Chapter 5
Activities of the Banking Supervision Department

1. INTRODUCTION

To keep the banking system stable in a changing economic environment, to protect depositors' money, and to assure fairness in bank–customer relations without compromising the competitive nature of the system and proper standards of management and control, the Banking Supervision Department takes action at several levels. Foremost among them are regulation by means of directives and guidelines; inspections, regular monitoring of banks' business activity including the soundness of their management and their ability to manage risks and adjust to economic developments; supervision of bank–customer relations; investigation of enquiries and complaints from the public against the banks; handling of the bank's standard contracts; monitoring of bank fees; supervision of credit limits at the single-borrower and single-industry levels; and so on.

The Department monitors banks' activities by gathering, analyzing, and drawing conclusions from various kinds of banking information. The information that accumulates includes (1) measurable quantitative data—about revenues, expenses, interest rates, fees, lending, and margins; (2) qualitative (non-measurable) information about management quality, data security, compliance with procedures, integrity of information given to customers, etc. The Department gathers this information by receiving regular and computerized reports and from discussions between members of its staff and executives and employees of the banks. The Department's inspections elicit valuable non-quantitative banking data and information. (3) Complaints from the public to the Department are another source of important information about irregularities at an individual banking institution or, since some complaints reflect problems that many customers encounter with several banking corporations, in the system at large. (4) The Department keeps abreast of new approaches to banking supervision abroad, research on banking in various countries, and the practical conclusions that flow from them.

The Department uses this information to adjust its directives and induce banks to correct irregularities and strengthen their stability. Importantly, however, the Department cannot and is not entitled to manage the banks; this is the sole responsibility of the banks' managements and boards of directors. The Department's actions do not absolve these players and the banks' internal auditing officers of their responsibility for the soundness of the management and actions of the banking corporation.

A review of the Department's functions and activities in 2003 follows.

2. REGULATION OF BANKING ACTIVITY

The regulation of banking activity is an important tool in banking supervision, guiding banking institutions with regard to the Supervisor's views and regulations in various banking and accounting matters. The Department's directives in this regard are meant to regulate the activities of banks' boards of directors and managements, improve internal and external reporting systems, strengthen internal auditing, and ensure that banking corporations are managed properly and prudently. The regulatory decisions, based on the processing and analysis of information that the Department obtains from various sources, are translated into regulations and rules of conduct for banks and are issued as *Proper Conduct of Banking Business Directives, Guidelines for Preparing Reports to the Public,* and *Guidelines for Preparing Returns to the Supervisor of Banks.*

The main directives issued this year concerned fees for advance payback of non-housing loans, limitations on single-borrower and borrower-group indebtedness, liquidity-risk management, information-technology management, and boards of directors. Secondary legislation gazetted in 2003 updated the Banking Rules (Customer Service) (Proper Disclosure and Presentation of Documents), mainly to assure appropriate disclosure of cost of service to customers.

3. EVALUATION

The Institutional Evaluation Unit is composed of five teams: four in charge of evaluating the banking groups and some independent banks[1] and one that combines evaluation and examination of small independent banks.

The main function of the institutional-evaluation teams is to coordinate and formulate the Department's periodic evaluations of the stability and strength of banking corporations (including auxiliary corporations, banking subsidiaries, and overseas branches). The teams also monitor changes in the mix of banking corporations' activities and the extent of their exposure to banking risks and profit-and-loss factors. In their monitoring function, the teams examine banking corporations' compliance with Proper Conduct of Banking Business Directives and the Banking (Licensing) Law and prepare position papers on selected banking issues of current importance.

[1] Banks not affiliated with a banking group.

Monitoring, analysis, and evaluation of the condition of the banking corporations are based on information that the unit receives and gather from various sources—mainly the banks' published statements and reports to the Bank of Israel, audit reports prepared by the Department's examination units, information concerning irregularities indicated by complaints from the public, and even information culled from the media and other sources.

In addition to their monitoring and evaluation duties, the economists of the Institutional Evaluation Unit deal with various requests and enquiries from banks.

In 2003, the teams of the Institutional Evaluation Unit focused on the following:

- implementation of the transitional provisions of the Prohibition of Money Laundering Order and the banking institutions' actions in this regard;
- the evolution of capital ratios, especially those of banks that are close to the limit, and examining ways of increasing the banks' capital;
- banking corporations' exposure to credit risks (forex credit, credit to the principal industries, and credit to large borrowers) and liquidity risk in domestic and foreign currency;
- banks' compliance with the Department's requirements concerning transactions with related parties, especially in respect to credit;
- preparations by banks and corporations controlled by them, in Israel and abroad, for the performance of a survey on embezzlement and fraud.

4. LICENSING

In its licensing activity, the unit processes requests that entail licensing from the Governor of the Bank of Israel or the Supervisor of Banks, mainly:

- examination of candidates for the acquisition of control or means of control in banking corporations in Israel;
- applications from banking corporations to form banking subsidiaries in Israel or abroad;
- preparation of policy on branches and processing of applications for opening of branches;
- applications from foreign banks to open branches in Israel or to use the word "bank" in the name of representative offices that they establish in Israel;

Licensing activity in 2003 focused on:

- the continued promotion of a draft amendment to the Banking (Licensing) Law (Amendment 13), meant to strengthen various facets of the Banking Supervision Department's functions and powers and to facilitate the privatization of Bank Leumi le-Israel, Ltd., by means of the capital market (application of the Marani Committee report);
- the merger of Maritime Bank of Israel Ltd. and Mishkan Bank Hapoalim Lemashkantaot Ltd. into Bank Hapoalim; the acquisition of control of Bank Polska Kasa Opieki (Bank P.K.O.) by Bank Hapoalim; the acquisition of a minority stake in Continental

Bank by Bank Hapoalim from the German bank SEB AG; and the relinquishing of controlling equity in Bank Hapoalim by the family of Yitzhak Dankner.

