

BANK OF ISRAEL

Office of the Spokesperson and Economic Information

Press release

November 27, 2024

**Bank of Israel Governor Prof. Amir Yaron’s remarks at the Banking Supervision Department’s 2024 conference**

The 2024 Bank Supervision Department Conference on Financial Fraud is taking place today. The conference was opened by Bank of Israel Governor, Professor Amir Yaron, and his full remarks are attached. Additional materials will be distributed during the conference.

Good morning everyone,

First, I welcome the ceasefire agreement in the north that came into effect early this morning. I hope it will also lead to the restoration of calm in the southern region, the return of all hostages to their homes, and the restoration of security for the residents of Israel.

I would like to commend the Banking Supervision Department for this important conference dedicated to the topic of financial fraud. In fact, this topic is part of a broader picture - the tectonic changes that the financial system has undergone in recent years and the right way to deal with them.

Therefore, I will focus my remarks on three topics: First, I will talk about the significant changes the global financial system is undergoing, the challenges posed by technological changes, and the ways different countries are dealing with these changes. Then, I will address the current state of the banking system in Israel, especially with regard to the challenges of competition and consumer well-being. Finally, I will present the steps we are taking to promote a more competitive banking system that will benefit the public while maintaining its stability.

So let's begin. To fully understand the challenges of the future, it is important first to return to the basics and understand the essential role of the financial system, or if you prefer, the world of finance, in the economy.

At its core, the financial system is responsible for the efficient allocation of resources in the economy. Banks, as central financial institutions, play a critical role in mediating between savers and borrowers, enabling economic growth by creating access to financial assets and financing. According to the classic model of Diamond and Dybvig, two economists who later won the Nobel Prize, the uniqueness of banks lies in the process of maturity transformation, where banks convert short-term deposits into long-term loans, thus bridging the gap between the liquidity needs of savers and the need for long-term financing.

This mechanism exposes banks to a unique risk: if for some reason public confidence in the bank is shaken, a 'bank run' situation may arise - where many depositors want to withdraw their money all at once. With the advancement of technology, this threat has become even more severe. We recently saw this in the case of SVB Bank and other banks, where technology enabled mass withdrawals at unprecedented speed.

Due to this special risk, maintaining public confidence is a necessary condition for the stability of the banking system. This is also why any entity seeking to accept deposits from the public and provide credit—in other words, to operate as a bank—must be supervised accordingly. The importance of financial supervision is highlighted by the impact that financial crises have on the real economy. As Ben Bernanke showed in in his research, a financial crisis—whether accompanied by a real crisis alongside it or due purely to financial reasons—can quickly escalate into a deep crisis in the entire economy. A contraction in the supply of credit can lead to a significant decline in investments, weakening of private consumption, and harm to employment.

These insights, which were reinforced during the Global Financial Crisis of 2008, when Bernanke served as Chairman of the Federal Reserve, reshaped the perception of supervision over the financial system. However, recent years have presented us with a new type of challenge: the entry of new technological participants and the development of innovative business models. These require an expansion of the concept of financial supervision beyond just maintaining stability.

The digital age has fundamentally changed the way we manage our lives. From video calls with friends on the other side of the world, through ordering products and services at the touch of a finger, to real-time navigation in traffic jams, almost every aspect of our lives has become faster, more accessible, and cheaper. However, the traditional financial system, which operated for a long time with outdated structures and processes, struggled to close the gap and adapt to changing needs.

The emerging mindset among leading financial institutions worldwide focuses on new principles for designing the future financial system. At the center of these are "unified ledgers", digital platforms that bring together a wide range of digital financial assets—"tokenized assets". These platforms allow the digital representation of a variety of assets, from traditional financial assets like bonds and securities to tangible assets. Through smart contracts, it is possible to transfer and exchange these assets immediately and simultaneously—what we call atomic settlement.

This is in contrast to the current situation, where a long and complex chain of approvals and adjustments between different systems is required, leading to high costs, long waiting times, and unnecessary operational risks.

