired stance of monetary policy is implemented by choosing the short-term interest rate operating target and maintaining bank liquidity consistent with that rate. The interest rate is signaled to markets every month following the meeting of the Monetary Forum. In addition, twice a year the BOI produces a detailed inflation report, which provides analysis of inflation developments and the BOI's inflation forecast.

B. Main Findings—Summary

197. **The conduct of monetary policy in Israel is highly transparent.** In practice, the objectives and operation of monetary policy are open and transparent. However, gaps between the monetary policy *de jure* and monetary policy *de facto* leave room for improvement in transparency in several areas. The multiple functions of the BOI under the BOI Law are vague and open to interpretation. The absence of formal specification by the law or government of whether the inflation target or exchange rate band has priority in the event of conflict means that the ultimate objective of monetary policy is not fully transparent, thereby weakening the independence of the BOI. Nevertheless, it has always been the exchange rate band, not the inflation target, that has been adjusted when serious conflict has arisen (e.g., June 1997). The need for government approval for some instruments may diminish the effectiveness of policy implementation by the BOI and weaken its accountability. The lack of clarity of the BOI Law regarding the conditions under which the Governor can be removed from office by the Government leaves room for indirect Government interference in BOI policy.

198. **The accountability of the BOI and the integrity of its officials is high.** However, detailed information on BOI income and expenditures (e.g., the net cost of banking supervision) is not easily available to the public.

199. **The current and recent governments and BOI governors have generally established clear goals for policy and the autonomy of the BOI to implement them.**

However, the dependence of BOI independence and accountability on personalities is a weakness. A new BOI law could go a long way toward filling these gaps between monetary policy *de jure* and monetary policy *de facto*.

C. Compliance with the Principles

200. **Main findings of the detailed assessment of observance to the Code are grouped and summarized below and in Table 11:**

Code 1: Clarity of Roles, Responsibilities and Objectives

201. **The conduct of monetary policy in Israel can be judged as highly transparent.** However, gaps between the responsibilities and objectives policy *de jure* and *de facto* leave room for improvement in transparency in several areas. In particular, the multiple functions of the BOI under the BOI Law are vague and open to interpretation. In practice, these legal functions do not necessarily lead to the actual aim of monetary policy to achieve price stability. Although, the effectiveness of policy does not seem to have been undermined by this discrepancy, a resolution of the legal functions and actual objectives of policy would improve transparency.

202. **Another gap arises from the shifting of the objective of monetary policy to an inflation target from an exchange rate band.** The inflation target and the exchange rate band, both of which are established by the Government, raise the possibility of potential policy conflicts. The absence of formal specification of which objective has priority in the event of conflict means that the ultimate objective of monetary policy is not fully transparent.

203. **The need for government approval for utilization of some instruments may diminish the transparency and effectiveness of policy implementation.** For example, the need for government approval for the issuance of government securities used for monetary management (Makam), which now is adjusted by formula, constrains the BOI's ability to implement monetary policy in the most efficient way. This weakens its accountability.

204. **Finally, the BOI Law establishes conditions under which the Governor can be removed from office by the Government that potentially give the government considerable discretionary control over the Governor.** The current provision leaves room for indirect Government interference in BOI policy.

Assessment: Largely observed

Code 2: Open Process for Formulating and Reporting Monetary Policy Decisions

205. **The formulation and reporting of monetary policy decisions is open and transparent.** The Governor, who is legally empowered and responsible for setting the monetary policy interest rate, is advised on the setting by a "Monetary Forum" of relevant department heads. The BOI publication *Economic Views*, issue number 8 (January 2001), describes the procedural aspects of the formulation of monetary policy, including a

description of the meetings that are held, departments that participate, nature of material that is presented, etc. The deliberations of the Forum are not public, but since 1998, the BOI has published twice a year an *Inflation Report* on the monetary developments and the BOI's views on the required policies to achieve the inflation target. In addition, different departments of the BOI produce annual reports on economic, capital markets, and foreign currency developments. The regulations for monetary operations are publicly disclosed, and the settings of monetary policy instruments and operations are reported monthly.

Assessment: Observed

Code 3: Public Availability of Information on Monetary Policy

206. **In addition to its *Inflation Report*, the BOI makes available a wide and high-quality array of information in different media.** Israel subscribes to the IMF's Special Data Dissemination Standards (SDDS) and meets the SDDS specifications. Information about foreign exchange reserve assets, liabilities, and commitments by the monetary authorities are publicly disclosed on a preannounced schedule. A special unit within the BOI is responsible for providing information to the media and general public on BOI policies and activities. Press releases addressing monetary policy and financial issues are issued regularly and the Governor, Directors of the BOI and relevant senior staff appear regularly in the media and before the Knesset Finance Committee. The BOI Law specifies rules regarding emergency financial support of the BOI, although there is no established policy or recent experience with such loans and they are not explicitly disclosed.

Assessment: Observed

Code 4: Accountability and Assurances of Integrity by the Central Bank

207. **The transparency of accountability and integrity by BOI officials is good.** The Governor appears regularly in front of the Finance Committee of the Knesset Finance Committee. The accounts of the BOI are inspected by the State Comptroller and information on accounting policies and any qualifications are disclosed in the notes to the accounts. The financial statements are audited by an independent auditor and the annual work program of the auditor and his findings are available to the public under the Freedom of Information Law of 1998. Standards for the conduct of personal financial affairs and legal protection of BOI officials are publicly disclosed. However, detailed information on BOI expenses and revenues (e.g., the net cost of banking supervision) is not easily available to the public and to this date has not been disclosed. Annual financial statements provide only general statistical information on salaries. Any person can ask for information on the activities of the BOI, to the extent that the information is already internally available, under the Freedom of Information Law.

Assessment: Observed

208. **The main practical problem for the BOI is to obtain a clarification from the government with regard to the primacy of the exchange rate or inflation as the objective of policy.**

D. Authorities' Response and Recommended Next Steps

209. **The BOI basically agreed with the FSAP team's assessments and recommendations.** The practice of monetary policy in Israel is much better than the legal framework that supports it. The team strongly supports the adoption of a new central bank law that reflects the principles of Maastricht. The potential conflict between exchange rate and price objectives of policy should be removed. Other central banks that evolved from an exchange rate anchor to an inflation-targeting framework have dropped any explicit exchange rate targets or bands.

XII. SECURITIES

A. Observance of IOSCO Principles of Securities Supervision

210. **This assessment covers the Israeli securities sector, for which regulation and supervision are largely the responsibility of the Israeli Securities Authority (ISA).** The main objectives of the assessment are to determine levels of observance of the International Organization of Securities Commissions (IOSCO) principles and to suggest areas where further development may be appropriate. This assessment was undertaken as part of a Financial Sector Assessment Program (FSAP) report on Israel.

211. **The assessment was conducted by Melinda Roth-Alexandrowicz, a Senior Financial Sector Specialist, Financial Sector Development Department of the World Bank.** The assessment is based on the recently completed Israeli IOSCO self-assessment. In addition, a review of the securities laws, the TASE Annual Report, Israeli market research information from investment banks and other publicly available information was made. Extensive discussions were held with ISA, including the heads of most of the relevant departments. In addition, meetings with market participants, the TASE, the TASE Clearing House and the domestic rating agency also provided input to the assessment. One important factor to note is that the updated securities laws are not available in English, but this did not affect the objectivity of the assessment.