- the closure of the Global Investment Bank (B.H.) Ltd.;
- the acquisition of a controlling stake in First International Bank of Israel by the Bino-Lieberman group.

5. INSPECTION

The Inspection Unit comprises six teams that specialize in various aspects of banking activity and management: credit and collateral; boards of directors, control and internal audit; risk management; bank–customer relations and capital markets; and information systems. The sixth team inspects all these areas at the independent banks and performs routine monitoring and evaluation. The inspection teams base their work on information that they gather directly from the banks' documents and books of account. The examination process is meant to ensure the proper conduct of banking business, including, but not limited to, adherence to the Department's directives in this matter and the relevant legal provisions. The teams' reports warn of irregularities found and set targets and deadlines for their correction. The activities of the Inspection Unit are set forth in periodic working plans that, while supported by cyclical targets for coverage of specific subjects related to the corporations examined, are basically dictated by priorities derived from general economic events and changes in the activities of the banking system itself. About one-third of the unit's resources are devoted to risk-related subjects and issues that are elucidated on an ad hoc basis during the year.

With respect to independent banks, the periodic working plans are based on the foregoing as well as ongoing risk analysis at the respective banks and their fields of activity, by means of audits coupled with data-monitoring tools.

Areas of emphasis in credit examinations were determined in view of the lengthy recession and a regulatory policy that aimed to assure prudence and conservatism in identifying and classifying problematic debt portfolios and making of provisions for them. Thus, apart from comprehensive credit examinations that evaluated the management, control, regulation, and quality of the credit portfolio, the unit's examinations in 2003 again stressed the adequacy of the processes used to identify and classify problem debts and to classify and provide for loan loss in lending to specific industries and borrowers.

As for ongoing examination of boards of directors, control, and internal audit, emphasis in 2003 was placed on the banks' preparations for the implementation of the Proper Conduct of Banking Business Directive concerning compliance officers, promulgated in 2002. The implementation and proper assimilation of this office strengthens the internal-audit function by helping the banks' boards of directors and managements to discharge their responsibility to comply with legal and regulatory requirements with regard to consumers and money laundering. In this context, actions to broaden the compliance officer's purview and responsibilities are being considered. In 2003, as in the past, the requisite "Chinese walls" between the functions of the executive echelon and those of supervision and monitoring of the performance of management—the main purpose of the board—were strictly upheld.

In the field of financial-risk management, examination of the adequacy of market-risk management systems continued, with emphasis on management of liquidity risks and risks associated with customer portfolios that are intensive in capital-market activity. A process meant to examine aspects of management, control, and supervision of the activities of off-shore branches began.

All banks that operate in Israel were examined with regard to the prevention of money laundering. This extensive effort did much to improve the banking sector's compliance with legal and regulatory requirements and was an important factor in the FATF's decision to terminate the surveillance that it had imposed on Israel after deleting Israel from its watch list of countries that it considered uncooperative in respect of money laundering.

With regard to bank–customer relations and the capital market, the unit continued to inspect for proper disclosure in the management of customer accounts, with emphasis on the prevention of conflicts of interest in the capital-market activities of banks and controlled companies. Pursuant to its activities in 2002 with regard to information technology, the unit emphasized information systems security and control, outsourcing of computer services, preparedness for emergencies, and internal-audit activities with regard to information systems. The accumulated experience in examination actions helped to promote and to phrase Proper Conduct of Banking Business Directive 357, which concerns IT management.

6. RESEARCH UNIT

The Research Unit monitors developments in banking in Israel and around the world and keeps abreast of new approaches toward matters such as assets and liabilities management, risk management, hedging assessments and methods, and capital adequacy, in view of the new requirements of the Basel Committee in these regards.

The unit culls knowledge from the professional and research literature as a basis for position papers and research on issues in banking supervision policy, development of tools for evaluation of the performance of banking institutions, formulation of banking regulations, and adoption of other measures for the advancement of Israel's banking system.

The unit publishes the Department's annual survey (in Hebrew and English), which analyzes developments in Israeli banking during the review period and in the long term.

In March 2003 the unit issued *Banking Review* No. 16 (in Hebrew). The main purpose of the periodical is to promote research in the fields of banking and finance. The latest edition contains articles on the following:

- risk premium and market power in Israeli banking;
- market discipline in Israeli banking;
- measuring competitiveness in the banking system, distinguishing between the household sector and business firms;
- using the biplot method to map the Israeli banking system—a model for early warning about system irregularities;
- estimating expected exchange-rate change on the basis of call options.

In December 2003, the unit published *Banking Review* No. 8 (in English), which contains English translations of research studies on banking issues that have appeared in Hebrew in previous issues of the above publication. A study on the market value/book value ratio of Israeli banks was published as part of the Working Papers series (in Hebrew).