The principles I mentioned are applied differently in different countries, depending on how developed the financial system is. In developing countries, where the traditional financial system was less developed, innovative digital infrastructures were built from scratch. For example, in India, the Unified Payments Interface (UPI) system allows immediate payments—Faster Payments—between all types of accounts and digital wallets. Similarly, in Brazil, the Pix system is another example of the model's success, with over 100 billion transactions in 2023. In contrast, developed countries like the UK and the US are moving their financial systems forward using a more decentralized hybrid model: a combination of public infrastructures from central banks and private sector infrastructures.

The financial system in Israel is in the midst of a significant "catch-up" with the more developed global financial systems. We are in the final stages of legislating the Securitization Law, working to promote a more sophisticated repo market, launching the "Shir" interest rate, which is equivalent to the American SOFR rate, and working to ensure the integration of the Israeli financial system into the global payments system. Similar to other developed countries, the success of these moves largely depends on the active involvement of the private banking system. Therefore, banks must recognize the evolving technological environment and prepare accordingly for the challenges and opportunities it presents.

To summarize my remarks so far, global experience has taught us a double lesson: first, the heavy price that society as a whole pays during financial crises and the crucial importance of financial stability as a condition for economic growth and prosperity, and second, a sharper understanding that the role of regulation is not limited to maintaining stability alone, but must also support the development of an innovative, efficient, and accessible system. In this context, I would like to commend the payment deferral plan that the banking system adopted during the war, which helped—and is still helping—many households of reservists, residents of the Gaza-proximity area and the confrontation line, and others hurt by the war. However, there is no doubt that the banking system in Israel is characterized by an insufficient level of competitiveness. The high profitability of the banking system relies largely on the significant current account balances that the public holds in their accounts. These provide a cheap and stable source of financing for the banks, while they do not yield a proper return for the customers. In addition, there is a gap between the pace and intensity of the adjustment of credit interest rates to changes in the Bank of Israel's interest rate and that of deposit interest rates. These challenges highlight the fact that the public’s trust in the banking system is not limited to the trust that its savings are being properly secured.

The banking system itself must internalize that fairness toward the customer, which includes maximizing the value of their savings, is an essential component in maintaining its reputation, and thus, also its long-term stability. At the same time, we are working, and will continue to work, to increase competition in the system, through several measures that I will briefly outline.

First, regarding the issue of current accounts—as I said, the public's current account balances remain particularly high, while these funds do not bear interest. At the same time, the banks continue to derive significant profits from them. In view of this, we instructed the banks to present concrete plans that would expand the options available to customers for investing their money in interest-bearing deposits. We are still in the process, and we will insist that the banks present tangible results on the ground, for the benefit of the public.

Second, regarding the gap between the high transmission of from changes in the Bank of Israel's interest rate to credit interest rates, compared to the low and slow transmission to deposit interest rates, we acted with the banking system on this issue and saw some improvement. Now, in an international comparison, we are not lagging behind developed countries, but there is still room for progress.

It is important to note that customers must also act on this issue. We publish on the Bank of Israel's website a comparison of interest rates on credit and deposits between banks, which the economic media also make accessible. I call on the public to use this information, compare prices, and challenge the banks. In addition, if we do not continue to see improvement in this matter, we will consider additional measures.

Now, I will address in detail a significant step we are taking to deepen competition: opening the banking system to additional participants through an innovative framework for granting banking licenses. The framework offers a graded and tailored approach, based on the principle of specialization. Financial entities will be able to obtain a banking license tailored to the specific area of activity in which they choose to specialize. For example, a credit card company seeking to expand its activities into the field of deposit collection will be able to obtain a tailored banking license focused on these activities.