212. **The assessment is based on the Principles of Securities Regulation adopted by IOSCO September 1998.** There were no adaptations made for specific country circumstances to the IOSCO Principles, as Israel is a full member of IOSCO and has an established regulator. There is no established methodology for the assessment, but the principles themselves contain explanations and specific areas that should be observed under each principle.

Background

213. **The ISA was established in 1968 through the implementation of the Securities Law.** This law was most recently amended three times in 2000 to authorize the ISA to sign Memoranda of Understandings (MOUs) (February), to make the law consistent with the recently passed Company Law regarding prospectus issues (May) and also to allow companies listed in the U.S. market to dual list on the TASE with streamlined disclosure requirements and document production (July). The ISA is a strong regulator with ample and comprehensive powers.

214. **TASE: The TASE trades stocks, bonds and derivatives such as options and futures on the Tel Aviv 25 index, on the exchange rate and, since March 2000, on interest rates.** The TASE has 29 members out of whom 13 are banks and the rest are security houses.

215. **Israel's stock market has grown dramatically recently.** Market capitalization was 66 percent of GDP as of end-1999 (or US\$65.4 billion), compared to just 38 percent three years earlier. Measured by capitalization, the stock market is broadly comparable to that of other industrial countries and exceeds that of large emerging market countries, although total value traded on the stock exchange is less than the average across both country groups. Total turnover in 1999 was US\$21 billion and about 670 companies are listed.

216. **A major change in the last five years is the dramatic increase in the number of firms—mostly high tech—that raised capital abroad in the United States and Europe.** Over 100 Israeli companies are currently listed on NASDAQ. The capitalization of Israeli firms that trade in the United States is almost as large as the capitalization of the TASE. A recent amendment to the Securities Law encourages dual listings for those Israeli companies listed on the three major U.S. exchanges, since ISA will accept the NASDAQ disclosure requirements and not require additional documentation (or translation into Hebrew).

217. **Derivatives: The OTC market for derivatives is mainly in the hands of the banks.** They trade forwards, swaps and options. The BOI is also very active as a writer of calls and puts options on the exchange rate. The BOI started this activity in 1989 in order to help develop a derivatives market in Israel.

218. **Debt Markets: The development of other segments of the Capital Markets in Israel has been uneven.** Outstanding government bonds are equivalent to 33 percent of GDP, comparable to the level in other industrial countries. However, the volume of trade is relatively small. The corporate bond market in Israel is tiny, with market capitalization of around 3 percent of GDP, and trading in this market is thin. Trading commercial paper is now legally possible, has not been a developing trend, since companies prefer bank lending.

219. **Market Infrastructure: The TASE Clearing House offers clearing, settlement, and custody services and acts as a central depository.** It complies with the G-30 international standards. Securities are held in book-entry form, and the computerized systems

enable fully automated trade processing. Custodian transfers are still processed manually, but automation plans are underway.

220. **Settlement occurs when Clearing House members' accounts are credited (or debited) on the trade date and trades settle on the following day (T+1), according to the delivery verses payment principle.** Most Clearing House members are also members of the TASE and comply with strict capital and liquid assets requirements. A mutual guarantee mechanism enforces joint responsibility for all Clearing House members to ensure full settlement of all trades.

221. **Institutional Investors: There are approximately 430 mutual funds in the Israeli market.** These funds are supervised by the ISA under the Joint Investment Trusts Law. Other collective investment vehicles include provident funds and pension funds. These vehicles, along with the insurance sector, are supervised by the Ministry of Finance and described in a different chapter.

222. **The venture capital industry is well developed.** This started with the establishment of YOZMA, a venture capital fund sponsored by the government. In recent years venture capital has increased its role as a source of financing to the high tech sector and small and medium size enterprises. There are about 60 venture capital funds operating now in Israel. Financing is therefore readily available in Israel, though the majority of institutional investors is passive and have not spurred the development of alternative financial instruments and techniques.

223. **The preconditions for effective securities supervision are numerous, but perhaps most critical include sound and sustainable macroeconomic policies conducive to investment and savings, enforceable property rights, a supportive political environment free from corruption, well developed infrastructure (such as legal and accounting practices, clearing and settlement systems, payments system) and an effective judicial system.** Corporate governance and insolvency mechanisms are also necessary, which appear to be largely in place in Israel.

224. **IOSCO also lists several attributes necessary for effective regulation.** No unnecessary barriers to entry and exit from markets and products; markets should be open to the widest range of participants who meet specified entry criteria; regulators should consider the impact of requirements when developing policy; and all who make financial commitments or promises must bear an equal regulatory burden. These preconditions appear to be met in Israel. The one caveat is that the dominance of the largest banks in capital market activities does not exclude other participants, but makes it more difficult for others to break into these businesses.

Main findings

225. **The ISA is a strong regulator with comprehensive powers, excellent capacity, and the willingness to carry out their supervisory mandate.** Supervisory objectives of ISA are clear through the securities laws: the protection of investors. ISA has the authority it

needs to carry out this objective as well as sufficient independence. Enforcement is excellent, since ISA has the powers it needs to ensure compliance with the securities laws. These activities include market surveillance and investigations of violations of the law. Stock watch, ISA market surveillance system, appears to be technologically advanced and thorough in allowing the regulator to see market irregularities.

226. Both ISA and the TASE continue to adapt to the dynamic situation that exists in all securities markets. The Securities Law was amended several times over the past year, including a significant amendment which will enable Israeli companies listed on the three major U.S. exchanges to become listed as well on the TASE with simplified procedures, including acceptance of U.S. disclosure and reporting requirements. Other changes in the legal and regulatory are proposed, including (i) the proposal to fund the ISA partially through a transaction fee to be paid by the TASE that would better reflect the range of the ISA's activities; (ii) the ability to report financial statements and material information on-line; (iii) modification of regulations relating to transactions between related companies and controlling parties thereof and transactions with conflicts of interest; (iv) adoption of IASC standards for accounting; and (v) design of a new model for prospectus disclosure for companies as well as mutual funds.

227. Other areas still require improvement, such as coordination between domestic financial sector regulators. This will help the Israeli financial sector supervisors to better understand the risks that market intermediaries are taking and whether those risks are properly accounted for and insured. Another improvement would be the ability for the ISA to impose civil sanctions, rather than security violations remaining only criminal. The ISA can now impose such penalties on mutual funds, and minor securities infractions by listed companies, such as reporting late should become penalties rather than criminal violations. This may require major changes in not only the legal framework, but also supervisory philosophies.

228. Another consideration is the possibility for ISA to become the supervisor of other collective investment schemes currently supervised by the Ministry of Finance. This is discussed elsewhere in the report.

