Chapter 6
Structure of the Banking System and Activities of the Banking Supervision Department

Much of the work of the Banking Supervision Department consists of monitoring the exposure of banking corporations to actual and expected risks in the banking system and ensuring that banks maintain sound relations with their customers. In 2001, in addition to these routine activities, the Department also dealt with regulation regarding boards of directors, set rules for the reporting of credit risks in high-tech activity, and required the appointment of compliance officers. The Department examined banking corporations' exposure to credit risks and, in the context of the economic and security situation during the year, ordered the banks to increase their loan-loss provision.

The Department performed special inspections in respect to credit cards (pursuant to customer complaints) and on-line banking services. Banking services over the Internet continued to expand in the course of 2001, as reflected in an increase in the number of registered customers and in the extent of their activity. The number of branches declined, in continuance of the trend in 1999 and 2000, and the banks made greater use of their entitlement to open temporary branches for periods of up to three months.

In the credit-card market, the most salient event of the year was the replacement of Alpha Card, Ltd., owned by the First International Bank of Israel, by Leumi Card, which began to distribute cards at the beginning of 2001. The structural changes enhanced competition in card issuance and clearing during the year.

1. INTRODUCTION

The first part of the chapter surveys changes and main developments in the structure of the banking system in 2001 and from a long-term perspective. The second part describes the Department's main activities this year in its areas of responsibility—regulation, bank-customer relations, information and reporting by banking corporations, applied research in banking fields, and inspection and evaluation of banking corporations' activity. The second part also describes the Department's activities in international relations, licensing, checks without cover, credit-card companies, and prevention of money laundering.

2. CHANGES IN THE STRUCTURE OF THE BANKING SYSTEM

General

The Israeli banking system is rather highly concentrated, although less so today than in the early 1990s. The change in concentration is reflected in the Herfindahl Index (the H-Index) of concentration,[1] which declined steadily during the 1990s (Figure 6.1), albeit at a somewhat slower rate in the second half of the decade than in the first. Notably, however,

Table 6.1
The Structure of the Banking System, 1980–2001

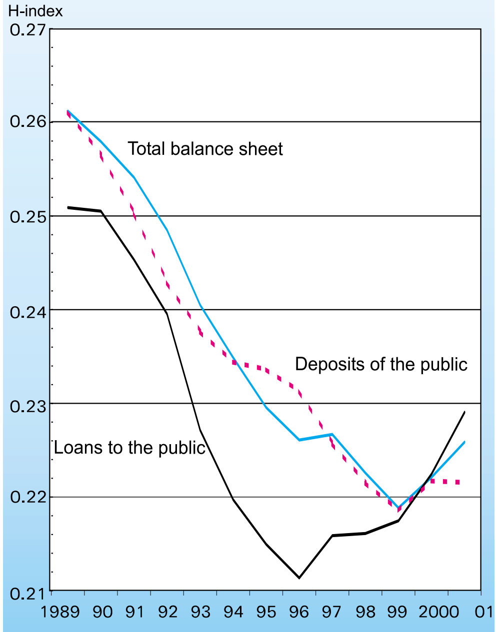
	Banking corporations[a]	Commercial banks[b]	Mortgage banks	Investment finance banks	Other banking corporations[b]
1980	63	30	16	8	9
1990	58[c]	26[c]	9	8	15
1995	46	24	9	2	11
1996	45	24	9	1	11
1997	45	23	8	1	12
1998	45	24	8	1	12
1999	45	23	8	1	13
2000	45	23	8	1	13
2001	43[d]	23[d]	7	1	12

[a] Includes commercial banks, mortgage banks, a foreign bank, merchant banks, credit unions, investment finance banks, financial institutions, and joint service companies.
[b] In 1998, Bank of Jerusalem, which was a financial institution, became a commercial bank.
[c] Excluding banks in the territories.
[d] In April 2002, Trade Bank was delisted as an active bank in the system due to an embezzlement that exceeded its capital.
SOURCE: Returns to Supervisor of Banks.

[1] The H-Index, one of several concentration indices, reflects the extent of competitiveness as manifested in the distribution of bank assets within the system.

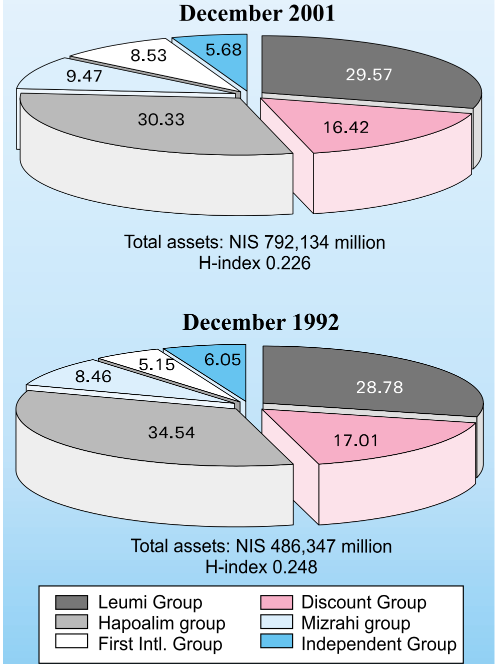
in contrast to the decline in the H-Index with regard to total balance sheet and deposits, which persisted throughout the 1990s, the H-Index in respect to credit has been rising since 1996. The index is affected both by the distribution of banks' market shares in the system and by the number of banking institutions. In the latter regard, no substantive changes have occurred in the past decade (Table 6.1), even though the number of active banking corporations in Israel declined from forty-five to forty-three in the course of 2001, as Carmel Bank and all its activity were sold to Union Bank and the Leumi and Co. Investment House Ltd. was shut down.[2] Thus, the difference in H-Index trends between credit to the public and deposits originates in a redistribution of market shares within the system. This may be due to the effect during this period of credit to large borrowers for use in leveraged buyouts. The type of demand that increased was for large-scale credit, which naturally is given by large banks since, among other reasons, the single-borrower limit makes it difficult for small banks to provide extensive credit. The proportion of credit by the various banking groups in total credit to the public supports

Figure 6.1
H-Index of the Five Major Banking Groups and the Independent Banks, 1989–2001



SOURCE: Published financial statements.

Figure 6.2
Distribution of Assets of Banking Groups, December 2001 vs. December1992



SOURCE: Returns to Supervisor of Banks.

[2] The mortgage banking license of Carmel Mortgage and Investment Bank, Ltd., was revoked on December 10, 2001, and that of Leumi Business Promotion Bank, Ltd., was revoked on October 25, 2001.

this explanation. The share of the two largest banking groups in total credit climbed from 56.6 percent in 1996 to 62.1 percent in 2001, in contrast to a downtrend in the share of medium and small banks in that period. In contrast, since there is no large-depositor limit, medium and small banks are better able to compete with the two largest ones in the deposit markets, evidently including the market of relatively large depositors. The competition for deposits is reflected, as stated, in the steady decline of the H-Index during the 1990s, even though this index in respect to deposits was slightly higher in 2000–2001 than in 1999. The H-Index of the total balance sheet was 0.226 at the end of 2001 as against 0.248 in 1992 (Figures 6.1 and 6.2).

Branches of foreign banks[3]

In 2001, three foreign banks (Standard Chartered Bank, HSBC Bank Plc, and CitiBank N.A.) had branches Israel. They account for only a small share of activity in the Israeli banking system because their branches became operative only about a year ago. For the time being, the branches have been focusing their activities more on business banking—forex services, business room, cash-flow management, and corporate credit—than on households. They have also segued into private banking, with emphasis on large customers. They contribute to competition in the banking industry mainly by offering services with conventional foreign attributes to Israeli customers and by competing for the business of elite customers in both the business and the private sectors. The branches of these institutions also provide customers with more convenient and efficient access to international markets, in which they, as opposed to Israeli banks, have representative offices and/or branches. Alongside the banking system, financial institutions from various countries (European and American) operate in Israel by means of representative offices and investment banks that, unlike branches that provide banking services, do not require a permit from the Banking Supervision Department.

Overseas banking offices

In 2001, the number of Israeli banking corporations' offices abroad climbed to 111—a steep 13.3 percent increase—on the heels of a 4.3 percent increase in 2000. Most of the growth (eleven of the thirteen new offices) occurred in domestic banks' foreign subsidiaries. The increase in number of offices was also reflected in a 13.0 percent upturn in employee posts since 1997 (Table 6.2). For an expanded discussion of overseas banking offices, see Chapter 4 in this survey.

The credit-card market

Alpha Card, Ltd., owned by First International National Bank of Israel, entered the credit-card market in the second half of 1998 as a clearer and issuer (FIBI had a 67 percent

[3] In addition to the banks listed here, two banks—PKO and Investec—operate by means of subsidiaries and one financial institution, Dexia, is active.

Table 6.2
Overseas Banking Offices, Branches and Employee Posts, 1991–2001

	Total number of offices	Number of branches and representative offices[a]	Number of subsidiaries' offices[b]	Number of employee posts[c]
1991	128	70	58	
1992	126	70	56	3,210
1993	123	73	50	2,962
1994	114	73	41	2,717
1995	108	72	36	2,418
1996	105	72	33	2,225
1997	95	62	33	1,972
1998	93	60	33	2,055
1999	94	60	34	2,044
2000	98	62	36	2,125
2001	111	64	47	2,226

[a] Branches and representative offices abroad of Israeli banking corporations.
[b] Branches of subsidiaries abroad.
[c] Not including overtime.
SOURCE: Returns to Supervisor of Banks.

stake in ownership). Until then, the clearing market was a duopoly (controlled by Isracard, Ltd., fully owned by Bank Hapoalim, and Visa ICC, Ltd., co-owned by Bank Leumi le-Israel and Israel Discount Bank.). The advent of Alpha Card enhanced competition in this market, as reflected in marketing measures and initiatives by all credit-card companies such as the revocation of charges for the issue of cards and a lowering of commission rates charged to businesses and suppliers. The banks' waiver of direct revenue from the issue of credit cards and the reduction in their revenues from businesses led to increases in the number of credit cards issued and in the intensity of their use, which offset some of the decline in operating revenues from this activity. Alpha Card accrued losses due to steep entry expenses.