During the year, the unit began to develop an index for the ranking of banks in view of performance in terms of capital, asset quality, management, profitability, liquidity, and exposure to market risks. Such an index, conventional in many Western countries, is meant to help the Department to evaluate the state of the banks and decide how intensively to supervise them. During the year, the unit analyzed factors that affected banking-system stability from the standpoint of the industry at large.

7. INTERNATIONAL RELATIONS

The Department's attentiveness to international relations is a necessity in view of globalization, the expansion of Israeli banks' international activities, the growing interest of foreign investors in the Israeli banking system, and recommendations of the Basel Committee that stress the importance of cooperation and information transfer among regulatory authorities around the world.

The main focus of the unit incorporates:

- pro-active monitoring of the regulatory policies of foreign supervisory authorities and international agencies and assistance to licensing authorities in matters in which specific expertise in aspects of banking abroad is required;
- analysis of trends and developments in banking abroad that have implications for Israel's banking system;
- regular interaction with regulatory authorities abroad and international agencies to create an infrastructure of information channels—in order, among other things, to exchange information as required under the core principles of the Basel Committee.

The unit's main areas of activity in 2003 included:

- transfer of information about the Israeli banking system to various entities overseas, including regulatory authorities, international institutions, and rating companies;
- Israeli participation in the OECD Liberalization Code;
- handling of matters related to the activities of Israeli branches overseas, in conjunction with foreign regulatory authorities;
- gathering of information, assistance, and study of matters such as "Basel II" and licensing.

8. BANK–CUSTOMER RELATIONS

Protecting bank customers' rights is one of the Banking Supervision Department's important functions in keeping the banking system stable and reliable. To discharge this function, the Department takes action to uncover and correct irregularities in the banks' performance with regard to customer relations. The Department invests heavily in this activity, which includes investigation of public enquiries by the Public Enquiries Unit, handling of general matters that surface in the wake of public enquiries and other information that comes to the Department's attention, and monitoring of bank fees and standard contracts. To defend customers' rights, both by investigating public enquiries and by general regulation by means of procedures and instructions, the Bank–Customer Relations Unit cooperates with other units of the Department to make the banking system fair and stable and to keep it that way.

a. Public enquiries

The Public Enquiries Unit derives its powers from Section 16 of the Banking (Service to Customer) Law, 5741-1981, which empowers the Supervisor of Banks to investigate

Table 5.1
Investigation of Complaints and Enquiries[a] from the Public, 2002 and 2003

	2002		2003	
	Number	Percent of total	Number	Percent of total
Complaints on which decision was made				
Complaints found wholly or partly justified	852	16.7	727	15.7
Complaints found unjustified	1,842	36.1	1,764	38.0
Total	**2,694**	**52.7**	**2,491**	**53.6**
Complaints on which no stand was taken				
1. Treatment stopped due to legal proceedings	132	2.6	141	3.0
2. Treatment stopped for other reasons	276	5.4	279	6.0
3. Not within Unit's jurisdiction	364	7.1	239	5.1
4. Unable to take a stand	268	5.2	251	5.4
Total	**1,040**	**20.4**	**910**	**19.6**
Enquiries				
Requests	430	8.4	399	8.6
Clarifications	944	18.5	844	18.2
Total	**1,374**	**26.9**	**1,243**	**26.8**
Total number of complaints and enquiries whose treatment was concluded	**5,108**	**100.0**	**4,644**	**100.0**

[a] Out of all complaints and enquiries whose treatment was concluded during the year.
SOURCE: Banking Supervision Department.

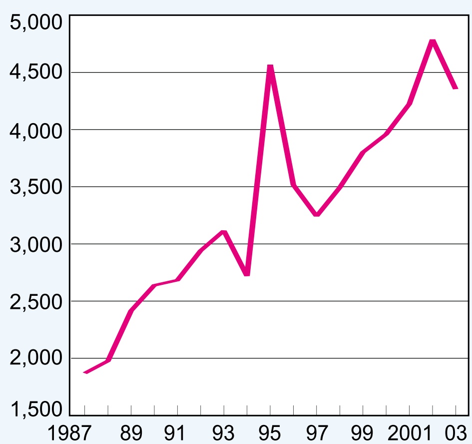
public enquiries about the business practices of banking corporations. The Public Enquiries Unit investigates such enquiries in accordance with various provisions of the law, rules promulgated by force of the law, and procedures that the Supervisor of Banks enacts for this purpose. After the investigation, the customer is given a detailed reply, including findings and conclusions, and is advised of the Department's attitude. When a customer's complaint is found justified, the Department works with the bank to correct the injustice caused.

Apart from investigating enquiries and ruling on specific disputes, the unit performs a valuable service in uncovering weaknesses in the banking system at large. The unit's incognito-inspection team visits bank branches countrywide to ensure compliance with the provisions of the law and the procedures of the Supervisor of Banks in bank–customer relations.

The unit completed its handling of 4,644 enquiries in 2003, taking a stance on 2,491 and taking no stance on 910. The remaining 1,243 enquiries were requests for information and clarifications (Table 5.1 and Figures 5.1 and 5.2). Among complaints on which a stance was taken, 727 (29.2 percent) were classified as justified or partly justified. Such a classification usually results in the implementation of practical steps, e.g., a refund of money to the complainant, compensation, honoring of a request, etc. The handling of 1,533 enquiries was concluded in this manner.