229. Several minor areas of improvement are also suggested in the detailed assessment. These include: (i) the ability for the ISA to investigate licensed or authorized market participants without necessarily having suspicion of breach, (ii) the ability for the ISA to settle cases (this is closely related to the suggestion above to move toward administrative and civil sanctions; (iii) eliminating the possibility for ISA to finance, in whole or in part, the costs to the plaintiff for class action law suits; and (iv) developing better investor and public relations through the launch of an ISA web site as well as publishing laws in English.

Compliance with the principles

230. Main findings of the detailed assessment of observance to IOSCO Principles are grouped and summarized below and in Table 12:

Principles relating to the regulator, Ps 1–5

231. The responsibilities of the ISA are stated in the following laws: Securities Law (originally passed 1968); Joint Investment Trusts Law (1994); and the Portfolio Manager and Investment Advisor Law (1995). Regulatory authority is established under the Securities Law, which states that the function of the ISA is to protect the interests of the public when investing in securities. The ISA is operationally independent in implementing its powers. The chairperson is appointed by the Minister of Finance, as are the other 12 members. They can only be removed with good cause, and are therefore independent but yet accountable.

232. The ISA's activities are self-financed. Currently, fees paid by public companies and mutual funds cover most of the expenses of the ISA that are incurred from its activities. The ISA has recently proposed to collect fees from TASE transactions, based on three-year historical volume so that the TASE can better predict the costs of such a levy. This new fee structure would better reflect the wide range of activities imposed by the securities laws on the ISA.

233. Anyone concerned by a decision of ISA may appeal this decision in District Court, which provides a significant measure of accountability. Finally, the ISA has several safeguards to protect commercially sensitive information from inappropriate disclosure.

234. While the ISA has all the necessary powers, resources and capacity to carry out effective supervision of the Israeli market, the capital markets are changing rapidly through both globalization and new technology, and it will be important for the ISA to maintain both resources and capacity to ensure continued successful supervision.

Principles of self-regulation, Ps 6–7

235. **The TASE is a self-regulatory organization that is supervised by the ISA. It has 29 members, including the Bank of Israel.** The TASE is granted with rulemaking powers. Directives must be approved by the ISA and changes in bylaws must be recommended by the ISA to the Minister of Finance for Knesset Finance Committee approval. TASE is responsible for rulemaking in regard to trading practices, fair and orderly operation of trading facilities, clearing and settlement processes, and financial responsibility of their members. The TASE is also responsible for enforcing the listing rules that are designed to guarantee fair and orderly trading and maintenance of these rules.

236. **The TASE does not perform substantial market monitoring, as this is relegated to the ISA. This is unusual compared to other countries.** The TASE does have responsibility to monitor its nonbanking members regarding their market activities.

Principles for the enforcement of securities regulation, Ps 8–10

237. **ISA's enforcement powers allow for a wide range of activities aimed at ensuring compliance with the securities laws.** These activities include market surveillance and investigations of violations of the law. Stock watch, ISA market surveillance system, appears to be technologically advanced and thorough in allowing the regulator to see market irregularities.

238. **ISA has strong enforcement powers, including the ability to request any pertinent information or documents; apply to courts for warrants to enter premises; interrogate any person, company, investment company or mutual fund connected to the issue; and obtain injunctions or temporary orders to halt suspected activities.** In addition, the ISA has the power to arrest, although it is currently contained in a different law (there is a proposal to move the power to the Securities Law so that it is contained in the ISA's primary legislative framework as the arresting powers must currently be renewed annually by the Minister of Justice).

239. **It should be noted that these strong powers are necessary given that violations of the securities laws in Israel are criminal (with a few noted exceptions for administrative sanctions in the Joint Investment Trust Law).** This implies that the ISA only uses these powers when there is overwhelming substantiation of a given case, given the balance of protecting civil rights with rigorous enforcement of securities laws.

240. **Regarding mutual fund supervision, the Mutual Funds Department has an automatic computer program that allows any irregularities in the monthly required reporting by mutual funds to be detected automatically.**

241. **One issue related to enforcement that should be reconsidered is that a plaintiff may apply to the ISA to cover all or part of the expenses of a class action lawsuit.** While the original intent of this policy was meant to encourage the use of class actions as a tool to

maintain the integrity of market issuers and participants, there is some question as to whether or not the encouragement by ISA of such actions is appropriate. The ISA should have the ability to enforce its own civil sanctions rather than assist private individuals to pursue a class action through the offer of paying the costs of such an action.

242. Staffing which supports the ISA's enforcement area appears adequate, although with the increasing allure of the Internet as an investment and information dissemination tool (including for fraudulent activities), the ISA may need to strengthen the areas of inspection, investigation and surveillance.

243. One final minor outstanding issue is that suspicion of breach is necessary to begin an investigation. IOSCO Principles state that suspicion of breach should not be a necessary prerequisite to use inspection powers with regard to authorized or licensed persons.

Principles for cooperation in regulation, Ps 11–13

244. These cooperation principles are partially implemented as the Israeli system should be viewed in a historical context, in which the formerly closed economy with a healthy respect for privacy has defined how authorities cooperate, both with domestic counterparts as well as foreign ones. While cooperation with domestic counterparts can occur through formal, legal processes (such as court orders), such cooperation occurs on demand rather than through planned and clearly defined mechanisms (i.e., there are no domestic MOUs between financial regulators). The different financial sector regulators do often have representation on each other's governing bodies.

245. The ISA has only signed one MOU, albeit with a major market (the U.S. SEC) and one that has great mutual benefits. However, the ISA should consider additional MOUs in markets with mutual involvement. Without an MOU, the ISA may share only public information, providing it to foreign regulators who need such information. Under the International Legal Assistance Law (1998), foreign regulators can request nonpublic information through the Ministry of Justice without an MOU.

Principles for issuers, CPs 14–16

246. Israeli securities laws have comprehensive disclosure requirements.

247. Corporations seeking to offer their securities to the public must apply to the ISA for a permit to publish a prospectus. In the prospectus, the company must provide all pertinent information on the nature of its business, the company's management and major shareholders and the type of security being offered. The company also must provide annual audited financial statements by an independent certified public accountant. A necessary and critical part of this financial reporting disclosure is the Management Discussion and Analysis. Prospectuses are publicly available as soon as they are approved. Such regulations are actually more stringent than the U.S. SEC.

248. **Corporations whose securities have been offered to the public by prospectus are required to submit annual financial reports within 90 days after the end of the fiscal year.** An independent certified public accountant must audit these reports. Companies also must submit quarterly financial reports that have been reviewed by a CPA, within 60 days after the end of each of the first three fiscal quarters. Noncompliance is a criminal violation of the law.

249. **The Securities Law needs to be made consistent with the disclosure requirements now contained in the Company Law.** Such changes do not introduce new concepts but rather present modifications that are necessary for consistency. The ISA also expects to amend the Securities Law to allow for internet submission of financial reports. This should assist in providing timely and public disclosure of listed companies.

250. **These legal changes, which started when the Securities Law was first passed in 1968, allow continued improvement in the area of disclosure.**

Principles for collective investment schemes, Ps 17–20

251. **Collective investment schemes are regulated by various laws, depending upon the type of scheme.** Provident funds and pension funds are regulated and supervised by the Ministry of Finance and discussed elsewhere. Mutual funds are regulated by the ISA through the Joint Investment Trusts Law (1994).