In the course of 2000, Bank Leumi sold its share in Visa ICC to Israel Discount Bank[4] (IDB) and Alpha Card[5] left the credit-card market. Bank Leumi formed a new credit-card company—Leumi Card, Ltd.—on the basis of Alpha Card's operating infrastructure;[6] the new company carried out a pilot issue of cards in late 2000 and began issuing cards to customers in January 2001.

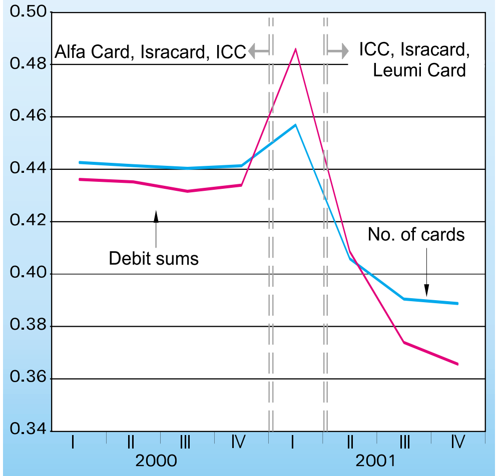
[4] At the request of the Supervisor of Banks and the Director-General of the Antitrust Authority. The Supervisor exercised his powers under Paragraph 11b of the Banking Law, 5741-1981, and allowed outside players—Fishman Family Properties and Harel Hamishmar Holdings—to acquire holdings in an auxiliary banking corporation so that a third clearer could remain in Israel's credit-card market and, thereby, enhance competition.

[5] Of the First International Bank of Israel.

[6] The customer base was transferred to Visa ICC.

The change in ownership of Visa ICC—from co-ownership by Bank Leumi and IDB to co-ownership by First International Bank and IDB—and the establishment of a new company under the ownership of Bank Leumi led, as the H-Index trend shows (Figure 6.3), to a more even distribution in the credit-card market, in terms both of number of cards issued and sums of charges, even though the number of competitors in the credit-card market (three) remained unchanged. Due to these structural changes, the H-Index declined. For the time being, it is hard to judge whether these changes will also be reflected in competition i.e., in the services that these companies provide and in the levels and types of commissions.

Figure 6.3
Activity of Credit-Card Companies (Composition and Sums), H-Index, 2000 and 2001



SOURCE: Published financial statements.

Branch structure

In January 2001, the Bank of Israel simplified the process of obtaining permits to open bank branches and has been allowing branches to be active in different locations—sometimes with no need for a specific permit. The main easing of requirements is in permits for the opening of temporary branches: a bank may obtain a blanket (‘framework’) permit that allows it to open temporary branches for periods of up to three months, at which it may provide a range of services under the conditions spelled out in the permit. Under this arrangement, the bank may open a temporary branch without obtaining a specific permit and must only advise the Department of its having done so. The number of temporary branches that a bank may open concurrently under this arrangement depends on the relative size of the bank, which is determined in accordance with the number of its regular offices. Temporary branches are limited to a predetermined domain of activity (counter or room) and must carry appropriate signs of the bank. Employees of the temporary branch must be employees of the banking corporation and must be suitably trained in their duties. Customers of the temporary branch must be furnished with the address of the permanent branch where their account is managed; they may visit the permanent branch to perform transactions and make enquiries. These restrictions are meant to ensure that the banking activity does not take on characteristics of ‘peddling.’

Banks use temporary branches to market their services and gain access to new areas and, thereby, new customers. They first developed such branches in focused marketing promotions that aimed at specific customer groups (university students at the beginning of the academic year, visitors to expositions, etc.). Recently, temporary branches have also been opened on the premises of business firms (e.g., high-tech enterprises) and in colleges.

The growing use of temporary branches is evinced by data gathered by the Banking Supervision Department: 125 branches of this type were opened in 1999, 170 in 2000, and 240 in 2001, 40 percent of which were at universities and colleges.

As regards other branches, customer use seems to be declining steadily in recent years due to developments in computer and general communications. For this reason, and in view of the cost of maintaining a branch and other business considerations, the banks have been closing branches, merging them,[7] and redefining their purposes (e.g., by focusing their activity on business and commercial customers only[8] or on private banking services). The number of branches (net) decreased by eighteen in the course of 2001[9] after a decline of twenty-three in 2000. Ten of the branches that closed in 2001 belonged to the three largest banking groups. Among the medium-sized banks, eight branches (net) were closed this year—a 3.8 percent decrease in the number of branches relative to 2000. In the group of small banks, the number of branches was unchanged (Table 6.3).

Table 6.3
Number of Offices of Commercial Banking Groups, by Size of Group,[a] 1995–2001

	Number of offices by size of bank				Relative share (percent)		
	Large	Medium	Small[b]	Total[b]	Large	Medium	Small
1995	846	210	13	1,069	79.1	19.6	1.2
1996	843	219	13	1,075	78.4	20.4	1.2
1997	839	224	13	1,076	78.0	20.8	1.2
1998	833	225	13	1,071	77.8	21.0	1.2
1999	805	217	13	1,035	77.8	21.0	1.3
2000	787	213	13	1,013	77.7	21.0	1.3
2001	777	205	13	995	78.1	20.6	1.3

[a] Large banks: Leumi (including Arab Israel), Hapoalim (including Otsar Hahayal, American Israel, Yahav, Massad, and Israel Continental), and Israel Discount (including Mercantile Discount and Mercantile Israel).

Medium banks: United Mizrahi, First International (including Poalei Agudat Israel), and Union.

Small banks: Maritime, Euro-Trade, Trade, Industrial Development, Agriculture, Global Investment, Polska, Kupat Haoved Haleumi, and Investec Clali.

[b] Excluding the 18 branches of Bank of Jerusalem (19 in 2000, 20 in 1999, and 21 in 1998), most of whose activity is in mortgages.

SOURCE: Returns to Supervisor of Banks.

[7] For a comprehensive discussion, see *Israel's Banking System, Annual Survey 1999,* Chapter 6.

[8] For example, by concentrating integrated business services in regional centers.

[9] Not including Bank of Jerusalem, which is still active mainly in housing loans. (Bank of Jerusalem closed one branch per year in 1999–2001.)

Table 6.4
Offices and ATMs, 1986–2001

	Number of offices[a]	Temporary offices[b]	Cash-withdrawal ATMs	Number of information machines	Number of residents per office[c]	Number of residents per ATM
Average 1986–90	1,049	–	555	1,320	4,311	8,043
Average 1991–95	1,063	–	722	1,695	5,017	6,787
1996[c]	1,075	–	1,056	2,000	5,357	5,454
1997	1,076	–	1,131	2,055	5,488	5,221
1998	1,071	–	1,241	2,133	5,537	4,872
1999	1,036	125	1,292	2,111	5,874	4,801
2000	1,013	170	1,322	2,170	6,160	4,857
2001	995	241	1,368	2,132	6,425	4,758

[a] Regular branches, limited-service branches, and counters in Israel, excluding branches of bank of Jerusalem.
[b] A branch opened for a period of up to 3 months and meant to provide banking services under terms listed in the permit.
[c] Excluding offices of commercial banks operating in the territories.
[d] Since 1996 the number of residents has been determined on the basis of the *de jure* population, and updated for previous years.
SOURCE: Returns to Supervisor of Banks.

Furthermore, the high concentration of the three largest banks in the totality of branches was basically unchanged at 78 percent (a decline of only 1 percentage point since 1995).

The adoption of technologies that improve customer service without requiring customers to visit the branch (as explained in greater detail below) has led to a decrease in the number of customer visits to branches.[10] This is evinced by the decline in one indicator of the frequency of visits to branches, the number of debit transactions at the counter for cash withdrawal (in terms of monthly average per branch). In recent years (1996–2001), cash withdrawals at counters of bank branches have been declining by 3 percent on annual average (monthly average per office, Table 6.5). In 2001, the year-on-year decrease was 2.0 percent. The monthly average number of cash withdrawals per ATM also declined—by a gentle 0.8 percent in 2001 relative to 2000—mainly due to a 3.5 percent increase in the number of ATMs. The number of cash-withdrawal transactions was 9.6 million on monthly average in 2001, 2.7 percent higher than in 2000 (Tables 6.4, 6.5, and 6.7).

Since the number of branches has been falling over the years, each branch has been serving more customers on average. In 2001, each branch served an average of 6,400 inhabitants, 4.3 percent more than in 2000 (Table 6.4 and Figure 6.4). About half of the

[10] Customers are becoming habituated to the use of bank services that involve technology, such as on-line and computerized services.

