

## *Chapter 2*

# *The Banking Supervision Department's Activity In 2005*

### 1. INTRODUCTION

The principal function of the Banking Supervision Department is to maintain the stability and robustness of the banking system and the system's ability to adhere to its liabilities to depositors in a changing economic environment. Concurrently, the Banking Supervision Department ensures that fairness is maintained in bank-customer relations while endeavoring to increase competitiveness and to impose suitable standards for the management and control of banking activity. For this purpose, the Banking Supervision Department operates in a number of areas. The main areas are: regulatory coverage by means of directives and guidelines; inspection (audit) activity; and current monitoring of the banks' business activity, including the proper management of the banks and their ability to manage risks and adapt to developments in the economy. The Banking Supervision Department also concerns itself with the relationships between the banking corporation and its customers, clarifies the matter of enquiries from the public and complaints by the public against the banks, and examines the banks' standard contracts and their charges for banking operations. The following is a brief review of the activities of the Banking Supervision Department's different units in 2005.<sup>1</sup>

### 2. REGULATORY COVERAGE OF BANKING ACTIVITY

The regulatory coverage of banking activity plays a key role in the Banking Supervision Department's activity in briefing the banking institutions regarding the Supervisor's positions and directives on various banking and accounting matters. The regulatory

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<sup>1</sup> For details of the functions of the different units in the Banking Supervision Department, see Bank of Israel, Supervisor of Banks, Israel's Banking System, 2003, Chapter 5 – Activity of the Banking Supervision Department.

directives are intended to cover the activity of the bank's board of directors and its management, to improve the internal and external reporting systems, to strengthen the system of internal controls, and to ensure that the corporations are managed properly and in a cautious manner. The regulatory directives are collated in the files on "Proper Banking Management Directives", "Directives on Reporting to the Public", and "Directives on Reporting to the Banking Supervision Department".

The main regulatory directives issued in 2005 were on the subjects of: management of credit lines in demand deposits, transfer of activity and closure of a customer's account, credit card activity, prevention of money laundering and financing of terrorism, and identification of customers and the adoption of the requirements stipulated in the Sarbanes-Oxley Law. In addition, directives were applied concerning service to the customer in respect of the timing of the crediting and debiting of checks as well as service to the customer in respect of interest calculation methods, and the bank business day was extended by two hours.

### 3. INSTITUTIONAL EVALUATION AND LICENSING

The principal function of the Institutional Evaluation Unit is to collate and compile the Banking Supervision Department's periodic assessments on the extent of the banking corporations' stability and robustness (including in this respect auxiliary corporations, banking subsidiaries and overseas offices).

The five units responsible for assessing the banking groups and the banking corporations operated in accordance with an annual work program, which was concerned *inter alia* with the following matters:

- Current monitoring and periodic evaluation of the banking institutions in Israel;
- The banking corporations' exposure to credit: credit in foreign currency and credit by principal sectors of the economy – for example, to the construction industry and to the local authorities – and credit to large borrowers;
- The banking corporations' exposure to liquidity risks in local currency and in foreign currency;
- Supervision of the credit card companies, including examination of the market for settling credit card transactions;
- Enforcement of the Supervisor of Banks' directives in different areas, such as the procedure for the initiation of contacts by directors and the issue of complex Tier 1 capital.
- Examination of the implications for the banking system of the implementation of the Bachar Committee's recommendations;
- Regulatory coverage of the banks' marketing of insurance policies as an accompaniment to the extension of housing loans and the roll-over of housing loans.

The sixth institutional evaluation unit is the Licensing Unit, which processes applications for permits from the Governor of the Bank of Israel or from the Supervisor of Banks with respect to matters such as the examination of candidates for the control or for the holding of the means of control in banking corporations, the establishment of subsidiaries, branch network policy and the activity of foreign banks in Israel. During the year reviewed, this unit engaged in the following matters:

- Completion of the privatization of Israel Discount Bank and as part of this process, an examination at the end of which a permit for purchasing the bank was granted to the Bronfman-Schron Group;
- Coordination and planning of the sale of the State's holdings in Bank Leumi and involvement in the completion of the first stage of the sale process;
- Approval of the competence of office-holders in the banking system;
- The opening of branches of foreign banks in Israel;
- Processing various issues arising from the Amendment to the Banking Law (Licensing) (Amendment 13);
- Revocation of the licenses of the Kupa Haoved Haleumi Leashrai Vehisachon in Netanya ("National Worker's Fund for Credit and Savings in Netanya"), Poalim Capital Markets Investment Bank, Agriculture Bank and Euro Trade Bank banking corporations.