252. **The ISA grants permits to mutual funds to publish their prospectuses and offer their units for sale to the public.** Supervision of mutual funds is accomplished through continuous disclosure, monthly reports to the ISA and annual prospectuses. ISA routinely inspects these electronically filed monthly reports and enforces their compliance through civil fines as stated in the Joint Investment Trusts Law.

253. **The question of regulatory arbitrage and the possibilities of coordinated supervision of the financial sector are discussed elsewhere, but policy makers may wish to consider the possibility of transferring responsibility for other collective investment schemes to the ISA.**

254. **Foreign funds are currently not allowed to offer units or shares in the State of Israel. Currently, funds must be registered in Israel and domestically owned.** This domestic advantage should be eliminated, given the realities of a global economy.

Principles for market intermediaries, Ps 21–24

255. **The securities laws provide minimum requirements intermediaries (whether banks or not) must meet.** Many provisions in the laws are designed to minimize the potential conflict of interests between intermediaries and their clients. The ISA supervises the banks as intermediaries in the securities markets and as firms whose securities are listed on the TASE.

256. **The Ministry of Finance regulates pension funds and provident funds.** It licenses them and sets minimum entry requirements. The ISA regulates mutual funds. The Joint Investment Trust Law sets minimum entry standards for mutual funds to operate in the market. Mutual funds are required to file an annual prospectus, which describes its investment policy and discloses all material information on the mutual fund's manager and trustee.

257. **Under the Investment Advisors and Portfolio Managers (IAPM) Law, ISA is responsible for licensing portfolio managers and investment advisors.**

258. **Failure of market intermediaries are unlikely to disrupt the overall market given the legal framework, which provides for segregation of assets and the fact that securities belong to clients and not exchange members or fund managers.** If a mutual fund goes bankrupt, the assets belong to the unit holders. In this situation, the fund can either be liquidated or the management transferred to another mutual fund. This is also true for portfolio managers. Another safeguard is that market intermediaries are required to have insurance. Therefore, investors appear protected to the extent possible and damage to investors would be minimized.

259. **If a licensed investment advisor is advising clients, he may not select stocks/assets of his own firm or subsidiary.** This regulation is meant to prevent conflicts of interest. Investor clients can easily become captive to the Israeli financial conglomerate system in which all of the banks have fund manager subsidiaries and offer investment advisory services. The law is designed to ensure the client is offered the true range of competing investments. However, practice has been for investment advisors from banks to guide clients to their own mutual funds and provide only information/brochures on their related party instruments. The ISA has informed the banks (and other investment advisors) to comply with the law, but has not yet imposed any sanctions.

260. **These principles are difficult in which to achieve full implementation, especially in more complex markets, which have more sophisticated, and potentially more risky instruments and financing techniques.** Given the large size of the Israeli derivatives market, it is unclear if market intermediaries properly reflect these instruments in their activities. Whether or not prudential requirements and margin levels are set appropriately are only known ex post. In addition, the relationship between the banks and their financial intermediary subsidiaries, off balance sheet affiliates and related parties renders this principle difficult to assess. However, regulation cannot remove risk from the marketplace, but only ensure that proper management of that risk occurs.

Principles for the secondary market, Ps 25–30

261. **According to the Securities Law, the ISA supervises the fair and orderly operation of the TASE.** The ISA must approve the directives of the TASE and recommend approval of the TASE bylaws to the Minister of Finance.

262. **The TASE conducts regular audits of exchange member's operations. In addition, the capital and liquidity requirements of Exchange members are strict.**

263. **In 1997, the TASE launched Tel Aviv Continuous Trading (or TACT). Equity, fixed income, and derivatives are all traded under this state-of-the-art computerized, order-driven electronic network.** Trading volumes for derivatives more than doubled when this market was brought into the system in 1999. TACT has improved transparency of trading as well as liquidity and fairness as investors are guaranteed an equal opportunity with respect to entry of orders.

264. **TASE Clearing House offers clearing, settlement and custody services and acts as a central securities depository. Its rules comply with the G-30 international standards.**

Authorities' response and recommended next steps

265. **The authorities agreed with the teams assessments and recommendations.** With regard to the mission's recommendation that the ISA not be permitted to provide financial support for class actions suits, the Authority stated that while they agreed in principle that their practice might be reconsidered, they thought that it might be too early to do so now.

266. **The FSAP team recommended several initiatives to further improve securities supervision.** It recommended that the ISA improve cooperation with other financial sector supervisors by adopting more formation arrangements (such as a Council of Financial Supervisors, and MOUs). In addition, it should launch an informational web site, obtain the authority to impose civil sanctions, adopt new model prospectuses, and should consider taking over the supervision of collective investment schemes currently supervised by the Ministry of Finance.

B. Transparency of Securities Supervision Policies

267. **This assessment is of the transparency of securities supervision policies as they are currently conducted by the Israeli Securities Authority (ISA), an independent Government authority reporting to the Minister of Finance.** The ISA has a Chairman and 11 other Members, all of whom are appointed by the Minister, and is governed by the 1968 Securities Law, as subsequently amended. In 1994 the ISA was also given responsibility for supervision of mutual funds and in 1995, investment advisors and portfolio managers. The assessment was made in the course of an FSAP.

268. **The assessment was conducted by Mark Robson, a Senior Advisor from the Financial Stability Area of the Bank of England.** It was based mainly on: (i) an examination of the relevant laws (particularly, the 1968 Securities Law as subsequently amended, the 1994 Joint Investment Trust Law and the 1995 Investment Advisor and Portfolio Manager Law) and regulations; (ii) a self assessment of implementation of the IOSCO Principles (see above); and (iii) discussions with the Chairman and senior officials of the ISA, senior officials of the Tel Aviv Stock Exchange and its clearinghouse, and others.

269. The assessment was based on the *Code of Good Practices on Transparency in Monetary and Financial Policies* and its three supporting documents, as approved by the Executive Board of the IMF July 9, 1999, and July 24, 2000, respectively.

Main findings

270. **Securities supervision is well defined, with a clear fundamental law that has been regularly updated to reflect the need of the regulator to keep abreast of changing market conditions.** The ISA's policies and rules are clearly communicated to market participants, but as it already recognizes, the agency needs to do more to explain its role and responsibilities to the general public and overseas investors in particular. A web site is being developed, to be launched shortly. The ISA is directly accountable to the Minister of Finance and the Knesset Finance Committee. Changes to its regulations, including a new proposed method of funding, are therefore the subject of public hearings. Its relationship with the Tel Aviv Stock Exchange, and the by-laws and directives of the Exchange, which the ISA has to approve, is transparent.