Table 6.5
Number of Employee Posts and Over-the-Counter Debits,[a] 1996–2001

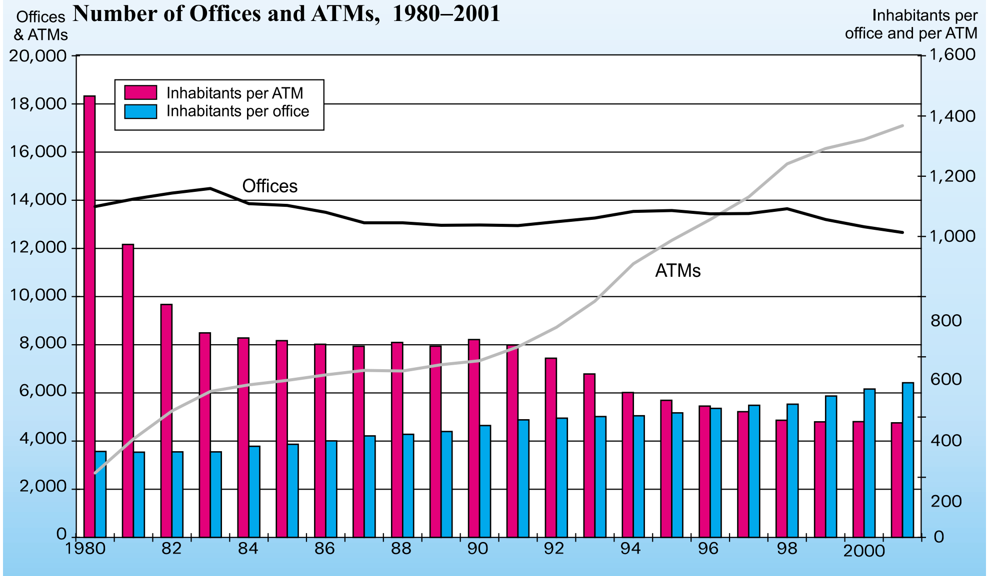
	Number of branches[a]	Number of employee posts[b] *(average)*	Number of employee posts per branch	Employee posts per 1,000 persons	Monthly average: Number of over-the-counter debits per branch	Monthly average: Number of cash withdrawals per ATM
1996	1,075	34,676	32.3	6.0	2,080	7,294
1997	1,076	34,870	32.4	5.9	2,045	7,300
1998	1,071	34,839	32.5	5.8	1,911	7,015
1999	1,036	34,224	33.0	5.5	1,940	7,043
2000	1,013	34,410	34.0	5.4	1,850	7,074
2001	995	34,502	34.7	5.3	1,778	6,999

[a] Excluding branches of Bank of Jerusalem (see note b, Table 6.3).
[b] Data pertain to activity in Israel only. (The computation is explained in note b, Table 3.8.)
SOURCE: Returns to Supervisor of Banks.

increase this year was occasioned by a decline of nearly 2 percent in the number of branches; the rest is attributable to population increase.

Data reported to the Banking Supervision Department point to a moderate upturn in the number of employee posts in the banking system.[11] In 1992–1997, the number of

Figure 6.4
Number of Offices and ATMs, 1980–2001



SOURCE: Returns to Supervisor of Banks.

[11] Weighted posts, i.e., full-time position equivalents.

posts climbed by nearly 10 percent in cumulative terms, peaking at 34,870 in 1997, whereas in 1997–2001 they declined by 1.1 percent. The cumulative decrease is ascribed inter alia to the fact that several large commercial banks have been encouraging employees to accept voluntary retirement. On annual average among the seven largest banks, the expenditure on account of voluntary retirement in 2001 was 3.9 percent of total wage and related expenditure. Bank Leumi and Israel Discount Bank stood out in this regard, their shares of expenditure for voluntary retirement climbing from 2.7 percent in 1998 to 7.6 percent (at Leumi) and 9.0 percent (at IDB) in 2001. Due to the cumulative decrease in employee posts and the faster decline in the number of branches, the average number of posts per office increased somewhat and reached 34.7 in 2001 (Table 6.5).

Another indicator of greater efficiency in the banking system is the average number of employee posts per 1,000 of population. This figure has declined from nine in the early 1980s to six in the second half of the 1990s and 5.3 in 2001 (Table 6.5 and Figure 6.6). The pace of decline has accelerated, from 0.7 percent on annual average in 1992–1997 to 2.4 percent on annual average in 1996–2001. Some of the recent decrease (from 6.0 per 1,000 inhabitants to 5.3) should be credited to efficiencies occasioned by greater use of high-tech banking services, allowing fewer bank clerks to serve a larger population.

These figures reflect the efficiency measures—foremost in the field of operations and organization—that have characterized the system in the past two years and are expected to continue in 2002.

Technology, computerization, and banking services

The extent of use of high-tech banking services over time is largely a function of the assimilation of these services by the customer public, a process that is obviously protracted.

Israel's banking system provides customers with a range of Internet banking services. The supply and use of these services have been expanding since 2000, when the Banking Supervision Department authorized the banks to allow customers to perform transactions within their accounts (including securities transactions) and financial transfers to third parties over the Internet.

Internet banking services continued to expand in 2001—partly at the expense of other on-line services—and cellular telephone services were inaugurated, albeit on a small scale. The increased resort to the Internet as an information source and for banking transactions in Israel was reflected in the growth in the number of customers who used Internet-based banking services to 500,000 in December 2001 (a 60 percent upturn from December 2000).

The rise in the number of customers using the Internet was also reflected in the extent of their activity. On monthly average in the last quarter of 2001, the number of requests for information amounted to 7.6 million, almost twice as many as in December 2000. The use of IVR (Interactive Voice-Response System) and ATMs also increased from December to December, albeit at a more modest rate (Table 6.6). The use of customer

Table 6.6
On-Line Banking, 2000 and 2001

	2000	2001		2000	2001
	December	Qtr.II[a]	Qtr.IV[a]	December	Qtr.II[a]
		(thousands)		*period-on-period (pct. change)*	
Customers (private and business)					
By means of Web browser	314	396	502	26.1	26.8
Direct on-line	38	35	39	–7.9	11.4
Requests for information					
By means of Web browser	3,870	5,970	7,570	54.3	26.8
By means of computerized call center	3,270	3,560	3,650	8.9	2.5
From customer workstation	5,440	5,250	5,190	–3.5	–1.1
By means of ATM	1,820	1,970	2,000	8.2	1.5
On-line transactions					
Deposit/withdrawal of NIS	24	32	37.5	33.3	17.2
Transfers between accounts of same customer	3.6	8.3	11.8	130.6	42.2
Transfers to third party	0.6	3.3	5.3	450.0	60.6
Purchase/sale of securities	33.5	37.5	52.9	11.9	41.1

[a] Monthly averages of data for quarters ending in June and December respectively.
SOURCE: Returns to Supervisor of Banks.

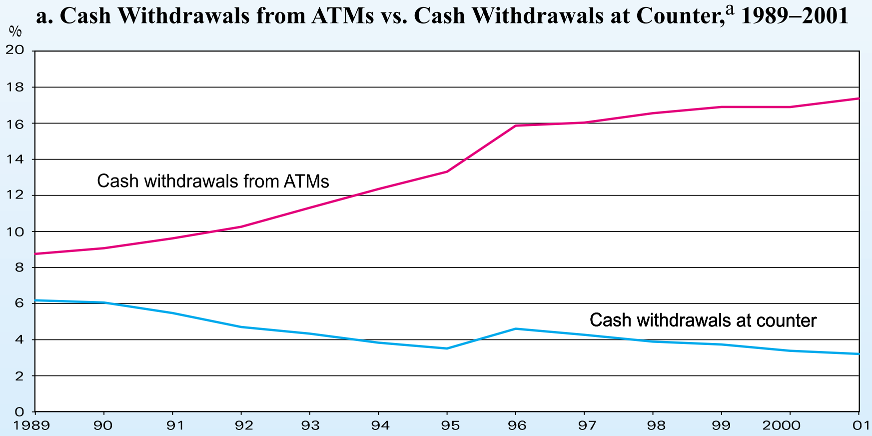
information stations in or near branches was down by about 5 percent from December 2000, however, possibly due to the greater use of the Internet, which is a substitute for information stations.

Along with greater use of the Internet for retrieving information, the number of transactions made over the Internet increased substantially, even though the share of such transactions in total monthly average debits to checking accounts (55.1 million) is still negligible (0.2 percent). On monthly average for the quarter ending in December 2001, there were 37,500 deposits to/withdrawals from NIS deposit accounts (an increase of 56 percent over December 2000) and 12,000 transfers between accounts of the same customer (three times as many as in December 2000). As for transfers to third parties over the Internet, which were allowed in the second half of 2000, initial evidence of activity is visible but its level remains low (about 5,000 transactions on monthly average in the last quarter of 2001).

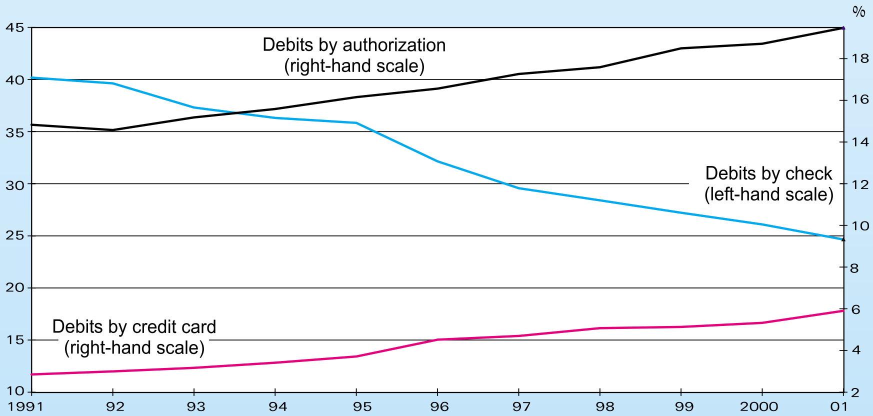
Changes in levels of activity on the Tel Aviv Stock Exchange are also reflected in reports on the number of securities transactions (purchase/sale) carried out over the Internet. The monthly average number of such transactions was volatile: 200,000 in the middle of 2000, 34,000 in the fourth quarter of 2000, and 53,000 in the last quarter of 2001.