In such a case, it will not be required to meet the full range of regulatory requirements that apply to a bank offering the full range of banking services, such as in the field of foreign trade or managing a trading room. This approach will significantly reduce compliance and operational costs and allow new participants to compete efficiently in their areas of expertise. Of course, this process will be carried out gradually and carefully, in compliance with international standards and maintaining system stability. In the long term, the step is expected to lead to a more competitive and diverse financial market. This move is part of a series of steps that the Bank of Israel has led in recent years, aimed at promoting competition and innovation in the financial system. These steps are designed to strengthen the financial system and create a competitive and innovative operating environment for the benefit of the entire public.

Another topic I would like to discuss, related to the level of competitiveness in the banking system, concerns the ownership structure in the financial system. I will start with a brief historical description.

Until the early 2000s, the financial system was characterized by the almost absolute dominance of banks, which enjoyed control over both traditional banking activities and the management of public savings. This situation created high concentration and inherent conflicts of interest. The Bachar Committee, established in 2004, led to a significant structural change. It separated provident funds and mutual funds from the banks and prohibited institutional investors from simultaneously controlling banks. Since then, the structure of the financial system has undergone significant change. Institutional investors have developed and become significant participants, especially in the field of business credit. However, structural and regulatory characteristics still make it difficult for them to penetrate the banking fields, which include providing consumer credit and raising deposits.

As part of our efforts to address this challenge and expand competition in the market, we recently began issuing approvals for holding companies that hold institutional investors to control credit card companies.

The experience of the last two decades since the Bachar reform raises questions about the effectiveness of structural changes in the financial system. Although the separation of ownership allowed new participants to enter the capital market, the level of competition did not increase to the expected extent, and operational efficiency was impaired.

These lessons require us to re-examine the desired level of separation in the system. Therefore, we are currently examining the possibility of allowing holding companies that control institutional investors to expand their activities to control small banks as well, subject to restrictions that will ensure fair competition and prevent excessive concentration.

This move holds significant potential alongside complex challenges. On the one hand, institutional investors, as experienced and financially sound players, can contribute to the development of small banks through capital support, risk management expertise, and experience in developing innovative financial products. This combination may strengthen the competitiveness of small banks and expand the range of services to the public, especially in the fields of small business credit, consumer credit, and deposits.

On the other hand, the move raises concerns about structural conflicts of interest between the bank's activities and the institutional investor’s activities, especially in the fields of investment advice and credit provision. In addition, the creation of large financial conglomerates may pose new challenges for regulatory supervision. It is important to emphasize that this is a subject under in-depth examination, with the aim of formulating a balanced policy that will serve the public interest as a whole.

Before concluding, I would like to address some legislative proposals that have recently been raised regarding the banking system. First, it is important to emphasize and understand the inherent uniqueness of banking activity. As I presented earlier, the combination of accepting deposits from the public and providing credit creates unique risks, primarily run risks, which require dedicated supervision. Today, technology allows many companies to offer services that were previously exclusive to banks. Technology companies and new financial entities are entering traditional banking fields, blurring the familiar boundaries. But we must not be confused: An entity that accepts deposits and provides credit is a bank and requires full banking supervision. This principle, which has proven itself over the years, is more vital today than ever before for maintaining public trust and system stability.

Second, it is important to emphasize the critical role of banks in maintaining orderly economic activity, both locally and internationally. The banks are required to comply with international rules, such as sanctions regimes, designed to ensure Israel's integration into the global economy. Legislative proposals intended to require banks to ignore sanctions originating from countries like the US expose banks to serious risks that could harm their stability and public trust and damage Israel's reputation as a business hub.

Finally, legislative intervention in pricing, such as requiring banks to offer a minimum interest rate on deposits or capping interest rates on credit, could lead to undesirable and sometimes even opposite results from its goals. Such interventions could impair banks' ability to properly manage risks and allocate credit efficiently. Complex issues like these require professional judgment and adaptation to changing market needs.

In conclusion, economic theory, past experience, and future challenges highlight the guiding principle by which we have acted and will continue to act: uncompromising maintenance of financial stability, alongside promoting competition and embedding technological innovation in a balanced and responsible manner.

I would like to once again thank the Bank Supervision for organizing this important conference and wish us all fruitful learning for the rest of the day. Thank you very much.