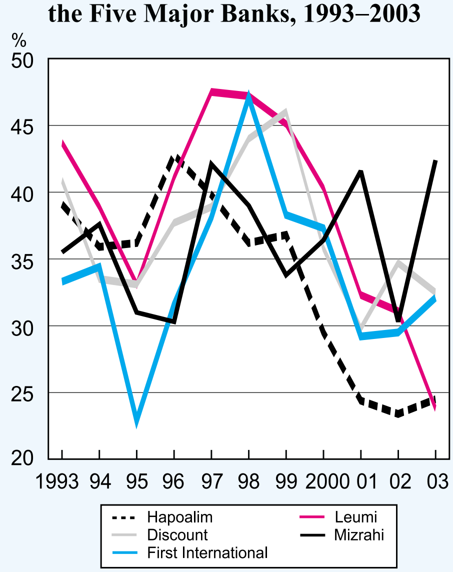
The unit also deals with more than 10,000 telephone enquiries each year.

Figure 5.1
Complaints from the Public Received by the Banking Supervision Department, 1987–2003



SOURCE: Banking Supervision Department.

Figure 5.2
Percentage of Justified Complaints[a] in Total Complaints Against Each of the Five Major Banks, 1993–2003



[a] On which a decision was made: justified/ partly justified/ unjustified.

SOURCE: Banking Supervision Department.

Table 5.2
Complaints and Enquiries from the Public, by Subject, 2002–2003

	Total complaints and enquiries whose treatment was completed during year[a]				Total number found justified[b]		Percent of total complaints on the subject[c]	
	2002	2003	2002	2003	2002	2003	2002	2003
Subject	*(Number)*		*(percent)*					
Credit	258	231	5.1	5.0	26	17	18.3	12.8
Collateral	20	23	0.4	0.5	3	4	33.3	25.0
Implementation of court orders	160	123	3.1	2.6	17	21	19.5	27.3
Debt collection	191	182	3.7	3.9	19	11	25.7	16.2
Debit by authorization	113	124	2.2	2.7	33	34	46.5	38.2
Bank debts to customer	46	83	0.9	1.8	3	17	13.0	34.0
Long-term savings	309	225	6.0	4.8	35	34	31.0	47.9
Bank account	834	853	16.3	18.4	124	129	27.4	29.5
Debit card	426	328	8.3	7.1	123	79	38.0	34.3
Foreign currency	198	173	3.9	3.7	19	24	13.8	19.8
Bank documents	67	110	1.3	2.4	12	17	38.7	41.5
Mortgages	1,111	832	21.8	17.9	229	142	36.6	30.7
Securities	200	143	3.9	3.1	24	10	25.0	13.5
Branches	70	80	1.4	1.7	15	21	44.1	45.7
Forwards	23	14	0.5	0.3	5	1	29.4	11.1
Fees and commissions	269	340	5.3	7.3	27	52	20.1	24.3
Third party guarantees	74	71	1.4	1.5	14	13	41.2	40.6
Checks	361	399	7.1	8.6	97	76	47.5	36.0
Other banking services	170	184	3.3	4.0	25	23	33.3	22.5
Other[d]	208	126	4.1	2.7	2	2	20.0	25.0
Total	**5,108**	**4,644**	**100.0**	**100.0**	**852**	**727**	**31.6**	**29.2**

[a] Including complaints and enquiries carried forward from previous year.
[b] Including those found partly justified.
[c] On which a stand was taken (justified/partly justified/unjustified).
[d] Enquiries or complaints on other subjects.
SOURCE: Banking Supervision Department.

The five main topics of concern in public enquiries were current accounts, housing loans, checks, fees, and credit cards (Table 5.2).

The Public Enquiries Unit does not confine itself to demanding that banks correct irregularities that were uncovered in specific enquiries. Its treatment of an individual enquiry may have general ramifications for a bank or the entire banking system, e.g., refunds to groups of customers or correction of procedures.

Table 5.3 lists general issues and matters of principle that came to light due to public enquiries and additional information that the Department received. After these matters were dealt with, large groups of customers received refunds (even though most had not complained about the problem and may not have been aware of it at all). These refunds in 2002–2003 amounted to approximately NIS 54 million, not to mention NIS 50 in refunds on account of telephone service that are currently being processed (the second half of 2004).

b. Fees

Ongoing activity with regard to fees includes examination of regular reports about adjustments of fees (banks and credit cards) and requests to introduce new fees; improving disclosure of and access to information about fees, including the publication of comparisons of fees via the media, in order to encourage competition among banks; a demand to place fees under price control with the Controller of Prices at the Ministry of Industry, Trade, and Employment; handling of general fee-related issues insofar as they come to light in public enquiries; involvement in amending procedures; and comparison of Israel's bank fees with those in other countries.

In addition to its regular activities, the team dealt in 2003 with the following:

- *An amendment to the appropriate disclosure rules*: at the Department's initiative, the Banking Rules (Customer Service) (Proper Disclosure and Presentation of Documents) 5752-1992, were amended to expand and improve disclosure requirements for banks vis-à-vis their customers, especially with regard to fees.
- *Charges pursuant to standing orders*: The Supervisor of Banks and the Director of the Antitrust Authority reached an agreement about the maximum level of inter-bank fees that may be charged for standing-order charges.