Figure 6.5

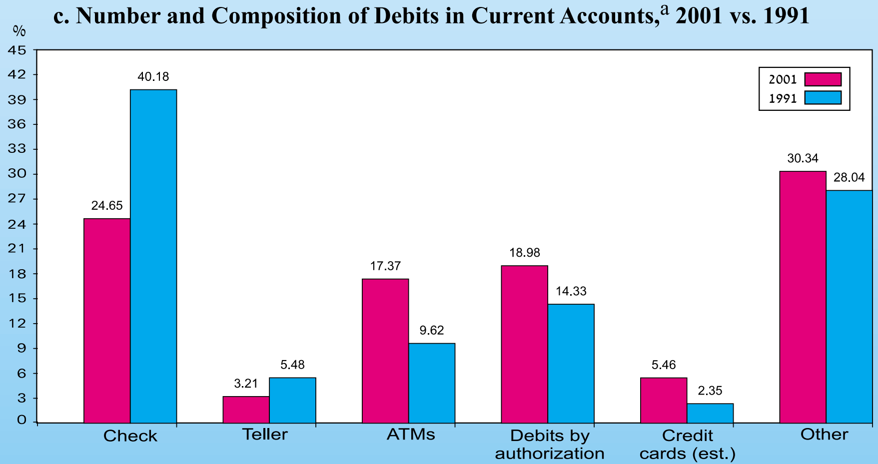
a. Cash Withdrawals from ATMs vs. Cash Withdrawals at Counter,[a] 1989–2001



b. Debits by Check vs. Substitutes: Debit by Authorization and Debit by Credit Card,[a] 1991–2001



c. Number and Composition of Debits in Current Accounts,[a] 2001 vs. 1991



[a] Number of transactions as share of total debit transactions in current accounts.
SOURCE: Reports to Banking Supervision Department.

Table 6.7
Number and Composition of Debits in Current Accounts, the Seven Major Banks, 1991-2001

(monthly average)

	Number of debits (percent of total)						
	By check	At counter	ATM	Author-ization	Credit card	Other	Total (mill.)
1991–1995	37.9	4.4	11.4	14.8	2.7	29.1	48.0
1996	32.1	4.6	15.9	16.1	4.0	27.9	48.5
1997	29.6	4.3	16.0	16.8	4.2	29.2	51.5
1998	28.4	3.9	16.6	17.1	4.6	29.5	52.6
1999	27.2	3.7	16.9	18.0	4.6	29.5	53.8
2000	26.1	3.4	16.9	18.2	4.8	30.6	55.3
2001	24.6	3.2	17.4	19.0	5.5	30.3	55.1

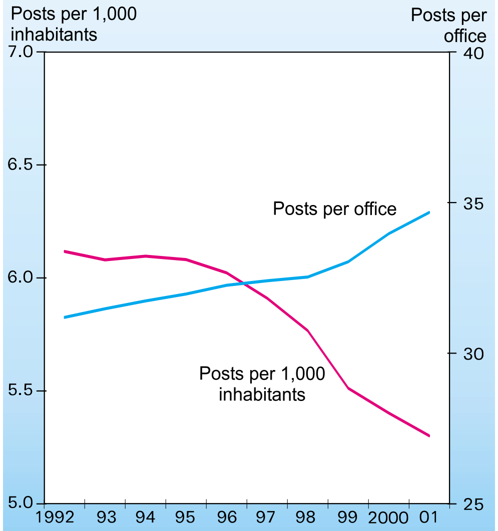
SOURCE: Returns to Supervisor of Banks.

Third-party payments by methods other than visits to bank branches were a well developed practice in Israel relative to many other countries even before the Bank of Israel allowed such payments to be made over the Internet. Presumably due to the availability of these payment alternatives (such as standing orders and debit-of-account authorization), the use of the Internet for transactions will presumably develop more slowly in Israel than elsewhere.

The data show that the contribution of the Internet to the expansion of banking services is occurring mainly in information services and their availability, which are being assured at lower cost to banks and customers. Since convenience of use and lowering of costs are interests that banks and customers have in common, untapped potential for the expansion of Internet banking services probably remains.

The effects of technology on the manner and extent of performance of banking transactions, and the degrees of technology assimilation among customers, are also reflected in the composition and level of debits to checking accounts. The decline in the share of non-automatic debits (by checks and at the counter) in total debits continued in 2001. The trend was prominent in checks, the share of which in total debits fell from 40 percent at the beginning of the 1990s to 24.6 percent in 2001. A similar decrease occurred in debits at the counter,

Figure 6.6
Employee Posts in the Banking System,[a] 1992–2001



[a] Posts per office and posts per 1,000 inhabitants.
SOURCE: Returns to Supervisor of Banks.

their proportion falling to only 3.2 percent of total debits to checking accounts in 2001 as against 5.5 percent in 1991. The decrease in non-automatic banking transactions (checks and counter services) translates into a gentle increase in transactions that entail minor manual intervention by customers and banks, and this occurred in 2001 as well (Table 6.7 and Figure 6.5).

Sale of controlling interest and change of ownership

In early 2001, equity held by the State of Israel and the banks in Otzar Hashilton Hamekomi was sold to Dexia, Ltd., a European banking corporation, and to Ruimi. Due to this transaction and a parallel one with other shareholders, Dexia's stake came to 67 percent of the right to appoint directors, 60.4 percent of voting rights, and 45.1 percent of entitlement to dividends.

The acquisition of Carmel Bank by Union Bank was completed in October 2001. The Bank of Israel required the purchasers to transform Carmel Bank into an auxiliary banking corporation and the activity of the bank was merged with that of Union Bank. Consequently, the branches of Carmel Bank were closed and most of its employees were dismissed. The acquisition increased Union Bank's long-term activity in housing loans, which today account for 7 percent of total assets.

At the beginning of the year, the Finance Ministry adopted the recommendations of the Gal Committee[12] concerning the sale of controlling equity in Bank Leumi le-Israel. The committee recommended the sale of the state's remaining holdings in Bank Leumi in one of three ways: (1) Sale of the controlling equity to a foreign strategic investor; (2) Sale on the capital market in two phases—first, all shares of the bank apart from the controlling quantity would be sold on the capital market; if a controlling group with a permit from the Governor of the Bank of Israel were to be formed the controlling quantity would be sold to the group, otherwise other ways of effecting the sale of this quantity of shares would be examined; (3) Sale of control to a dispersed group of investors consisting of many shareholders (15–20) who would regulate their participation in the controlling equity by contract.

In an attempt to implement the first alternative, M.I. Holdings, Ltd., contracted with the Merrill Lynch investment bank as a consultant in the sale. The sale to a strategic investor did not succeed, mainly in view of the security and political situation. Late in the year, the Minister of Finance and the Governor of the Bank of Israel decided to sell the state's holdings in Bank Leumi share equity by means of the capital market, and a joint committee with representatives of the Finance Ministry, M.I. Holdings, and the Bank of Israel was established to work out details concerning the legal and other arrangements needed to carry out this decision. As of December 31, 2001, the state held

[12] A joint Finance Ministry-Bank of Israel professional committee, chaired by Shimon Gal, to explore alternative ways of selling controlling equity in Bank Leumi. The committee presented its recommendations on November 26, 2000.

41.7 percent of share equity in Bank Leumi and 57.1 percent of share equity in Israel Discount Bank (Table 6.8).

Table 6.8
Holdings of the State, Principals, and the Public in Equity of 'Arrangement' Banks, December 1998[a] and December 2001 vs. 1992

	1992	1998		2001				
					Principals[b]		General public	
Bank	Government	Government	Public	Government	Domestic investors	Foreign investors	Domestic & foreign investors	Total
Mizrahi	97.0	6.7	40.6		58.8		41.2	100
Discount	87.0	60.0	26.8	57.1	12.6		30.4	100
Leumi	95.0	54.1	45.9	41.7	24.5		33.8	100
Hapoalim	99.9	24.3	30.5		32.4	12.9	54.8	100
First Intl.	58.0	19.5	4.2		84.7		15.3[c]	100

[a] For principals' holding in 1998, see Israel's Banking System, 1998, Table 5.4.
[b] Who are not principals as defined by the Tel Aviv Stock Exchange.
[c] Thereof, 11.3% is held by Bank Leumi. It is agreed that Bank Leumi will not be a principal.
SOURCE: Tel Aviv Stock Exchange, and published annual reports.

3. ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT

The main functions of the Banking Supervision Department are to maintain the stability and soundness of the banking system and to ensure fairness in bank-customer relations. This involves making sure that banking corporations are properly managed so that they may meet their obligations to depositors.

The day-to-day work of the Banking Supervision Department consists mainly of examining and monitoring banks with regard to changes in the extent and mix of their activities, their skill in risk management, and their ability to adjust to macroeconomic and other developments. The monitoring function includes gathering, analyzing, and drawing conclusions from various kinds of banking information. The information gathered includes: (1) Measurable quantitative data such as revenues, expenditures, interest rates, fees, credit, and margins; and (2) Qualitative information, e.g., about management quality, data protection, adherence to procedures, completeness of information provided to bank customers, etc. Some information is gathered in regular computerized reports and some is obtained in discussions between Department staff and banks' managements and employees. In the course of the Department's inspections, valuable banking data and qualitative information are gathered. (3) Complaints from the public to the Banking Supervision Department are an important source of information on deficiencies in an individual banking institution or, since they sometimes reflect problems that many customers of several banking corporations encounter, in the system at large. (4) The

Banking Supervision Department also keeps abreast of new international approaches to banking supervision, banking research around the world, and the practical conclusions to be drawn from them all.