#### 4. INSPECTION

The Credit Risk Inspection Unit conducted audit operations at different corporations during 2005 for the purpose of examining the overall propriety of their credit risk management. In most of these audits, an emphasis was placed on the propriety of the processes for identifying and classifying problem loans and for determining loan-loss provisions in respect of problem loans. From the sector-specific aspect, an emphasis was placed in 2005 on the real estate industry, in view of its position and the amount of credit attributed to it. A particular examination was made of the topicality and propriety of the assessment of repayment ability and the collateral provided against credit in that industry. Together with its current audits, the unit completed the preparations for operating comprehensive auditing channels for examining management processes, and the control and monitoring of credit at different banks. This auditing mechanism will focus on the efficiency and integrity of these processes and the assessment of the quality of credit risk management entities at the portfolio level, including the processing of concentration risk. This auditing activity will integrate into the overall preparations made by the banks and the Banking Supervision Department for advanced risk management in line with the implementation of Basel II.

In the area of information technology, an emphasis was placed in the audit on information systems notable for material operational risks as well as financial risks. Examples in this respect are credit management systems and systems for the management

of dealing room activity. As in the past, audit efforts were directed at e-banking, using various tools for reducing the concrete risks typical of this area of activity. System-wide audit activities were continued in the area of IT systems' back-up, and disaster survival and recovery capabilities. The audit responded as in the past to certain exceptional events in the area of information security and where necessary, expanded the audit procedures for the general system processing of specific risk centers. Audit activity was extended for the process of assisting in familiarization with Proper Banking Management Directive No. 357, and professional support was increased with respect to the processes relating to the provision of permits and the regulatory coverage of activities and services which the banks offer to their customers, and the processes related to familiarization with Basel Committee guidelines concerning the management of operational risks.

The Management, Supervision and Control Systems Inspection Unit ("Manof"), which was established at the end of 2004, engaged in user-familiarization with advanced internal control frameworks and the implementation of advanced and lucid approaches for risk-focused auditing in the banking corporations' internal auditing operations. Comprehensive audits were conducted of information infrastructures and the quality of the risk assessments forming the basis for internal auditing work programs. A model was developed for characterizing and rating a banking corporation's internal auditing environment, and audits were conducted on the basis of this model. Audit results are also used for examining overall supervisory strategy in the different areas of internal control, and a comprehensive policy document on the subject of internal auditing will be completed during 2006. In the audits covering the entire banking system, an emphasis was placed on preparations for preventing embezzlement and fraud in accordance with the principles determined by the Supervisor of Banks and international regulations applying to the processing of this sensitive area.

The unit also compiled draft guidelines on the subject of "An internal control framework at banking corporations". These guidelines provide defined standards for assessing the control system at a banking corporation, and form the basis for implementing the Sarbanes-Oxley directives and for implementing the principles deriving from the future work environment under the Basel II regime.

The Risk Management Inspection Unit focused its activity in 2005 on examining and assessing the quality of the management of the risks deriving from the banks' activity in the centralized and OTC capital markets. An emphasis was placed on control horizons for activities giving rise to market risks.

In the course of this activity and in order to ascertain the adequacy of models and their validity, an examination was made of the assumptions, documentation and methodology of different models used for estimating market risks. Also examined were the functioning of the various entities involved in the management and control of risks, the proprietary of the banks' risk management procedures and the infrastructures in this area.

Emphasis was also placed in inspection activity on the management of market (indexation, interest-rate) risks and operational risks, as well as the risks typical of

dealing room activity and especially the market risks involved in activity in financial instruments.

The unit assisted in promoting the regulatory coverage of the banking system's activity in the Maof market. Remedial measures were necessary in this area in view of past audit findings and changes which the stock exchange made in the rules concerning the provision of collateral.

In addition, the unit completed the formulation of a detailed and methodical infrastructure for the audit of liquidity risks.

The banking system was subjected to further audit coverage in 2005 in the area of money laundering prevention. Alongside the enforcement of legislative stipulations, an emphasis was placed on examining the preparations which the banking corporations were required to make in accordance with Proper Banking Management Directive No. 411.

In the area of the banks' service to the customer, audits of the enforcement of specific regulatory directives were conducted in the mortgage sector, and audits of the management of customer accounts were continued.