Table 5.3
Total Monetary Refunds to Groups of Customers, by Subject, 2002 and 2003

	Refund (NIS)
Re-presented direct debits	17,000,000
Mortgage interest	14,400,000
Lien cancellation fee	10,500,000
Charge for telephone clarification from a teller and when consumer did not request a print-out	7,560,000
Fee for cash deposit for early repayment of mortgage	1,900,000
Fee for early repayment contrary to paras. 4(b)1 and 4(c) of the Banking Order	907,000
Miscellaneous[a]	1,424,000
Total[b]	53,691,000

[a] Refunds of interest loans fees, overcharges and various debits.
[b] Refunds for telephone service for a total sum of about NIS 50 million currently being made.
SOURCE: Returns to the Supervision of Banks.

- *Fees for information retrieval by customer*: under Proper Conduct of Banking Business Directive 441, concerning information retrieval by customers, banking corporations were required starting on September 1, 2003, to allow customers to retrieve information at in-branch workstations. Consequently, the Supervisor of Banks set a minimum number of queries that each banking corporation must allow customers to make at no charge—enough, in the Supervisor's opinion, to allow customers to keep track of their accounts properly. Notably, said information shall be given in addition to that provided at no charge under the proper-disclosure rules.

c. Standard contracts

The Department is examining various phrasings of important contracts between banks and customers in order to identify and revoke sections that are disadvantageous to customers. Whenever such sections are found, the Department and the bank discuss whether the bank will be willing to amend the terms of the contract. If the bank refuses to amend or revoke all terms that are disadvantageous to customers, the Department, in conjunction with the Ministry of Justice, applies to the Standard Contracts Court to have the relevant sections revoked. Legal aspects that arise after the contracts are investigated and the disadvantageous terms are identified are reviewed in conjunction with the Legal Department of the Bank of Israel.

Thus far, the court has been asked to strike down disadvantageous terms in four standard contracts: Bank Leumi's current-account management contract; the housing-loan contract of First International Mortgage Bank; Bank Hapoalim's contract for the provision of on-line banking services; and Tefahot: Israel Mortgage Bank's guarantee under the Sale (Apartments) (Assurance of Investments of Persons Acquiring Apartments) Law, 5735-1974.

The court, in a recent ruling on the request to revoke disadvantageous terms in Bank Leumi's current-account management contract, accepted most of the arguments of the Attorney General and the Banking Supervision Department and instructed the bank to revoke or amend dozens of disadvantageous sections in this contract. Pursuant to the ruling, the other banks will also be asked to revoke or amend these parts of their contracts.

9. INFORMATION AND FINANCIAL REPORTING

Information and Reporting Unit

The Information and Reporting Unit is responsible for receiving reports from banks and converting them into readily-available, reliable data that can be used by the various units of the Banking Supervision Department to monitor the banks' activities. The banks report and present data about their areas of activity in different cross-sections and using different reporting systems. The data are obtained at different frequencies, depending on the

Department's needs, and are funneled into forty-three reporting systems. For each reporting system, the unit uses sophisticated statistical tools to perform numerous checks and identify problems with the data simultaneous with the process by which the banks prepare the data, i.e., before the Department receives it. The unit receives the banks' reports and manages the Department's databases. This process, too, involves sophisticated checks in which data from diverse reporting systems and different banks, for different reporting periods, are compared. The unit summarizes the results of these checks in an 'examination report' that includes recommendations for corrections at the banks and in the unit's own systems. The unit uses the information to monitor the banks' compliance with the quantitative restrictions that are issued in the Banking (Licensing) Law and in Proper Conduct of Banking Business Directives. The unit, in conjunction with the Financial Statements Unit, also visits banks for report-verification inspections in order to check the reliability of the data that the Department receives. The discovery of irregularities in the course of the inspection visits and the internal checks makes it possible to improve the reporting systems and the data submitted by the banks. The unit writes new reporting directives and updates existing ones to improve the information available to the Department and sends the banks aggregate information as feedback. The banks use this information as a management tool and as a way to compare their data with those of the banking system at large.

The unit issues several publications that provide concise information about the banking system. *Annual Information on the Banking Corporations,* with information on the Israeli banking system over a five-year period,[2] *Current Information on the Banking Corporations,* a loose-leaf binder with up-to-date information on the banking system in Israel; and *Main Data on the Activity of Each Bank,* a Hebrew-language quarterly that compares the banks on the basis of information culled from their financial statements.

Each year, the unit handles more than 1,500 requests for information from various economic entities and advertises fortnightly (in print and over the Internet) the maximum and average interest rates in the 'gray market' that mortgage banks use to calculate their early-payback fee.

In early 2003, the unit dealt with the banking system's emergency preparations for the second Gulf War. In view of concern about the impending war, the unit, with the banks' cooperation, updated the risks of "core branches"—those branches through which the banking system would continue to provide services in an emergency if they were unable to operate their entire network of branches. A computerized system was established to receive condensed reports from banks in an emergency. Companies that provide banks with vital services were identified and, in conjunction with the Ministry of Labor, declared crucial emergency enterprises (provisional). A modus operandi for the handling of computer malfunctions at banks and at Automatic Banking Services, Ltd., and ways of assuring information security for customers, were established.