Observance of the Code

271. **Observance of the Code is summarized below and in Table 13.**

272. **The ISA observes the Code with respect to clarity of roles, responsibilities and objectives, which are clearly set out in legislation and regulations.** The only aspect with which the team had some concerns was in the relationship with the two other financial regulators, the Banking Supervision Department of the Bank of Israel and the Capital Markets, Insurance and Savings Division of the Ministry of Finance. Although the ISA's broad objective is clear and statutory—to protect the interests of the public investing in securities—it was not clear to the team how, in practice, it could be sure of fulfilling that role efficiently in cases where passing information to one of the other regulators quickly was desirable, given the strength of the privacy and secrecy laws. The team was unable to form a clear and consistent view of what happens in practice, except when there was clear evidence of criminal action or an order of the Court.

273. **With regard to open process for formulating and reporting of policies, the Code is clearly observed in relation to market professionals for whom most of the work of the ISA is directly relevant, including the Tel Aviv Stock Exchange.** It is less clear, however, that to date the ISA has paid adequate attention to the desirability of engaging the general public, and in particular overseas investors, in its policy formulation and reporting. The annual report has only been available in Hebrew, and the ISA has not had a web site.

274. **It will however, soon have rectified the position and plans to devote more resources to public availability of information on securities supervision policies.** Use of a web site will enable links to be created to the TASE web site. This already contains information on sectoral developments and aggregate data envisaged by the Code to be made readily available to the public but which the ISA has not itself made available, because it saw

no point in duplicating information available from TASE or felt that there was likely to be insufficient interest its work from the general public. In so far as current practice falls short of the Code, therefore, the deficiency will soon be rectified.

275. The ISA appears fully to observe the Code on accountability and assurances of integrity by securities supervision agencies. The ISA reports at least annually to the Minister of Finance and Knesset Finance Committee. There are strong statutory restrictions on personal securities dealing and business interests by Members of the ISA, to avoid possible conflicts of interest.

Authorities' response and recommended next steps

276. The ISA agreed with the team's assessment and recommendations. The ISA is very transparent. However, the team recommended launching an informational web site that includes English translations of important laws and regulations. This is now planned for the summer of 2001. In addition, the ISA should establish MOUs with the other two financial sector supervisors setting out the relationship between them.

277. Little needs to done by the ISA to achieve full observance of the transparency code. The most important change is already under way, since a web site will be launched before the end of the year. In developing this new service, the ISA needs to bear in mind that there may be a very broad and diverse audience for information on its activities, certainly including foreign investors of varying degrees of sophistication.

278. Coordination among the three financial regulators should be more formalized. A Memorandum of Understanding between the three financial regulators should set out precisely the relationship between them, including a procedure for dealing with any overlaps or gaps which might arise from time to time and clarification of the circumstances in which supervisory information can be exchanged between them, or with overseas regulators. This would be worthwhile both under current legislation and after reform.

XIII. INSURANCE SUPERVISION

A. Observance of IAIS Core Principles of Insurance Supervision

279. This is an assessment of the observance of the core principles of the International Association of Insurance Supervisors (IAIS) in Israel. Insurance is supervised in Israel by the Capital Markets, Insurance, and Savings Division of the Ministry of Finance (MOF). This assessment was undertaken as part of a Financial Sector Assessment Program (FSAP) mission.

280. The assessment was conducted by Rodney Lester, Lead Specialist in the Financial Sector Development Department of the World Bank under the supervision of Warren Coats, Assistant Director of the Monetary and Exchange Affairs Department of the International Monetary Fund. Major sources of information used for the assessment included the answers to the questionnaire submitted by the IMF prior to the mission,

extensive information available on the MOF web site, an advance English language copy of the 1998 annual report of the Capital Markets, Insurance, and Savings Division, and unofficial English language versions of the new companies law and the key insurance statutes. In addition, extensive interviews were conducted with senior offices of the above-mentioned division, members of the actuarial profession and senior managers of two insurance groups. All those interviewed gave generously of their time and were anxious to be helpful.

281. **This assessment has been based on the draft Insurance Core Principles Methodology of the International Association of Insurance Supervisors dated June 24, 2000.** This contains all the Principles currently being used in FSAPs by the IMF and World Bank, including three new principles (organization, market conduct and cross border cooperation). The Methodology lists essential criteria required to meet the core principles.

Background

282. **Israel is the world's 27th insurance market. At the end of 1999 the private sector contained 37 licensed insurers, the majority of which were authorized to write both life and non-life contracts and a number of which are inactive.** The industry is rationalizing, and by end-1999 four groups controlled 76.3 percent of the gross premiums. In 1990, the top four groups controlled only 60.4 percent of the market.

283. **The industry as a whole is in transition from a solidarity-based approach to product design and pricing to a more entrepreneurial, competitive, and individualistic approach.** Life insurance growth is dominated by pension-related universal life products that largely transfer market risk to the policyholder, and non-life by motor bodily injury and physical damage classes. The major sources of profit have also been life insurance and motor bodily injury (MBI) insurance. Property classes tend to be heavily reinsured. The long-term results of the MBI market have effectively been guaranteed by the government through its ability to raise premiums and the Ministry of Finance is now moving this market to a more competitive, but controlled, model. Banks cannot own insurance companies and are severely restricted in what they can distribute.¹⁴

284. **Legal practices reflect British and Ottoman roots and taxation law is still based on the original British ordinance.** The insurance sector (unlike provident funds) does have a substantive legislative base, and in particular the Insurance Business (Control) Law, 5471-1981. While there is an accounting standards board in Israel, insurance accounting standards for the insurance sector are set the Minister of Finance under the powers of the aforementioned statute. Except for MBI and health insurance, these do not specify standards for setting insurance technical reserves, the most important balance sheet item,. In practice,

¹⁴Banks are allowed mortgage-related general insurance but not credit-related insurance.

the chief actuaries of the large insurers have internationally recognized qualifications for the most part, and work to the standards of their own professional bodies. The supervisor is now beginning to take an interest in this area but advanced life insurance actuarial skills are scarce in the supervisor's office.¹⁵ These will become more important as the market moves from a prescriptive to a competitive governance based regulatory model and specific standards need to be developed for the Israeli context to guide the industry while not inhibiting it.

285. The supervisor has 32 professional staff who are civil servants. Most of the senior officers have special contracts, which provide higher than standard civil service incomes but which are still not competitive with the private sector. Morale is reasonable but the staff are under pressure from high wages outside and the inevitable frustrations of trying to drive reform with limited resources. The supervisor does have extensive powers at the time an insurer is being set up or gets into trouble, although their exercise is often subject to approval by the Minister. Intermediate powers and sanctions are limited both at law and in practice. Staffing is inadequate, which is exacerbated by the need to deal with a number of contemporary threats. These include the need to develop a reserving methodology for earthquake exposures, establish a methodology for dealing with guaranteed annuity conversion options on some older types of life contract,¹⁶ and forestalling potential market conduct issues arising from managers' insurance.

286. The market is growing relative to the economy with gross premiums being equal to 6.2 percent of GDP, up from 4.7 percent in 1989. This is split roughly equally between life and non-life, but life is growing faster, a feature of more advanced economies. Aggregate policyholder liabilities at December, 999 amounted to NIS 83.2 million, an amount equal to 19.1 percent of savings in banks.