## 5. THE RESEARCH UNIT

The Research Unit monitors banking developments in Israel and abroad, and obtains information on new approaches to the analysis and assessment of such matters as asset and liability management, risk management, operational efficiency, approaches to immunization against various banking risks, and methods of estimating capital adequacy in accordance with the Basel II Committee's new requirements on these matters.

Banking Issues 17, which the Research Unit published in 2005, contained four articles: "Hosen – An index for examining the resilience and robustness of banks in Israel", "The market value compared with book value of the banks' shares in Israel", "The expected distribution of the shekel-dollar exchange rate – implied asymmetrical distribution in foreign-currency options", and "Optimism and business cycles – the credit channel in the Israeli economy 1997-2004". The first two articles were written by the unit's economists, and the others by economists from other departments at and outside of the Bank of Israel.

Apart from these articles, the unit published a discussion paper on "Competitiveness in the banking industry: theoretical aspects and empirical evidence from Israel and abroad"- a study examining the extent of competition in the Israeli banking system compared with the banking system in a peer group of countries abroad.

The unit also published the Banking Supervision Department's Annual Survey for 2004, in Hebrew and English.

## 6. INTERNATIONAL RELATIONS

The Banking Supervision Department's main activities in the area of international relations during 2005 were:

- Meetings with representatives of international rating companies (Fitch, Standard & Poor's, Moody's), including the transfer of information.
- Meetings with representatives of foreign banks which engage in correspondent activity with Israeli banks.
- Meetings with representatives of other international entities (such as investment houses, institutional investors and financial consultants) on the subject of the banking industry in Israel and the regulatory environment.
- Meetings with representatives of the BIS and central banks on the subject of the Israeli banking industry and the regulatory environment (principally the completion of questionnaires and the transfer of information).
- Development of relations with countries bordering the Mediterranean and European countries within the framework of the "Barcelona process" (Euro-Mediterranean market).
- An examination of banking related agreements in preparation for the ENP Wider Europe project.
- The implication of Israel's joining the OECD from the aspect of banking supervision.

## 7. BANK-CUSTOMER RELATIONS

One of the main functions of the Banking Supervision Department – and an important factor in maintaining the stability and credibility of the banking system - is to protect the rights of the banks' customers. For this purpose, the Supervisor of Banks operates in accordance with the Banking Law (Service to the Customer) of 1981. Under the provisions of this law, the Banking Supervision Department identifies deficiencies in the banks' functioning in the area of bank-customer relations and stipulates methods for remedying these deficiencies. This activity is centered in the Public Enquiries Unit and in the Standard Contracts and Fees unit, which cover the area of bank-customer relations.

### **a. The Public Enquiries Unit**

The processing of 5,501 enquiries was completed in 2005 compared with 5,467 enquiries in 2004 (Figure 2.1). Part of those enquiries were received in that year and part of them were received in previous years.

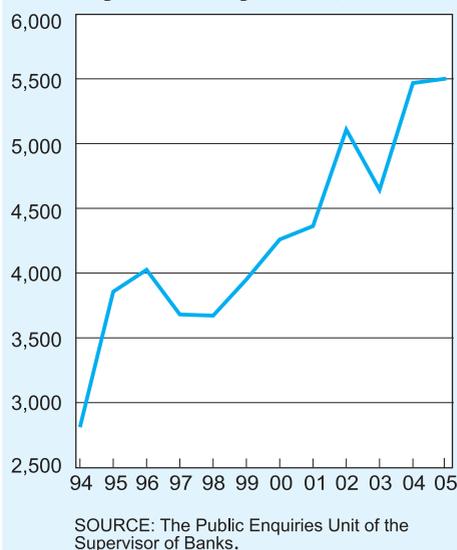
Of the 2,646 enquiries comprising complaints regarding which a position was taken, 709 (26.8 percent) were found to be justified or partly justified. 1,638 enquiries were requests for information and questions for clarification (Table 2.1). When a complaint

is found to be justified or partly justified, this is usually of practical benefit for the complainant, such as repayment of money, compensation and/or a positive response to the complainant's request. The amounts paid by the banks to their customers in 2005 as a result of the processing of specific complaints totaled NIS 2,023,475.

Table 2.2 details the distribution by banks of complaints regarding which a position was taken and the processing of which was completed in 2005.

The main subjects of complaint are mortgages, management of a bank account, checks and bank charges. The Public Enquiries Unit's activity is not restricted to requiring the bank to remedy the deficiency mentioned in a specific complaint. The processing of a single complaint may have overall implications for the banking corporation or the entire banking system.