[2] Available at the Bank of Israel website, www.bankisrael.gov.il, under "Publications and Information."

Financial Reports Unit

The unit has two main functions: (1) preparing directives for the banks on the preparation of annual and quarterly published reports (which include a statement by the board of directors, a management survey, and the banking corporation's financial statement) and regulation of the work of the CPA-auditor of a banking corporation, and (2) inspecting, at the system-wide and individual-bank levels, the banks' financial statements and their returns to the Banking Supervision Department.[3]

As a related activity, the unit deals with day-to-day matters pertaining to the banks' financial statements (answering enquiries from banks, solving occasional problems, issuing guidelines to specific banks and to the system at large, dispensations in disclosure, etc.).

In 2003, the unit completed the regulatory process concerning disclosure of accounting policy in critical matters, and updated and expanded the existing disclosure provisions concerning remuneration of the CPA who audits the board of directors' statement.

To bring the directives concerning reporting to the public into alignment with Israel's generally accepted accounting practices, the guidelines in the directives were adjusted so that Accounting Standards 12 and 17, concerning the termination of inflation adjustment of financial statements, and Accounting Standard 13, concerning the effects of exchange-rate changes—as published by the Israel Accounting Standards Board—could be implemented.

The unit continued to take action on important regulatory issues related to financial reporting by banking corporations: accounting treatment of asset-transfer transactions including repo, lending of securities, and securitization; adjustment of rules concerning measurement and disclosure of problem loans and loan-loss provisions to American norms; accounting treatment of structured notes; housing loans—reducing the loan-loss provision commensurate with the size of arrears— basing disclosure of sensitivity to changes in interest rates on fair value (in consultation with Prof. Dan Galai); and updating the accounting treatment of derivatives and hedging.

In the process of bringing its directives into line with the Generally Accepted Accounting Practices, the unit prepared a draft for the adjustment and integration of Securities Authority guidelines into its directives in the following regards:

- minimum disclosure in respect to valuations and their aggregation;
- reportage about directors who have accounting and financial skills;
- the work of the CPA-auditor.

In 2003, regulation of the work of banking corporations' CPA-auditors was broadened. Banking corporations' CPAs were given an instruction concerning "conflict of interests and infringement of independence as a result of other activities of CPAs of banking corporations." This comprehensive instruction, based on SEC guidelines, was applied in

[3] This activity takes place in conjunction with the Information and Reporting Unit.

addition to rules under the CPA regulations that pertain to “conflict of interests and infringement of independence as a result of other activities” and the Securities Authority’s decision about “auditor’s independence” and CPA-auditors of banking corporation were also ordered to comply with additional auditing standards and guidelines published by the American Institute of Certified Public Accountants.

The unit continued to make progress in regulating communications by CPA-auditors on auditing issues with parties who have overarching control of the audited entity (as members of a team including CPA-auditors of banking corporations).

The unit’s inspections in 2003 focused on the following:

1. Adequacy of disclosure in financial statements to the public—the annual statements at large, specific matters, and monitoring of the correction of irregularities uncovered in previous inspections.

2. Measurement and disclosure of fair value of financial instruments and of banking corporations’ investments (including capital investments) in held companies.

10. CHECKS WITHOUT COVER

The Checks Without Cover Section, basing itself on information that it receives from commercial banks, the Execution Office (bailiffs’ service), and the rabbinical courts, among others, operates a complex computer system that deals with people who write ‘bad checks.’ The main purpose of the system is to implement the Checks Without Cover Law, 5741-1981, as amended in 1992, in order to reduce the incidence of writing checks on insufficient funds.

The section’s main function is to declare customers as restricted under aggravated circumstances and to serve them with notice to this effect. Such customers are those who have been restricted under ordinary circumstances and are restricted again during the term of the restriction or within three years after its end. Due to legislative changes in 1994 and 1995 that expanded the restriction obligations of the Supervisor of Banks, the section has expanded the definition of ‘restriction under aggravated circumstances’ to include men who refuse to grant their wives a divorce under religious law and persons whose accounts, in accordance with an order from the director of the Execution Office, should be restricted under aggravated circumstances.

The section receives lists of accounts restricted under ordinary circumstances and guides the banking system with regard to banks’ computerized systems that deal with restrictions and the control of these systems. The section deals with violations of the law and with oral and written enquiries from the public in cases where court appeals have been filed. It cooperates with the police in handling cases of fraud and acts to improve the systems that deal with writers of bad checks.

There were 168,722 restricted accounts in 2003, up 12.8 percent from the previous year, and 97,481 restricted customers, up 14 percent (Table 5.4). The number of customers restricted under special circumstances—those who have files with the Execution Office and those who refuse to grant their wives divorces—increased by 25.3 percent over 2002 and came to 24,435. Most of the increase was due to an upturn in the number of customers who have files with the Execution Office and were restricted per decision of the Office. The uptrend in the number of restricted customers and accounts is evidently related to the recession.