287. Capital and surplus (NIS 5.3 million at December, 999) is low by international standards but has been adequate to date (earthquake risk aside) because of low risk. Until 1991, the government underwrote the market risk of insurers by providing guaranteed real return non-tradable bonds up to 85 percent of total assets, and as mentioned earlier, the current product range passes market risk to the insured. Mortality assumptions have been set at very conservative levels and are well out of date; however, they are due to be revised in the next round of filings following the commencement of a policyholder class action currently in the courts. Overall solvency at 6.6 percent of policy liabilities is up in previous years, but risk is rising as investment choice increases and the industry wishes to issue new contract styles. Rules of thumb for minimum solvency in normal markets are 5 percent of policy liabilities for life and 20 percent for non-life.

¹⁵There is one senior North American trained actuary who has specialized in pension matters for most of his career, but who does have life insurance and financial training.

¹⁶ A circular letter requiring the setting up of special reserves against this contingent liability was sent after the mission.

Main findings

288. **The Insurance Business (Control) Law provides substantial powers to the supervisor, either directly or through the Minister of Finance.** In addition the supervisory body is well structured and has a core of capable and engaged officers who are committed to reforming the market and in particular to introducing genuine competition for the benefit of consumers and the economy at large. The main limiting factor is a lack of actuarial and on-site inspection capacity. In addition, the roles of the Minister and the Knesset Finance Committee appear in some cases to impinge on the legitimate supervisory role of the Commissioner.¹⁷ Examples include specification of contract forms and some of the supervisory responses available when an insurer shows signs of distress. Israel is unusual by industrial (and many developing) country standards in continuing to allow the licensing of composite insurers offering both life and non-life insurance, and not completely sealing these from one another.

289. **The main findings by category of Principle are as follows:**

290. **Organization, CP 1—largely observed.** The supervisor is backed by strong and clear legislative powers, has a highly professional civil service staff, is able to hire and train capable recruits, and can apply third-party support. However remuneration levels are somewhat below market levels and key technical staff, such as actuaries, are hard to attract and keep. In addition, there is a complete lack of on-site inspection capacity. The supervisor is overly dependent on the approval of the Minister for various responses to perceived threats and has very limited powers to influence insurers after they are licensed and before they get into trouble (see governance).

291. **Licensing and Changes in Control, CPs 2–3—observed.** The Insurance (Control) Law and its method of operation satisfies virtually all criteria for these principles, including establishing appropriate definitions, enforcing fit and proper criteria, requiring a business plan, defining initial products and setting minimum capital levels. In addition, strong limits exist on the ability to transfer control. The only significant essential criterion not fully met is number 13, which prohibits composites unless strong separation of activities can be achieved.

292. **Corporate Governance, CP 4—materially non-observed.** The supervisor does not have the authority to require boards of directors to clearly set out their responsibilities for governance of their undertaking. The company's law does require some corporate governance functions including setting out strategic objectives, appointment procedures, division of responsibilities and internal and external audit. However, there is no mention of the fundamental need to have in place and monitor risk management functions by nature of activity.

¹⁷ Where fundamental change is concerned, such as the introduction of more competition to the MBI market, these authorities continue to have a legitimate role.

293. **Internal Controls, CP 5—materially non-observed.** The insurance supervisor has limited formal powers outside the licensing, product approval and threatened insolvency situations. In particular, the supervisor does not have the authority to require the board of directors to provide suitable prudential oversight such as setting standards and monitoring controls for underwriting risk, valuation of technical provisions, investment and liquidity management. Reinsurance is covered under a circular letter. A number of criteria relating to organization, separation of duties and audit are covered under the company's law.

294. **Prudential Rules, CPs 6-10—largely observed except for derivatives.** The Insurance Business (Control) Law and regulations clearly addressed most of the criteria under the prudential heading and proposed changes in asset management requirements will reinforce compliance. The main areas where some strengthening is desirable include giving the supervisor the right to require a more specific approach to asset risk management and a more active approach to monitoring the adequacy of technical provisions through both on and off-site inspections. There appear to be no requirements in place for companies using derivatives to have established an appropriate policy for their use and risk management formulated and monitored by the board of directors.¹⁸ The supervisor does not have the resources to check that insurers have in place adequate internal controls with regard to derivatives.

295. **Market Conduct, CP 11—observed.** Most of the essential criteria are met under the Insurance Contracts Law and the Insurance Business (Control) Law. Further regulation is likely to be required under the seeking of information about needs before selling a product **heading** (Essential criterion 5). In addition it will be desirable for the supervisor to develop an on-site inspection capacity under this heading (Essential criterion 3).

296. **Monitoring, Inspection and Sanctions, CPs 12 – 14—largely observed.** Most of the essential criteria are satisfied by the powers granted by the Insurance Business (Control) Act. Lack of on-site inspection capacity is the main limiting factor.

297. **Cross-border operations, CP 15—materially non-observed.** A number of essential criteria are satisfied including the ability to control foreign insurers operating in Israel. However the key ability to exchange information with other insurance supervisors as necessary on the operations in Israel of the insurance establishments of foreign insurers is limited by current secrecy rules.

298. **Supervisory coordination and cooperation, and confidentiality, CPs 16-17—largely observed.** The supervisor is not able to enter into an agreement with any other supervisor both in other jurisdictions and in other sectors of the financial markets to share information or otherwise work together. On the other hand the staff of the insurance

¹⁸ This was largely rectified after the formal assessment date through new investment regulations.

supervisor are subject to professional secrecy constraints. A unique, but undesirable feature of the supervisory scene in Israel is the necessity to share confidential information with an industry-based advisory committee.

299. The team discussed the medium-term challenges for insurance supervision.

These include developing a viable on-site inspection capacity, building up actuarial capacity, developing key actuarial standards, producing a workable model for controlled competition in the MBI market, enforcing boards of directors' accountability for risk management, developing an information exchange capacity with other financial sector supervisors and continuing the current market reform program. In addition a number of specific issues need to be dealt with including earthquake reserves and annuity conversion options.¹⁹

Authorities response and recommended next steps

300. The authorities generally agreed with the mission's assessment and recommendations.

The key and most urgent recommendation is the recruitment of additional skills in the life insurance actuarial area and the strengthening of the on-site inspection capacity of the supervisor. Introducing an on-site inspection manual based on overseas best practices (probably Canada) would support such moves, as would working with the actuarial and accounting professions to establish a formal actuarial standards setting process.

301. The Insurance Commissioner should have more independent authority. The Commissioner should be given greater and more flexible powers of intervention before an insurance company gets into serious trouble.

B. Transparency of Insurance and Pension Supervision Policies

302. This assessment is of the transparency of insurance and pension supervision policies as they are currently conducted by the Capital Markets, Insurance, and Savings Division of the Israeli Ministry of Finance. Although it is one among several Divisions of the Ministry of Finance, it is headed by a Commissioner of Insurance, a statutory appointment under the 1981 Insurance Business (Control) Law. The assessment was made in the course of the FSAP evaluation.

