FOR AGENDA

SM/01/217
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

July 23, 2001

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Israel—Financial System Stability Assessment**

The attached correction to SM/01/217 (7/11/01) have been provided by the staff:

Page 19, para. 49, lines 8-9: for "Banks are not allowed to underwrite insurance products but can act as distributors."
read "Banks are not allowed to underwrite insurance products."

Questions may be referred to Mr. Coats (ext. 38422).

Att:

Other Distribution:
Department Heads

Corrected: 7/20/01

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 groups[3] 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.

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[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**