Table 5.4
Restricted Customers and Accounts, 2001–2003 (end of year)

	2001	2002	2003	Percent change in 2003 (%)
Restricted accounts	133,683	149,616	168,722	12.8
Of which For checks returned	89,375	95,196	105,434	10.8
Restricted customers	75,795	85,465	97,481	14.1
Of which Under ordinary circumstances[a]	32,096	36,007	40,848	13.4
Under aggravated circumstances[b]	30,862	29,956	32,198	7.5
Under special circumstances[c]	12,837	19,502	24,435	25.3

[a] A customer restricted under ordinary circumstances is restricted in one account and is allowed to use other accounts but may not open new accounts.
[b] A customer restricted under aggravates circumstances is restricted in two accounts and may not draw checks on any of his/her accounts.
[c] A customer restricted under special circumstances is restricted by the director of the Execution Office or by a rabbinical court.
SOURCE: Returns to Supervisor of Banks.

The number of requests for investigation of writers of ‘bad checks’ continued to increase during the year, as did the number of queries to the answerphone service and the Web site of the Bank of Israel. Some 2,100 written requests from the public and other entities were received, including 820 appeals to the courts. Responses were given to some 7,000 telephone requests for investigations and information. The answerphone service was contacted 22,000 times in 2003, 10 percent more than in 2002. The number of enquiries addressed to the Web site doubled to 87,000 (Table 5.5).

Information services for the public about restricted accounts and customers were expanded and were also provided at the Web site of the Bank of Israel (www.bankisrael.gov.il/black.html) and by answerphone (Telemeser 1212332755). These modalities allow the public to receive at no charge, on the basis of Section 14 of the Checks Without Cover Law, 5741-1981, information about restricted checking accounts and data, based on ID numbers (for private customers) and corporate numbers (for businesses), on restrictions under aggravated circumstances.[4] The goal in disseminating information at the Web site is to achieve wider dissemination and, thereby, to allow more individuals and firms to determine in real time whether the checks they are given have been drawn on accounts that are restricted under ordinary or aggravated circumstances.

[4] Information about customers restricted under aggravated circumstances does not include data on customers with ‘special restrictions’ (due to liquidation, a file with the Execution Office, or refusal to grant a divorce), customers who have appealed their restriction in Magistrate’s Court, and customers who were apprised of their restriction less than sixty days earlier.

Table 5.5
Public Enquiries and Complaints Regarding Checks without Cover, 2002 and 2003 (end of year)

	2002	2003	Percent change in 2003
In writing	1,124	1,234	9.8
Appeals to courts	876	823	–6.1
Via answerphone	20,000	22,000	10.0
By phone to the Unit	6,000	7,000	16.7
To Bank of Israel web site	43,000	87,000	102.3

SOURCE: Returns to Supervisor of Banks.

11. PROHIBITION OF MONEY LAUNDERING—LEGISLATION AND REGULATION

Legislation and Regulation

In August 2003, the Governor of the Bank of Israel signed the first amendment to the Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporation), 5761-2001 (hereinafter: the Order). The amendment reflects the experience that has accumulated since the Order was enacted and corresponds to IMF recommendations that Israel has decided to adopt. The amendment toughens the reporting requirements, addresses matters that did not find expression in the original Order, and corrects the Order in view of changes that were introduced to the law.

Enforcement

Examinations: During 2003, the Israeli banking system was subjected to an intensive, concentrated round of comprehensive examinations concerning its implementation of legislative provisions related to the prohibition of money laundering. The examinations showed that the banking system has acted to apply and adopt the international standards set forth in the legislation. The banks made extensive preparations at all levels—entailing coordination and cooperation among departments—and thousands of employees changed their outlook and internalized the awareness that they must assist in the war on money laundering in addition to providing customer service.

Sanctions Committee: Although the banks invested efforts and resources in applying the legislative provisions concerning the prohibition of money laundering, examinations by the Department turned up irregularities and violations—at some banks, material violations—that were dealt with through the offices of the Sanctions Committee for

Banking Corporations. In 2003, the committee found that three banks and one banking trust company had violated certain provisions against money laundering; in 2004, the committee found that nine commercial banks and two mortgage banks had done so. In most of these cases, the committee sent the offenders a written warning and refrained from financial sanctions, mainly because the violations were committed shortly after the provisions of the law, the orders, and the regulations had gone into effect. However, several banks that were found delinquent in making their preparations and guilty of numerous irregularities were fined, even though they had corrected most of the irregularities since the examination.

The most common violations and irregularities concerned identification and verification procedures upon opening of bank accounts, including obtaining statements about beneficiaries and controlling principals and safeguarding identifying documents. Irregularities were also found in the procedures for reporting to the Prohibition of Money Laundering Authority, reporting on the basis of transaction size, and reporting of irregular transactions. The committee sent these banks and the trust company a written warning.

FATF audit and deletion of Israel from the watch list: After the Financial Action Task Force decided (in June 2002) to delete Israel from the NCCT, the blacklist of countries and territories that were deemed non-cooperative in the war on money laundering, and to upgrade its status to the Watch List, an FATF mission visited again in September 2003. In the aftermath of this audit, the FATF deleted Israel from the Watch List—a decision made, among other things, in view of the Department's intensive enforcement measures and extensive and comprehensive examinations of the banking system.

Appendix
Activities of the Banking Supervision Department in 2003

27 January
The banking license of Leumi Industrial Development Bank, Ltd., was revoked.

29 January
An amendment to the Banking Rules (Customer Service) (Proper Disclosure and Presentation of Documents) (Amendment 2), 5763-2003, was gazetted. The amendment went into effect on July 1, 2003.