303. The assessment was conducted by Mark Robson, a Senior Advisor from the Financial Stability Area of the Bank of England, acting as consultant to the Monetary and Exchange Affairs Division of the IMF. It was based mainly on an examination of the relevant laws, particularly the Insurance Business (Control) Act, 5741-1981, and regulations made under that Act; the comprehensive annual public reports issued by the Division and its web site; and discussions with many officials of the Division, including the Commissioner, Vice Commissioner, Deputy Commissioner for Pensions and their Assistants, the Chief

¹⁹ However, it is important to see footnote [4] above.

Actuary and officials from the Legal and Budget Divisions of the Ministry of Finance. Discussions with partners of the leading accountancy firm of KPMG Somekh Chaikin and officials of the Bank of Israel and Securities Authority also provided helpful information. The authorities were fully co-operative.

304. **The assessment was based on the *Code of Good Practices on Transparency in Monetary and Financial Policies* and its three supporting documents, as approved by the Executive Board of the IMF July 9, 1999, and July 24, 2000, respectively.**

Main findings

305. **In practice, insurance (but to a lesser extent, pension) supervision is fairly well defined.** Although the 1981 Act appointing the Commissioner of Insurance does not specify objectives for insurance supervision, in practice, various objectives that are currently not prioritized have been developed, all with a view to protecting the interests of policyholders. In the case of pension funds, the objective is not clear given continuing political controversy arising from the 1995 reform program. In its comprehensive annual reports and increasingly through its web site, the Division provides the public with a lot of information of high quality on its policies and activities and on the financial results of the government traded bond market, life and general insurance, provident and pension funds and savings plans. The Code standards on open formulation of policy and accountability appear to be fully met.

306. **Although current insurance and pension supervision practices observe most of the provisions of the Code, the main weakness noted is regarding clarity of roles, responsibilities and objectives.** The enabling legislation, which is focused on insurance policies rather than pension funds, does not specify objectives for the Commissioner. The mission was told that the key responsibility of the Division was regarded as protecting the interests of policyholders, which could be furthered in several different ways, including minimum capital and liquidity rules, financial reporting rules, approval of premium rate bands and increased competition in the sector. A Consumer Ombudsman Unit within the Division deals with complaints and other inquiries from the public. It would be helpful if objectives could be explicitly prioritized. Responsibilities are not fully transparent in all respects. Since the formal sanctions provided for in the Law are very limited (essentially limited to revocation of licenses), the Commissioner relies heavily on the cooperation and openness of insurance companies finding themselves in difficulties.

307. **With regard to pensions, the objective is less clear. Funded pensions do not obviously sit very easily within the framework of the 1981 Law.** A majority of the pre-1995 semi-funded or "budgetary" pension funds are in actuarial deficit and will in due course run out of liquid assets to meet pension liabilities in payment. There are some difficult political issues with respect to the post-1995 comprehensive "accrual" pension funds and arrangements for the transfer of public employees to funded arrangements. Although this sector is currently open to competition in principle, through employees' choice, in practice, all the large funds are controlled by the major trade unions, and independent fund managers have been able to capture only a very small share of the market. This in turn has implications

for the style of regulation that have still to be developed. The situation is greatly complicated by the continuing failure of government and trade unions to reach agreement on future funding of the insolvent pre-1995 pension funds.

308. **The Division also deals with the capital markets (i.e., traded government bonds), provident and training-related funds, fully funded or defined contribution "general" pension plans, and shorter-term savings in the form of term deposits. The reason is the historic one, that the Ministry of Finance appeared the most appropriate place from which to ensure that the qualifying conditions for the tax-privileged status of all these vehicles continued to be satisfied. From the point of view of public information, this organizational structure enables comparative information on rates of return to be presented in a consistent way across all products, enhancing consumer awareness and choice. It is not so clear, however, that the regulatory objectives fit well alongside the tax policing ones when professional staff resources are severely limited. The case of term deposit savings plans or provident funds provided by banks is an example of a confusing overlap between responsibilities of the Ministry of Finance and the Banking Supervision Department of the Bank of Israel.**

309. **Regarding an open process for formulating and reporting of insurance and pension supervision policies the Division appears fully to observe the Code.** The industry and general public are kept completely informed of, and consulted on, practical developments in supervision. A great deal of information is made available through the Division's annual reports and increasingly on its web site too. The Code on **public availability of information on insurance and pension supervision policies** is therefore also close to being fully observed. The only slight shortcoming is that Internet development, soon to include details of all relevant laws, regulations and directives, quarterly financial results, and interactive ranking of companies, is targeted at industry professionals, such as financial advisors, and sophisticated investors. For the benefit of first-time and relatively unsophisticated investors, many who will not have access to the Internet, it would be advisable to have a program of short, simple advisory leaflets explaining the basic features of the many different savings products available in Israel. This is particularly desirable in the case of insurance, since complaints about the selling of products or difficulties in making claims form about 90 percent of the Consumer Ombudsman Unit's caseload.

310. **Finally, as regards accountability and assurances of integrity by insurance and pension supervision agencies, the Code appears to be fully observed.** The Commissioner and her senior staff frequently appear before the Knesset Finance Committee or make presentations and speeches at industry conferences or to the press. While the Division does not produce separate financial statements, the budget and results for the Ministry of Finance are analyzed by function and type of expenditure annually and presented to the Finance Committee. Further details are provided on demand under the recent Freedom of Information Act.

Recommended plan of action and supervisory response to the assessment

311. **It is recommended that the adequacy of the 1981 Law be systematically reviewed in the light of practical experience and market developments since it was enacted, and reforms to the pension fund system since 1995.** Objectives for both insurance and pension supervision should be specified. The range of statutory sanctions available to the Commissioner should be expanded. Consideration should also be given to the possible merits of establishing an independent authority for the supervision of financial institutions and products that depend on expert actuarial advice (i.e., principally insurance and pensions).

312. **Cooperation among the three financial regulators should be more formal.** A Memorandum of Understanding between the three financial regulators should set out precisely the relationship between them, including a procedure for dealing with any overlaps or gaps which might arise from time to time and for clarification of the circumstances in which supervisory information can be exchanged between them or with overseas regulators. This would be worthwhile both under current legislation and after any reform.

313. **In developing its web site, the Division should take account of the needs of less sophisticated or experienced investors and make appropriate information available (also in printed form) to introduce them to the complex variety of financial products and help determine their suitability.**

Table 8. Summary of Main Findings for Basel Core Principles Assessment

Subject	Main Findings
CP 1 Objectives, autonomy, and powers of supervisor	All of the preconditions for effective supervision are complied with except for the ability of the supervisor to share banking information with other supervisors.
CPs 2–5 Licensing and structure	These principles are generally observed. However, the BOI should have advance information on all material investments by banks.
CPs 6–14 Prudential regulations and requirements	Compliance is generally good. However, loan classification, reporting, provisioning and disclosure requirements could be improved. In addition, more specific requirements on the analysis of country and transfer risk should be developed.
CP 15 Money Laundering	With the adoption of a new law last year and implementing regulations earlier this year, full compliance should be in place by early 2002.
CP 16–20 Methods of ongoing supervision	Supervision is generally compliant. However, the BOI should develop a “fit and proper” regime covering all banks, and extending to all directors and key senior executives. It should also explore more extensive cooperation with external auditors.
CP 21 Information requirements	The BOI meets all information requirements, and is in compliance with this principle.
CP 22 Remedial measures	The inclusion of an explicit statutory duty within legislation for prompt corrective action should be considered to prevent forbearance.
CP 23–25 Cross-border banking	The Banking Ordinance prevents adequate information sharing with domestic and foreign supervisors.