A review of the Department's activities in 2001 follows.

Regulating 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 directives in various banking and accounting matters. The directives in this matter are meant to regulate the activities of banks' 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, is translated into directives and rules of conduct for banks and are issued as *Proper Conduct of Banking Business Regulations, Guidelines for Preparing Reports to the Public and Guidelines for Preparing Returns to the Supervisor of Banks.*

The main regulatory directives issued in 2001 pertained to boards of directors, opening of branches, reporting of credit risks in high-tech activity, the issue of housing loans, checkbooks, appointment of compliance officers, 'closed system' practices, etc. These directives are listed in the Appendix to this chapter.

The main piece of secondary legislation published in January 2001 was the Prohibition of Money Laundering Order[13] (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporation), 5761–2001—an important prerequisite for the implementation of the Prohibition of Money Laundering Law, 5760-2000. The main purpose of the Order is to prevent use of the banking system as a tool for money laundering.

Evaluation

The Institutional Evaluation Unit is made up of seven teams, five of which are responsible for evaluating the banking groups. The other two evaluate the small independent banks; one of them combines evaluation and examination and the other deals with evaluation and licensing.

The units monitor each banking corporation and prepare current periodic assessment reports of the corporations' financial situation, management, and risks (including subsidiaries and branches abroad), as well as special assessments of selected specific topics. The analysis of banking corporations' condition is based on information gathered from many sources, mainly the banks' published statements and reports to the Bank of Israel, examiners' reports prepared by the Banking Supervision Department, information obtained in the course of discussions with senior executives of the banking corporations,

[13] For an expanded discussion, see Box 6.1 in *Israel's Banking System, Annual Survey 2000.*

irregularities indicated by complaints from the public, and even information culled from the press and the electronic media.

In addition to their monitoring and evaluation duties, the economists of the Institutional Evaluation Unit deal with various requests from banks (to open overseas offices, extend activities to new fields, issue capital notes, etc.). In 2001, the unit focused on the following, among other things:

- Analysis of banking corporations' credit positions—credit in foreign currency, to nonresidential industries, and to large borrowers, loan-loss provisions in respect of these kinds of credit, and the Special Provision.
- Approving the issue of capital notes by banks and monitoring the trend in capital ratios, especially in banks that are close to the minimum. Additionally, a framework for the issue of Tier 2 capital—a new type of capital in Israel—was created on the basis of the principles of the Basle Committee on Banking Supervision.
- Regulation of banks' holdings in overseas corporations and issue of permits for the formation of such corporations and increases in their equity. This topic was given special emphasis in view of the perceptible uptrend in such activity this year. The unit also strengthened its relations with supervisory authorities abroad and broadened its exchanges of information with them.
- The banks' compliance with the requirements of the Department in regard to transactions with interested parties, particularly in regard to credit.
- Monitoring the activities of branches of foreign banks that recently began to operate in Israel and establishing a supervisory framework for them.
- Continued assimilation of market-risk management by the banks and implementation of the Department's directives in relation to it.

Inspection

The Inspection Unit is composed of 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 the capital market; and information systems. The sixth team inspects all these areas at the independent banks and performs evaluations. To do their work, the inspection teams gather information directly from the banks' documents and books of account. The examination process is meant to assure the proper conduct of banking business, including, but not limited to, adherence to the Department's directives in this matter and the provisions of relevant laws. The units' reports warn of deficiencies found and set targets and deadlines for their correction. The activities of the Inspection Unit are set forth in periodic work 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 inputs 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 banks and their fields of activity, by means of audits coupled with the use of data-monitoring tools.

In the field of credit, emphasis was placed in 2001 on assessing the extent to which the classification of problematic debts and loan-loss provision was appropriate. The inspection activity focused on areas that were believed to have become riskier: construction and real estate, hotels, communications, and leveraged buyouts. Other credit transactions that showed signs of heightened risk were found were examined as well.

With regard to management, monitoring, and internal audit, emphasis this year focused on separating day-to-day management functions, for which the executive echelon is responsible, from supervision and monitoring of the activities of the executive echelon, for which the board of directors is responsible. Additionally, identification procedures and restrictions on transactions with interested parties were implemented more stringently.

In the field of risk management, the examination of market risk management systems continued. Considerable resources were invested in inspecting the management of positions resulting from activities of banks and their customers in money and capital markets. Banking corporations' procedures for supervision and control of offices abroad were also examined.

In respect of bank-customer relations and the capital market, the inspection of the activity of banks and bank-controlled corporations in order to prevent conflicts of interest, and also with regard to investment advice, continued. Special inspections were performed in response to incidents and complaints from customers in the credit-card market. The adequacy of activities in the management of floating-interest loans was examined, as was compliance with amendments to the directives of the Supervisor of Banks in this regard. Finally, early-payback fees, interest calculations, proper disclosure, activities by means of checks, and aspects of investment portfolio managers' operations under the auspices of commercial banks were examined.

In electronic data processing and information systems, the main emphasis was placed on systems that provide on-line banking services, including those implemented by means of the Internet and cellular telephones. Processes related to management and control of computer systems were also inspected, focusing on security.

International relations

In the wake of globalization, the expansion of Israeli banks' international activities, and the growing interest of foreign investors in the Israeli banking system, the Department established a special unit for international relations. In accordance with recommendations of the Basle Committee, the unit was also tasked with cooperation and information transfer among supervisory authorities around the world.

The main focus of the International Relations Unit incorporates:

- Gathering information about the regulatory policies of supervisory authorities and international agencies abroad from various sources and transferring it to the relevant units of the Department.

- Pro-active monitoring of matters of importance to the Banking Supervision Department and assisting in the licensing process where 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 contact with supervisory authorities and international agencies abroad to create an infrastructure of information channels—in order, among other things, to exchange information as required under the core principles of the Basle Committee.

In 2001, the International Relations Unit dealt with a variety of matters related to the goals described above, mainly:

- Visiting supervisory authorities in the UK and the US in order to study the possibility of privatizing banks in the capital market without a controlling interest.
- Gathering information, providing assistance, and studying various topics for the Department's day-to-day work, e.g., capital instruments to ensure adherence to the minimum capital ratio, compliance officers, operating risks, and credit derivatives.
- Handling issues related to the activities of Israeli branches abroad, in conjunction with supervisory authorities abroad.
- Corresponding with other countries' supervisory authorities for the purpose of harmonizing supervision.
- Helping to implement the findings of the International Monetary Fund delegation's examination.
- Transferring information about the Israeli banking system to various foreign agencies, including international institutions and rating services.

Research

The research unit serves the Banking Supervision Department as a task force for the examination and analysis of the effects of macroeconomic and other factors on the performance of the banking system and the risks it faces, i.e., its financial stability. The unit monitors developments in banking around the world and keeps abreast of new approaches toward subjects such as assets and liabilities management, risk management, hedging assessments and methods, and capital adequacy, to name only a few.

The unit uses information culled 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 meant to advance Israel's banking system.

In 2001, the research unit published Issue 15 of the journal Banking Review (in Hebrew). The main purpose of the journal is to promote research on banking and finance from a microeconomic point of view, with emphasis on empirical studies and applied research. The most recent issue included articles on the following topics:

- The optimum structure of the banking system in Israel;

- Wages of senior officials and executives in the Israeli banking system;
- Risk-adjusted return and the optimum structure of assets in Israel's banking system;
- Assessment of market risks by means of Value at Risk (VaR)—application in Israel's banking system;
- Calculating the implicit credit margin in the prices of convertible bonds.

Several studies were written on the following topics: (1) estimating competitiveness in the Israeli banking industry, with a distinction drawn between households and business firms; (2) estimating the effect of the risk premium and 'market power' on interest spreads in Israel's banking system; (3) determining whether 'market discipline' exists in Israeli banking; and (4) the effect of floating interest on housing-loan credit.

Bank-customer relations

Israel's Banking Supervision Department, unlike banking-supervision systems in other countries, has the additional responsibility of defending the rights of banks' customers. This function is enshrined in the Banking (Service to Customer) Law, 5741-1981.

Protection of the rights of banks' customers is a substantive and important function in protecting the stability and reliability of the banking system. There is undoubtedly a long-term correspondence between a bank's solvency and profitability and the extent to which it treats its customers fairly. With this in mind, the Banking Supervision Department attaches particular importance to the banks' adherence to the legal and regulatory provisions in this field, particularly as regards transparency and proper disclosure.

The Department ensures the attainment of these goals by means of two entities: the Public Enquiries Unit and a team that monitors bank fees and standard contracts.

Public enquiries

The Public Enquiries Unit derives its powers from the Banking (Service to Customer) Law, 5741-1981, and functions as an agency of the Supervisor of Banks for the implementation of Paragraph 16 of the aforementioned statute.[14] Insofar as a customer's complaint is found to be of substance, the Supervisor of Banks may invoke the powers vested in him by the Ordinance, e.g., to rule that the bank acted improperly and to specify the deficiencies that must be corrected, including compensation for the customer.

Apart from investigating enquiries, the unit is an important source of information for the Supervisor of Banks in regard to weaknesses at individual banks and in the banking system at large. The unit also fields an incognito-inspection team.

[14] Paragraph 16 instructs the Supervisor to investigate complaints by members of the public concerning their business with banking corporations as far as they appear to him to be of some substance, and to exercise his powers under the Banking Ordinance, 1941, for this purpose.