30 January
Pursuant to the Banking Order (Early-Repayment Fees), 5762-2002, the directive concerning the early repayment fee on a non-housing loan was amended. The main provisions of the amendment follow:
1. The directive was extended to cover loans given for terms of less than one year.
2. The sum of early repayment was reduced from 50 percent of the balance of the loan to 25 percent, plus interest and indexation differentials accrued and unpaid as of the actual date of repayment, and the limit on the original sum of the loan was abolished.
3. The fee was lowered from 1 percent to 0.25 percent.
4. A requirement of at least thirty days' prior notice about early repayment of forex and forex-indexed loans, where the desired early repayment date is between the first and the fifteenth day of the month, was established.
5. Rules concerning proper disclosure to customers were set forth.

16 June
To bring them into compliance with the transitional provisions of the Prohibition of Money Laundering Order, banking corporations were asked to step up their efforts to complete the upgrade of customers' identifying particulars and to sign customers to statements with regard to beneficiaries and controlling interests as the Order requires. In accounts for which no statements about beneficiaries were received, banking corporations were ordered to take action to obtain them.

4 August
The license of Maritime Bank of Israel Ltd., was revoked.

6 August
After the U.S. Securities and Exchange Commission issued new directives with regard to the compulsory reporting format and level of detail about the remuneration of external auditors, the Reporting to the Public directives were amended to require additional details and information.

17 August
An amendment to the Prohibition of Money Laundering Order—Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporations) (Amendment), 5763-2003—was gazetted. Most sections of the amendment went into effect on Jan. 1, 2004; several did so on April 1, 2004.

20 August
To prevent excessive concentration of the credit portfolio, the directive regarding limitations on the indebtedness of a borrower and a group of borrowers was amended. The main provisions of the amendment follow:
1. The definition of a group of borrowers was expanded to include borrowers materially related in such a way that undermining the financial soundness of one may affect that of the other and borrowers whose financial soundness may be affected by the same factors.
2. The definition of control was adjusted to clarify that a person controls a corporation if he/she holds the largest share of the means of control of any type or if there is no holder of the means of control of any type who holds a larger share of the same means of control.
3. The section allowing a group of borrowers composed of a jointly controlled company or a partnership of several controlling interests to split its debts was repealed.
4. It was explained that non-recourse credit to a borrower, guaranteed by securities shall be considered, for the purpose of the limitations in the directive, credit of the borrower and of the company that issued the securities, and shall be reported accordingly.

26 August
In view of changes and developments in the banking world—more vigorous competition for deposits, a change in depositors' preferences, the increase in off-balance-sheet activity, and technological improvements, all of which affecting the structure of banking corporations' sources and the way banks manage their liquidity risks, a new directive with regard to liquidity-risk management was promulgated. The directive requires banks to establish and implement a comprehensive policy in this regard, including procedures, levels of responsibility and powers, the development of advanced models for liquidity-risk management, and the maintenance of information systems for control, monitoring, and reporting in this respect.

9 September
Complementary instructions for customer identification in accordance with the Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporation), 5761-2001, were gazetted. The guidelines stipulate, among other things, that a banking corporation may not perform transactions that entail interaction between a customer and a representative of the bank unless the customer signs a beneficiary statement form. These transactions include, inter alia, withdrawals or deposits

at the counter and the presentation of a checkbook or credit card. A customer's refusal to sign such a statement, or deliberate avoidance of signing, shall be considered reasonable grounds for refusal to manage an account for the purposes of the Banking Law (Customer Service) 5741-1981.

14 September

The directive concerning information technology (IT) management by banking corporations was updated in order to reflect the vast importance that the Banking Supervision Department attributes to IT for customer service, sound management and operation of banking corporations, maintenance of bank stability, and the need to maintain high standards of IT management. The directive covers a range of matters related mainly to aspects of management and control, on-line banking, data security, and IT system continuity in states of emergency. The directive corresponds to the principles of the Basel Committee in respect to electronic banking. The new directive will go into effect on January 1, 2004.

23 November

The transitional provisions of the directive concerning the limitation of the indebtedness of a borrower and a group of borrowers were amended after the banking corporations examined the matter and after it became possible to estimate the expected effect of the initial implementation of the directive. The amendment temporarily increases the maximum amount of credit that a bank may give to the six largest groups of borrowers from 135 percent of the bank's capital to 150 percent. The banks may maintain this level until the end of 2004 but subsequently will have to lower it gradually so as again to comply with the 135 percent limit by the end of June 2006. The amendment also obviates the need, in financial statements as of September 30, 2003, to make a supplemental loan-loss provision for infractions of the limitations that occurred due to the implementation of the recent amendments to the directive.

30 November

The directive concerning boards of directors was amended to create a clearer separation of the activities of boards of directors from those of banks' managements. The amendment states that a director shall not contact an employee of the banking corporation with regard to business initiatives for the banking corporation. The director may contact the chief executive officer of the banking corporation with regard to such initiatives, provided that the director has no personal stake in them. Furthermore, a director may not turn to an employee of the banking corporation with regard to the business affairs of specific customers or specific investments of the banking corporation. In such a case, too, the director may contact the chief executive officer, and the chair of the board or the chair of a board committee may ask for clarifications with regard to a matter directly related to a discussion in the plenum of the board or in one of the board committees.

The Banking Supervision Department: Organizational Structure