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SUPERVISOR OF BANKS

ISRAEL'S
BANKING
SYSTEM

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Letter of the Supervisor of Banks, Mr. Yoav Lehman, submitted with the 2005 Survey of Israel's Banking System, published by the Bank of Israel

The 2005 Annual Survey of Israel's Banking System is attached. The survey was written by the Research Unit of the Banking Supervision Department. It shows that the strength of Israel's banking system continued improving in 2005, reflected in a rise in the banks' profitability, a decline in the risks to which they are exposed, and an improvement in their capital adequacy. This trend has continued so far in 2006 too, despite the effects of the war in the north, during which the banking system maintained an adequate level of customer service even in areas affected by the hostilities.

In the period reviewed, the structure of the system itself, its ownership structure and its activities underwent important changes: the recommendations of the Bachar Committee regarding the separation of the provident and mutual funds from the banks began to be implemented, a step aimed at increasing competition in the financial system and the competitive threat to the banking system from the capital market; the privatization of the banks was in effect completed, with the sale of the state's holding in Israel Discount Bank and recently also in Bank Leumi (with the purchasers currently being assessed by the Bank of Israel for purposes of granting them the permit to control the bank); and the process of very small banks closing or merging was completed—banks whose contribution to competition was negligible but in which their depositors' money was at risk.

At the end of 2005 a directive intended to regularize, simplify and lower the cost of transferring from one bank to another became effective. The directive is aimed at increasing the level of competition in retail banking, in which it is sorely lacking, and providing customers with the tools to negotiate with banks on the terms and conditions they offer. The same applies to a directive that regularized various aspects of credit card activity, mainly making it more transparent to the customer. A special agreement was made with the banks relating to fees and commissions on handling households' current accounts ("package deals"). The agreement resulted in the cancellation of double charges, the fee for each line entry on the statement, and fixed management fees, and allows customers to choose the fee track most appropriate to them. These and other steps are intended to increase competition and to enable small customers too to exercise normal consumer conduct in their banking activity.

In June 2006 the Basel Committee on Banking Supervision published the final version of its recommendations regarding capital measurement and allocation with regard to credit, operational and market risks. The rules allow the adoption of either "standard" or "advanced" approaches to the management of risks and credit allocation. The banking system and Banking Supervision in Israel will adopt the principles of Basel II in a way that will enhance risk management and control in banks. The banking system is expected to adopt a relatively advanced approach to credit risk—the FIRB (Foundation Internal Ratings Based) approach—and the standard approach with regard to operational risk. The FIRB approach to credit will significantly improve credit risk management, via the

internalization of advanced methods of credit rating. It is not practical at this stage to introduce the advanced approach (AMA—Advanced Measurement Approach) regarding operational risk, but in the framework of the infrastructure required to implement the Basel II principles in this area the standard approach also includes the requirement for significant improvement in the management of operational risk as well as in all aspects of the control systems.

The overall implementation of Basel II in Israel will take place in 2009–10, a little later than in the first countries to implement the principles. The extra time is needed to allow the banks to complete the establishment of the management infrastructures, credit rating systems, and internal auditing, as well as the computer systems required to operate the new rules for credit allocation. Delaying the implementation will enable the Banking Supervision to complete the formulation of the relevant instructions based on the experience of the countries most advanced in this field.

In this context the Banking Supervision published a draft of the guidelines for credit rating systems, for advanced internal audit in the banking corporations, and for the management and control of operational risks, and this alongside the requirement to adopt the US rules for financial reporting (section 404 of the Sarbanes-Oxley Act—SOX 404). The Banking Supervision is currently also deeply involved in formulating a directive to define the requirements relating to capital allocation according to Basel II.

The Banking Supervision considers the improvement of capital adequacy above the 9 percent minimum requirement (effective since March 1999) very important, and the banks have in fact improved their capital adequacy in the last few years. It is of special importance to do so at a time of boom in the business cycle and of rapid growth, such as at present, as part of the preparations to face periods of recession in economic activity. This approach will apply even more strongly following the implementation of the new Basel II rules, which are more sensitive to business cycles. Until their implementation, the banks should prepare themselves and adjust to the amount of capital they will be required to hold according to the new rules, in line with their individual risk profiles.

Recently the directive regularizing the situation regarding exceptional overdrafts became effective. The existence of ongoing and large deviations from credit line limits was a peculiarly Israeli feature; it created uncertainty among customers regarding the amount and cost of credit the banks made available to them, adversely affected risk management and costing in the banks, and interfered with the identification of customers whose overdrafts expressed economic problems. Setting credit limits and costs as part of the process of implementing this directive helped to improve the assessment and management of the risks of retail customers in some of the banks. The implementation of the directive for the first time (in 2006) caused a sharp decline in the extent of deviations from credit limits, with only a small reduction in the amount of credit in current accounts, despite the large rise in the credit limits offered to customers by the banks. At the same time fixed term credit, which offers customers a cheaper alternative to a current account overdraft, increased. The choice of the most appropriate credit mix and the correct use of the credit limit in the current account are likely to reduce the

cost of customers' banking activity, as well as help customers to improve their overall management of their income and expenses. In this way any problem that may arise in this flow will be spotted in good time, and dealing with it will enable the customer (and the Bank) to avoid more serious financial complications.

Yoav Lehman
Supervisor of Banks

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