Table 6.9
Investigation of Complaints[a] from the Public, 2000 and 2001

	2000		2001	
	Number of complaints	Percent of total complaints	Number of complaints	Percent of total complaints
Number on which decision was made				
Number found wholly or partly justified	741	17.4	770	17.6
Number found unjustified	1,370	32.2	1,535	35.2
Total	2,111	49.6	2,305	52.8
Number on which no stand was taken				
1. Treatment stopped due to legal proceedings	154	3.6	122	2.8
2. Treatment stopped for other reasons	236	5.5	218	5.0
3. Not within Unit's jurisdiction	176	4.1	182	4.2
4. Unable to take a stand	199	4.7	183	4.2
Total	765	18.0	705	16.2
Requests and clarifications				
Requests	637	15.0	651	14.9
Clarifications	747	17.5	702	16.1
Total	1,384	32.5	1,353	31.0
Total number of complaints treatment of which was concluded	4,260	100.0	4,363	100.0

[a] Out of all complaints, treatment of which was concluded during the year.
SOURCE: Banking Supervision Department.

(a) Number and Outcome of Enquiries

In 2001, the unit received 4,223 written enquiries (7 percent more than in 2000), answered approximately 10,000 telephone enquiries, and completed its handling of 4,363 enquiries (2.4 percent more than in the previous year), some of which it had received in previous years. Analysis of these data elicits the following findings:

(1) Of 2,305 complaints about which the unit made a decision (justified, partly justified, or unjustified) in 2001, 33.4 percent—770—were found justified or partly justified. Apart from these 770 complaints, the unit's handling of 682 additional complaints led to favorable results from the complainants' standpoint (response by the bank to their request, a special-dispensation refund, etc.), even though the complaints were not found even partly justified. In 134 of these 682 complaints (19.6 percent), such results were obtained even though the unit found the complaints unjustified.

Table 6.10
Distribution of Complaints Treatment of which was Concluded, 2000 and 2001 (by bank)

	Total enquiries[a,b]		Total complaints[b,c]		Justified complaints[d]		Pct. of justified complaints[d] in all complaints[c] against bank	
	2000	2001	2000	2001	2000	2001	2000	2001
Hapoalim	740	661	383	389	113	95	29.5	24.4
Leumi	729	681	392	396	158	128	40.3	32.3
Discount	375	369	190	208	68	62	35.8	29.8
First Intl.	295	269	142	171	53	50	37.3	29.2
Mizrahi	258	244	132	137	48	57	36.4	41.6
Other commercial banks[e]	728	783	461	513	162	209	35.1	40.7
Total	3,125	3,007	1,700	1,814	602	601	35.4	33.1
Tefahot	194	231	98	116	37	49	37.8	42.2
Leumi Mortgage	273	300	152	154	59	74	38.8	48.1
Mishkan	130	213	91	128	21	39	23.1	30.5
Other mortgage banks	117	138	55	62	22	7	40.0	11.3
Total	714	882	396	460	139	169	35.1	36.7
Grand total	3,839	3,889	2,096	2,274	741	770	35.4	33.9

[a] Excluding complaints in which the name of the bank is not noted.
[b] Including enquiries and/or complaints from previous years treatment of which was completed this year.
[c] Regarding which a decision (justified/partly justified/unjustified) was made.
[d] Including complaints found to be partly justified.
[e] Including credit-card companies and financial institutions.
SOURCE: Banking Supervisorion Department.

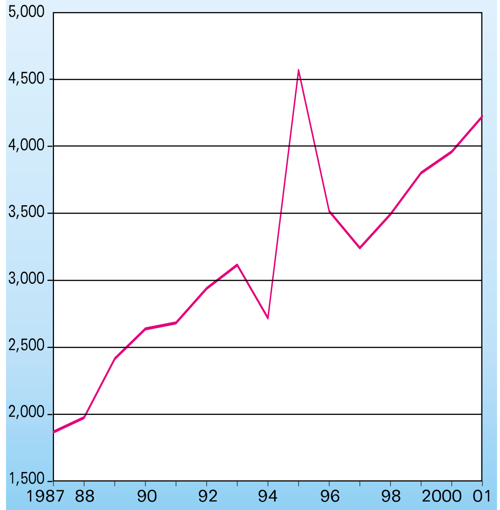
(2) The handling of 705 complaints was completed with no decision made.[15]

(3) The unit handed 182 complaints that it received in 2001 to other relevant agencies after finding that they did not fall within its purview.

(4) 1,353 enquiries, many stemming from ignorance of banking procedures and directives, were classified as enquiries for clarification or as requests.

(5) In 245 cases, the enquiries had implications for either a commercial bank or the banking system at large. In these instances, the unit asked the bank or the system to modify procedures, give employees refresher courses on working procedures, amend documents, etc. The allegations expressed in these enquiries pertained to a range of banking activities,[16] within which the unit chose to stress matters involving housing loans (Box 6.1).

Figure 6.7
Complaints from the Public Received by the Banking Supervision Department, 1992–2001



SOURCE: Returns to Supervisor of Banks.

Incognito inspections

As stated above, the Enquiries Unit has a team that visits bank branches incognito to determine whether the clerks are complying with the provisions of the law and the directives of the Banking Supervision Department in regard to bank-customer relations. The members of the team pose as potential customers, play out scenarios prepared in advance, and, if necessary, perform observations and supplementary inspections at the branch. When the inspection is over, the examiner discloses his or her identity to the branch manager, presents the manager with deficiencies discovered, if any, and asks him or her to respond to the findings. The findings are gathered in reports that are sent to the banks' managements, which are required to respond to them and take action to correct the deficiencies.

In 2001, the team performed inspections at ninety-six bank branches and issued reports about deficiencies that the banks were ordered to correct. The inspections focused on the following: mortgage banks' disclosure of information about floating interest rates, the

[15] This occurs when a complaint is withdrawn, conflicting versions are presented, legal proceedings are under way, or the topic of the complaint lies outside the unit's purview, etc.

[16] Bank accounts, debit cards, debit-of-account instructions, third-party guarantees, foreign exchange, collection of debts, bank documents, checks, long-term savings, fees, securities, housing loans, branches, bank obligations to customer, etc.

Box 6.1
Topics Related to Housing Loans Arising from Complaints from the Public

Keeping the interest rate constant throughout the process of obtaining a housing loan.

According to complaints received, there were instances in which borrowers began the process of obtaining a housing loan on the basis of an interest rate quoted to them by the bank, but by the end of the process the bank applied a higher interest rate to the loan.

In January 2001, the mortgage banks were advised that Paragraph 4(c) of the directives concerning for issue of housing loans requires them to determine a reasonable period of time—no less than ten days—during which a borrower may complete the process of obtaining the loan and present the requisite documents with no change in the interest rate. If the bank needs an additional period of time to examine the documents, the extra time should not be included in the aforementioned ten days and the interest rate should remain constant during that time as well.

Referring persons eligible for Housing Ministry loans to an inter-ministerial committee

A directive issued in May 2001, repealing a previous directive on the subject, requires mortgage banks to inform borrowers who are eligible for loans from the Ministry of Construction and Housing that they may apply to special committees (inter-ministerial and supreme) to settle their debts if they encounter economic hardship. The directive explains that banks should refer borrowers to these committees in the warning letters that they send to the borrowers before they declare them in default and begin the foreclosure process. It is also stipulated that the directive applies in cases where the foreclosure proceedings began before the directive was issued.

components of effective interest costs at bank branches making the issuance of a Leumi Card credit card conditional on opening an account, and activities of mobile bank counters.

As a rule, the Enquiries Unit need not limit itself to demanding that a bank correct a deficiency that it discovered when it investigated a specific complaint. In many cases, an individual complaint has implications for a given bank and/or the banking system at large. In other instances, the investigation points to further implications that entail regulation and legislation in bank-customer relations. Examples given below include a refusal to open a bank account and extend floating-rate housing loans, and regulation of ‘closed system’ practices.

Unreasonable refusal to open a bank account
Pursuant to many complaints from bank customers who are defined as 'formerly restricted,'[17] the Supervisor of Banks explained, in a letter sent to all banks in December 2001, that sweeping refusal by a banking corporation to open a current account in domestic currency on the grounds that the applicant was 'formerly restricted' is tantamount to an unreasonable refusal. The Supervisor called the banks' attention to their duty to provide certain services to all applicants.[18] The law does not allow them to refuse to provide such services, including the opening of an account, unless the refusal qualifies as 'reasonable.' The Supervisor of Banks also explained in his letter that refusal to open a non-checking creditory bank account merely because the customer is 'restricted' is also an unreasonable refusal, because according to the definition of an 'account' in the Checks Without Cover Law, 5741-1981, the rule against opening an account for a 'restricted' customer applies solely to a 'domestic-currency account on which checks are drawn.'

Floating-rate housing loans
In response to complaints from borrowers in 2000 about the interest rate on floating-rate housing loans—especially the rate for existing loans that was set at the time a change was made[19]—the Supervisor of Banks issued new directives to regulate the matter (see Appendix 6.1, August 1). The new directives are meant to improve the method used to set the floating rate on loans of this type, so that the banks set it not arbitrarily but on the basis of an objective external rate.

'Closed-system' practices
In early 2002, pursuant to the conclusions of an internal team appointed by the Supervisor of Banks, Proper Conduct of Banking Business Regulation 417 was issued. According to the new regulation, a customer need not open a current account at a bank with which he or she wishes to make a deposit. The customer may make such a deposit in various ways (personal check, telephone instruction, fax, debit-of-account authorization, Internet, cellular phone, or debit card), provided that at the end of the deposit term the proceeds of the deposit be returned automatically to the original current account.