Table 9. Summary of Main Findings for Banking Supervision Transparency

Subject	Main Findings
5. Clarity of roles, responsibilities and objectives of banking supervision policy	Generally good, but the statutory relationship between the Governor and the Government, between the different objectives of the BOI, and between the three financial authorities, should be updated and clarified. Explicit responsibility for payment systems oversight should be given to a separate division of the BOI.
6. Open process for formulating and reporting of banking supervision policy	Generally good, but public consultation should be wider than just the secret hearings of the Advisory Committee.
7. Public availability of information on banking supervision policy	Generally good. After a suitable delay, information should be provided on any emergency support given to banks. Consideration should be given to introducing some form of deposit insurance scheme.
8. Accountability and assurance of integrity by banking supervision agencies	Generally good, but more detailed information on the expenditure of the Banking Supervision Department should be provided in its annual surveys.

Table 10. Summary of Main Findings for Payment Systems Supervision

Subject	Main Findings
CP 1 Well-founded legal basis in all relevant jurisdictions	Rules and regulations applicable to the payment system are properly founded to address the issues given the present practice.
CPs 2-3 Understanding of the system's impact on risks; and procedures for the management of risks	The practice of the BOI in the settlement process does not give the banks the proper incentives for managing risks.
CPs 4-5 Final settlement; inability to settle by the participant with the largest single settlement obligations	In general, settlement does not take place on the same day and, where netting takes place, the systems do not have provisions to settle the position of the largest defaulter.
CP 6 Assets for settlement	All systems settle in central bank money.
CP 7 Security and operational reliability; and contingency arrangements	All systems have adequate provisions to ensure a high degree of security and operational reliability and have contingency arrangements for timely completion of daily processing.
CP 8 Systems are practical for the markets and efficient for the economy	Systems are efficiently organized, within the restrictions mentioned under CP2-3 and 4-5.
CP 9 Objective and publicly disclosed criteria for participation	The criteria for participation can be regarded as objective and are well known.
CP 10 Governance of the system should be effective, transparent and accountable	Governance of the systems is in principle adequate due to the involvement of the BOI under its legal basis.
CP 11 Responsibilities of the Central Bank in Applying the Core Principles	The BOI approaches payment systems issues very much from a supervisory perspective, which does not properly reflect the central bank responsibilities for the payment system that are assumed in the Core Principles approach.

Table 11. Summary of Main Findings for Monetary Policy Transparency

Subject	Main Findings
1. Clarity of roles, responsibilities, and objectives of monetary policy	The BOI law is weak with regard to objective of policy, instrument autonomy, and tenure of the Governor. Inflation target and exchange rate band are potentially inconsistent.
2. Open process for formulating and reporting of monetary policy	Adequate though views of the Monetary Forum, which advises Governor, could be published.
3. Public availability of information on monetary policy	Information is publicly available.
4. Accountability and Assurances of Integrity by the Central Bank	Detailed information on expenses and revenue of the BOI should be made available to the public. Improvements were made after this assessment.

Table 12. Summary of Main Findings for Securities Supervision Principles

Subject	Main Findings
Principles relating to the Regulator, Ps 1–5	ISA has broad powers and is independent yet accountable, as well as self-financing.
Principles of self-regulation, Ps 6–7	The TASE operates efficiently, but does not conduct sufficient market monitoring.
Principles for the enforcement of securities regulation, Ps 8–10	Enforcement is strong; the use of the Internet and new technology may make new demands on ISA.
Principles for cooperation in regulation, Ps 11–13	There are areas of some weakness, given inherited system and respect for secrecy and privacy. Domestic coordination requires improvement.
Principles for issuers, Ps 14–16	Israeli securities laws have comprehensive disclosure requirements.
Principles for collective investment Schemes, Ps 17–20	Given the strong regulation of ISA over mutual funds, policy makers may wish to consider the possibility of transferring responsibility for other collective investment schemes to ISA.
Principles for market intermediaries, Ps 21–24	The securities laws provide minimum requirements for intermediaries (whether banks or not). Market intermediaries may not properly be reflecting derivatives in their activities. The relationship between the banks and their financial intermediary subsidiaries, off-balance sheet affiliates and related parties renders these principles difficult to assess.
Principles for the secondary market, Ps 25–30	In 1997, the TASE launched Tel Aviv Continuous Trading (or TACT). The Clearing House is modern and well established.

Table 13. Summary of Main Findings for Securities Regulation Transparency

Subject	Main Findings
5. Clarity of roles, responsibilities and objectives of securities supervision policy	This principle is fully observed, apart from the need to clarify the relationship between the three financial authorities.
6. Open process for formulating and reporting of securities supervision policy	Reports and consultation on policies are satisfactory; to date the ISA has not been able to devote significant resources to explaining its policies to the general public, but has plans under way to do so shortly.
7. Public availability of information on securities supervision policy	An annual report is published in Hebrew, but it does not contain market information. The ISA's new web site will be able to include links to the TASE and other relevant web sites.
8. Accountability and assurance of integrity by securities supervision agencies	This principle is fully observed.

Table 14. Summary of Main Findings for IAIS Supervision

Subject	Main Findings
Organization of a supervisory body, CP 1	Resources and powers need to be expanded and made more flexible.
Licensing and changes in control, CPs 2-3	Capacity to approve of composites could be improved.
Corporate governance, CP 4	Key risk management issues are not covered.
Internal controls, CP 5	The supervisor's powers are not attuned to ongoing enforcement of good management practices.
Prudential rules, CPs 6-10	The risk management perspective and coverage of derivatives are also lacking under these criteria.
Market conduct, CP 11	Inspection capacity need to be strengthened, with selling practices upgraded.
Monitoring, inspection and sanctions, CPs 12-14	On-site inspection capacity is limited.
Cross-border operations and cooperation, CPs 15-16	The key capacity to exchange information is not available.
Confidentiality, CP 17	Confidentiality requires excessive disclosure by firms and has inadequate sharing of information among supervisors.

Table 15. Summary of Main Findings for Insurance and Pension Transparency

Subject	Main Findings
5. Clarity of roles, responsibilities and objectives of insurance and pensions supervision policy	No objectives are specified in the law. Those developed for insurance in annual reports need to be prioritized. Objectives need to be established and stated for pension supervision. The relationship between the three financial authorities should be clarified in legislation.
6. Open process for formulating and reporting of insurance and pensions supervision policy	The process is open and transparent.
7. Public availability of information on insurance and pensions supervision policy	Current enhancements to the Division's web site will provide full and detailed information. More simple, summary information could be produced in print for the public.
8. Accountability and assurance of integrity by insurance and pensions supervision agencies	The framework for accountability and assurance is fully adequate.