Monitoring of Fees and Standard Contracts

The Department's array in matters related to bank-customer relations includes, as stated, a team that monitors bank fees, probes banks' pricing systems, and systematically examines standard contracts between banks and customers in order to cleanse them of clauses that are disadvantageous to customers.

[17] Under the Checks Without Cover Law, 5741–1981.
[18] Paragraph 2(a)(2) of the Banking Services (Service to Customer) Law, 5741-1981.
[19] The interest rate is set on the basis of various mechanisms—a book rate, a scheduled rate, an average rate, etc.

Fees

Proper Conduct of Banking Business Regulation 415—'Procedures Regarding Fees'—was amended in several respects, including the extension of its incidence to credit-card companies.

In 2001, as in previous years, the unit published an index of fees at the five largest banks. The index reflects the average cost of the most frequently used banking services in view of their weight in total bank revenues during a half-year period. The five largest banks were also compared in terms of the cost of keeping a current account.

Standard contracts

Legal proceedings continued in the Standard Contracts Court concerning a request to purge Bank Leumi's checking-account contract of clauses that are disadvantagous to customers; the unit is awaiting the court's ruling. The unit also asked the Standard Contracts Court to strike down conditions adverse to customers that were found in a housing≠loan agreement routinely used by First International Mortgage Bank Ltd. In view of the increasing use of on-line banking services, contracts in respect to obtaining information and carrying out transactions by means of these services are being examined.

Information and Financial Reporting

Information and Reporting Unit

The Information and Reporting Unit receives and examines reports from banks that the Banking Supervision Department uses to monitor the banks' activities. The unit also manages the Department's databases and transforms the data into reliable information that the Department's other units and other departments of the Bank of Israel may access and use. The reports, pertaining to various types of bank information, are submitted to the unit at different frequences—fortnightly, monthly, quarterly, annual, and other, as the directives stipulate. The unit uses the information to monitor banks' compliance with the limitations of the Banking (Licensing) Law, 5741-1981, and the Proper Conduct of Banking Business Regulations.

The unit prepares new reporting directives and updates existing ones when the Proper Conduct of Banking Business Regulations and the public reporting directives are amended or at its own initiative. Whenever the reporting directives are amended or new directives are prepared, new reporting systems and formats are developed and resources including logical and other checks are invested in the results to improve data quality. Due to the complexity of the new information systems, the unit also helps the banks to assimilate them and gives the banks feedback by providing them with aggregate data with which they may check their data against those of the system at large.

Each year the unit handles more than 1,000 requests for information from various economic entities and publishes (in print and over the Internet) the maximum and average interest rates on the 'gray' market that mortgage banks use to calculate their early-payback fee.

The unit issues several publications:[20] *Annual Information on the Banking Corporations*, containing information on the banking system in Israel over a five-year period; *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 quarterly publication (in Hebrew) that compares the banks on the basis of information culled from their financial statements.

In conjunction with the Financial Statements Unit, the unit, undertakes examinations in banks with regard to topics on which banks submit returns to the Supervisor of Banks, in order to ascertain the reliability of these returns. A similar procedure is employed to undertake ongoing checks of data on specific subjects, for purposes of verification If irregularities are found in the course of these inspections this makes it possible to improve the reporting systems and the data furnished by the banks.

Financial statements 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 (2) (in conjunction with the Information and Reporting Unit) inspecting, at both the system and the individual-bank levels, the banks' financial statements and their reports to the Banking Supervision Department

In 2001 the unit completed preparation of regulations and directives in the following aspects of reporting to the public: (1) Reporting on 'main sectors of activity'[a] (2) 'Disclosure of problematic debts in reports of the board of directors;' (3) A temporary provision regarding the 'transition of banking corporations from adjusted to nominal financial statements;' and (4) A temporary provision regarding 'particulars of charitable donations by banking corporations' (based on securities regulations on this matter).

The unit, in coordination with the Information and Reporting Unit, also distributed an audit specification and a collection of questions and answers about 'Total Credit Risk to the Public, by Industries' and quarterly reporting on the banking corporation's exposure to risks related to borrowers who engage in high-tech activity.

Activity in the following main fields of regulation is continuing: revising the format of proper disclosure in derivatives and hedging activities, in accordance with a directive that adopts the American rules in this regard (FASB 133); proper disclosure of foreign-country positions; accounting in relation to buy-back transactions and securities lending; alignment of rules concerning measurement and proper disclosure of problematic debts and loan-loss provisions with the accepted global practice, and updates to the directive concerning proper disclosure of risk, itemized by industries.

The inspections performed in 2001 focused on the following subjects: (1)Total credit risk to the public, itemized by industries (regarding which inspections at the largest banks

[20] Available (in Hebrew) on the Bank of Israel's website, www.bankisrael.gov.il, under 'Publications and Information.'

served as a basis for the systemic guidelines that were circulated on this topic); (2) Accounting in relation to securities; (3) Monthly reporting on credit given and deposit received in the course of the month (including data on average interest rates) by commercial and mortgage banks; and (4) A system-level examination of disclosure of collateral by candidates for the *Ma'of* clearing house. Finally, an examination in regard to the fair value of financial instruments and risk-adjusted capital ratios, which began in 2000, continued in 2001 and was expanded to additional banks.

Licensing

The licensing function includes the processing of requests that entail licensing by the Governor of the Bank of Israel or the Supervisor of Banks. The main areas of concern are:

- The fitness of candidates for acquisition of control or instruments of control in a banking corporation in Israel;
- Applications by banking corporations to establish banking subsidiaries in Israel or abroad;
- Preparation of branch policy and processing of applications to open branches;
- Applications from foreign banks to open offices in Israel or to include the word 'Bank' in the name of a representative office that they are establishing in Israel.

As noted above, licensing activity belongs to the duties of one of the evaluation units.

In 2001, the procedure for opening bank offices was updated, control permits were considered and issued for the new owners of Otzar Hashilton Hamekomi Bank as part of its privatization; a permit for the acquisition of Carmel Bank by Union Bank was considered and issued; and alternative ways to privatize Bank Leumi le-Israel, Ltd., were explored.

Checks without cover

This section of the Department, in conjunction with the commercial banks, operates a complex computerized system that deals with checks drawn on insufficient funds. The system is based on the provisions of the Checks Without Cover Law, 5741-1981, which was last amended in 1992. In 1994 and 1995, the authority to restrict bank customers was extended through a series of new statutes to include customers with files against them at the Execution Office (bailiffs' service), men who refuse to give their wife a divorce despite court orders to do so, and bankrupts.

At the end of 2001, there were 133,683 restricted accounts, of which 67 percent were restricted because their owners had drawn checks on insufficient funds. There were 75,795 restricted customers at year's end—most (83 percent) under ordinary circumstances and the others under aggravated circumstances. The 6.4 percent decline in the number of restricted persons this year, notwithstanding the economic slowdown, is attributable to the toughening of control by the banks, which have become stricter about enforcing credit ceilings and encouraging customers to apply self-discipline. Another explanation has to do with wider distribution and greater availability of information about restricted accounts and customers—a deterrent that helps to reduce the population of restricted customers.

The number of ‘special restriction’ customers—those who have files with the Execution Office and those who refuse to grant their spouse a divorce—increased considerably this year (by 33 percent) and came to 12,837. Most of the increase in this population is due to the worsening of the economic slowdown, which resulted in a rise in the number of persons with Execution Office files in the fourth quarter of the year.

In 2001, restrictions were imposed on approximately 4,500 customers on monthly average due to restrictions on some 6,000 checking accounts.[21]

The computerized systems dealing with restricted customers are highly sophisticated. Thus, most of the section’s workload consists of guiding the banking system in dealing with processes and handling irregularities and complaints. Some 1,600 written requests for clarifications or other action were received from the public and other entities in 2001, of which 730 were appeals lodged with the courts. This figure does not include an estimated 6,500 telephone requests for investigation and information.

The website (www.bankisrael.gov.il/black.html) and the IVR service (tel. 12123382755) that provide the public with information about restricted accounts and customers were expanded in November. Thus, today one may use them to obtain information about restricted checking accounts as well as the ID numbers of private customers and corporations that have been restricted under aggravated circumstances.[22] These services are provided at no charge, on the basis of Paragraph 14 of the Checks Without Cover Act, 5741-1981. The number of enquiries about drawers of checks without cover increased substantially in the last two months of 2001—from 350 to 1,500 on monthly average through the IVR service and from several dozen to about 2,000 at the Web site.

Table 6.11
Restricted Customers and Accounts, 1999–2001 (end of year)

	1999	2000	2001	Rate of change in 2001 (%)
Restricted accounts	138,754	135,500	133,683	–1.3
of which for checks returned	97,390	93,797	89,375	–4.7
Restricted customers	77,365	76,860	75,795	–1.4
thereof:				
Under ordinary circumstances	34,130	33,600	32,096	–4.5
Under aggravated circumstances	36,470	33,632	30,862	–8.2
Under special circumstances	6,765	9,628	12,837	33.3

[21] Some customers have several restricted accounts.

[22] 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.

Supervision of credit-card companies

Credit-card companies are auxiliary banking corporations that are supervised and inspected by the Banking Supervision Department. The process of regulating these companies' activities and proper disclosure continued during the year reviewed.

Prevention of money laundering

The Department's activities in the prevention of money laundering are performed by the Inspection and Regulation Unit in conjunction with the Legal Department of the Bank of Israel.

The Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporation), 5761-2001—published on January 25, 2001, and effective as of February 17, 2002—includes three main types of provisions:

- Identification of customers and verification of their identifying particulars;
- Reporting to relevant authorities—objective reporting (by size and type of transaction) and subjective reporting (about irregular transactions);
- Management and documentation of records.

The Banking Supervision Department regards the anti-money-laundering rules as a crucial element in sound bank management and an integral part of the management of banking risks, foremost reputation risks, operating risks, and legal risks.

To complement the Order, the Department prepared a Proper Conduct of Banking Business Regulation in regard to the prevention of money laundering, adopting the Basle Committee guidelines concerning 'Customer due diligence for banks' (October 2001). The regulation[23] was published in May 2002 and will go into effect in September 2002.

To prepare for the application of legislation in this matter, the Bank of Israel established a special team—composed of a representative of the Legal Department and representatives of the Banking Supervision Department, including a member of the Inspection Unit—to monitor the implementation of legislative provisions against money laundering on a day-to-day basis. The team coordinates the Department's cooperation with the Ministry of Justice (Prevention of Money Laundering Authority), the Israel Police, the Israel Security Agency, and the supervisory authorities of financial institutions and the Association of Banks in all legislative proceedings and in implementation of the legislation.

In 2001, the Department inspected the preparations of the five large banks to implement the legislation in respect to working procedures, training, and organizational and computer systems. It also drew up an inspection specification for the future use of the Inspection Unit.

[23] Proper Conduct of Banking Business Regulation 411, 'Prevention of Money Laundering—Customer Identification and Record-Keeping.'

APPENDIX 6.1
Activities of the Banking Supervision Department in 2001

1 January Within the framework of the Regulations for Preparing Reports to the Public:

1. The regulation concerning accounting for derivative and hedging activities was amended after the United States issued a standard that modified the provisions of the previous standard. The amendment ensures the adaptation of the new rules in this regard to banking corporations in Israel.

2. A temporary regulation was set forth allowing a banking corporation to present an annual financial statement on a consolidated basis only while the summary of the (non-consolidated) statements of the banking corporation itself is presented in a note to the financial statements. This is allowed provided that the corporation receives prior approval from the Supervisor of Banks and meets all the stipulations in the regulation. The temporary regulation allows banking corporations to reduce the format of presentation in their annual statements in certain subjects.

10 January After the Companies Law, 5759-1999, went into effect on February 1, 2000, the implications of the statute for the Proper Conduct of Banking Business Regulation concerning the board of directors of a banking corporation and several additional regulations were examined, and the respective regulations were amended as warranted.

25 January The Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporation), 5761-2001, was published. The order sets forth requirements of identification, verification of details, and compulsory presentation of documents at the time a customer opens an account and stipulates reporting requirements on the basis of transaction size as well as supplemental reporting.

31 January 1. The regulation concerning distribution of a dividend by banking corporations was amended. The amended regulation prohibits a banking corporation from declaring a dividend unless it has prepared a written forecast showing that the ratio of capital to at-risk assets, in the year following the dividend, will not fall below the compulsory minimum for said banking corporation. The amended regulation also lists cases in which a banking corporation may not declare a dividend without prior authorization from the Supervisor of Banks and only up to the maximum sum approved.

2. The procedure by which banking corporations may open branches was updated in accordance with Paragraph 28 of the Banking (Licensing)

Act, 5741-1981. The framework of the general permits under which activities within stipulated conditions may be taken to relocate a branch in Israel, open a temporary branch of a mortgage bank, issue debit cards, and provide credit at work places was expanded. A format for permits pertaining to mortgage-bank activity at bank branches (mortgage counters), the provision of certain banking services, and a permit for the opening of temporary branches was also set forth.

3. It having been found that the credit-card companies did not have a standard procedure for the correction and deletion of records in customer accounts, a binding directive was issued requiring companies to employ uniform methods in correcting records due to error on the company's part or of the sort required by Paragraph 6A (unauthorized change) and by Paragraph 9 (missing documentation of transaction) of the Debit Cards Law, 5746-1986. It was stipulated that the interest rates for corrections shall be the prime rate (in domestic currency) and the LIBOR rate (in foreign currency). Credit-card companies were also required to serve customers with detailed notice about the correction of an erroneous record.

4 February — Investec General Bank, Ltd., was renamed Investec Bank (Israel), Ltd.

16 July — In view of the growth of high-tech activity and the attendant uncertainty, banking corporations were required to report to the Banking Supervision Department regarding the total credit risk to borrowers who engage in such activity and total investment in their shares.

1 August — 1. To enable the Banking Supervision Department to rely on more up-to-date information, the frequency of reporting about credit to the public and deposits from the public during the month was increased from monthly to two-weekly reporting.

2. The regulation concerning procedures for the issue of housing loans was amended and a transitional regulation for indexed loans at floating interest was added, creating an arrangement for floating-rate loans that were issued before November 1, 2000, not on an objective outside basis. The amendment was meant to assure proper disclosure to borrowers of the method used to adjust the interest rate on the loan and to set a ceiling for current rate adjustments so that it be consistent with the principle of indexation to an outside objective base. The computation is to be performed throughout the term of floating-rate loans at each renewal date.

3. In the regulation concerning the fee for early repayment of non-housing loans, the formula to use in computing the amount of the fee was replaced. The new formula reflects the entire economic loss occasioned by early repayment of floating-rate loans by taking into consideration the loss on

future payments from the day the interest rate is changed to the end of the loan term.

22 August The regulation concerning banking corporations' boards of directors was amended. To facilitate the boards' work, quantitative tests for identification of a director who is believed to have a potential conflict of interests were introduced. In addition, the injunction against the participation of such a director in board discussions or board committees that deal directly with that industry was revoked, provided that the discussions not concern specific customers.

10 September Banking corporations were ordered to make a special loan-loss provision in addition to the existing provisions. This was because the principles for the handling of problematic debts do not include a mechanism that would create sizable reserves for the creation of specific loan-loss provisions on account of credit portfolio risk, where credit losses on account of said risk have not yet been attributed to specific borrowers.

11 September The minimum capital ratio regulation stipulates that a loan that replaces a housing loan shall be weighted at only 50 percent (instead of 100 percent), thus making it easier for borrowers to refinance by taking a new loan that charges a different type of interest or a lower interest rate, either from the same banking corporation or from a different one. This relief is given only if the amount of the new loan does not exceed that of the repaid loan (including the costs of the replacement) and the level of collateral.

25 October 1. After the Government of Israel resolved to take immediately the requisite measures to cooperate with the Government of the United States in the war on terrorism in respect to the assets of terrorists and, in particular, to help the U.S. to apply the Presidential Executive Order in this matter, banking corporations were asked to scan customer accounts and submit a report to the Banking Supervision Department about accounts related to names that were included on lists appearing in the Presidential Executive Order and about transfers of funds since 1996 by or with one or more of the parties listed.

2. The merchant banking license of Leumi Merchant Bank, Ltd., was cancelled.

1 November 1. Pursuant to the regulation concerning the special provision, the regulations on Reporting to the Public were amended. Movements in the special provision shall be shown in the notes to the financial statements separately.

2. Banking corporations were instructed to provide more information in their quarterly financial statements for the first and third quarters of the year and to equalize this information with that provided in the second quarter.

10 December The mortgage banking license of Carmel Mortgage and Investment Bank, Ltd., was cancelled.

16 December After complaints about check forging were received from drawers of checks and agencies that deal with complaints from drawers of checks, and to enhance the confidence of drawers and users of checks whose negotiability was cancelled, the regulation concerning checkbooks was amended. The amended regulation states that any check whose negotiability was cancelled and is written in the format stipulated in the regulation, insofar as it was modified in any way after it is written, apart from a change in the date or the sum, even if it is certified by a signature that appears to be the customer’s signature, may not be deposited in the account to which it was received for deposit, and if it is deposited, it shall be returned.

23 December 1. Following the approval of accounting standards in regard to segments of economic activity, and to help users of financial statements to understand better the performance of the banking corporation, to evaluate its future returns, and to apply wise discretion in regard to the corporation as a whole, reporting rules were established in accordance with the various activity segments in which the banking corporations operate. It was stipualted that in their financial statements banking corporations shall provide information about each activity segment that meets the requirements and the quantitative conditions set forth in the regulation.

2. Following the approval of Accounting Standard no. 12, which deals with the discontinuation of adjusted presentation of financial statements and states that in 2003 all financial statements shall be presented in amounts adjusted to the index of the month in which the transition takes place—plus nominal amounts that are added and less sums that are subtracted after the date of the changeover—a temporary regulation was issued concerning the changeover of banking corporations from adjusted to nominal financial reporting.

31 December 1. The preparation of a regulation dealing with compliance officers was completed. Banking corporations were required to appoint a compliance officer, prepare a compliance program, and implement the program in a stipulated way. The obligation to appoint a compliance officer is part of the general rules of banking corporation risk management. It is meant to make

violation of laws and regulations much less likely, to facilitate early discovery of violations, to reduce the vulnerability of a corporation and its executives to lawsuits (including suits for violation of the officers' prudential and fiduciary obligations), to prevent financial losses that a banking corporation may incur for these reasons, and to maintain the bank's reputation.

2. The preparation of a regulation dealing with banking corporation' 'closed-system' activities was completed. The regulation states that customers may deposit funds with a banking corporation even if they do not conduct regular activity with it, without entering the branch, and without opening a current account. At the end of the deposit term, the proceeds shall be transferred back to the current account from which the deposit sum had been withdrawn. The regulation also determines rules for the investment of the deposit funds and for contacting the customer in the event that the deposit proceeds cannot be returned to the bank from which the deposit sum had been transferred.

The Banking Supervision Department:Organizational Structure