**Figure 2.1**  
**Complaints and Enquiries from the Public Received by the Banking Supervision Department, 1994-2005**



**Table 2.1**  
**Investigation of Complaints and Enquiries from the Public, 2004 and 2005**

	2005		2004	
	Number	Percent of total	Number	Percent of total
<b>Complaints on which decision was made</b>				
1. Complaints found wholly or partly justified	709	12.9	788	14.4
2. Complaints found unjustified	1,937	35.2	2,192	40.1
<b>Total</b>	<b>2,646</b>	<b>48.1</b>	<b>2,980</b>	<b>54.5</b>
<b>Complaints on which no stand was taken</b>				
1. Treatment stopped due to legal proceedings	219	4	200	3.7
2. Treatment stopped for other reasons	445	8.1	448	8.2
3. Not within Unit's jurisdiction	266	4.8	280	5.1
4. Unable to take a stand	287	5.2	248	4.5
<b>Total</b>	<b>1,217</b>	<b>22.1</b>	<b>1,176</b>	<b>21.5</b>
<b>Enquiries</b>				
1. Requests	546	9.9	460	8.4
2. Clarifications	1,092	19.9	851	15.6
<b>Total</b>	<b>1,638</b>	<b>29.8</b>	<b>1,311</b>	<b>24</b>

SOURCE: Supervisor of the Banks.

**Table 2.2**  
**Distribution<sup>a</sup> of Resolved Complaints during 2005, Commercial Banks**

	Total enquiries <sup>b</sup> (from all years) which were resolved in 2005	Total complaints (from all years) that were resolved in 2005	Justified complaints <sup>c</sup>	Proportion of justified complaints <sup>c</sup> in total complaints <sup>a</sup> against the bank
Hapoalim	1257	700	212	30.3%
Leumi	769	429	69	16.1%
Discount	507	259	75	29.0%
First International	276	142	36	25.4%
Mizrahi-Tefahot <sup>d</sup>	586	270	75	27.8%
Mortgage banks <sup>e</sup>	545	274	84	30.7%
Other commercial banks <sup>f</sup>	1,446	572	158	27.6%
Total of the banking system	5,501	2646	709	26.8%

<sup>a</sup> That were classified (justified/partially justified/unjustified).

<sup>b</sup> Excluding enquiries in which the name of the bank was not specified.

<sup>c</sup> Including complaints which were found to be partially justified.

<sup>d</sup> Including complaints against Bank Tefahot.

<sup>e</sup> Excluding complaints on matters against mortgage banks that were merged (Mishkan, Tefahot).

<sup>f</sup> Including credit card companies and financial institutions.

SOURCE: The Unit for Public Enquiries of the Supervisor of the Banks.

Examples in this respect are the repayment of money to groups of customers and the adjustment of procedures. Table 2.3 details general and specific matters which emerged from the public's enquiries and from additional information that was received in the Banking Supervision Department, and as a result of the processing of which money was repaid to large groups of customers (most of whom were not even aware of the problem and who had not complained about it). The overall amount of repayments to groups of customers totaled NIS 20,000,000 in 2005 (Tables 2.3 and 2.4).

**Table 2.3**  
**Total Monetary Refunds to Groups of Customers by Subject, 2005**

	Total refund (NIS)	Bank
Rounding of LIBOR to an eighth of a percent without disclosure to clients	9,000,000	First International
Leumiphone commission	4,618,768	Arab Israel
Charging of limited responsibility fees on expired Young ATM cards	2,146,000	Hapoalim
Charging of membership fees and limited responsibility fees after card has been frozen	2,048,365	Leumi Card
Indexation of grant at the time of calculating the adjusted mortgage balance for early repayment	876,638	Union
Liability tracking fee	719,200	Mizrahi-Tefahot
1. Charging an average index fee at time of early repayment on loans subsidized by the Ministry of Finance	315,263	Leumi Mortgage
2. Non-return of credits of up to NIS 25 to clients		
3. Misintepretation of section 11 in Banking Directive (fees for early repayment)		
4. Charging fee (loan amendment following reallocation due to divorce) before updating fee tariff.		
5. Charging agreement fee on additional pledge (beyond the amount under price supervision)		
<b>Total</b>	<b>19,724,234</b>	

SOURCE: Public Enquiries Unit of the Banking Supervision Department.

**Table 2.4**  
**Distribution of Complaints against the Five Major Banking Groups<sup>a</sup> by Subject, and Description of Banks by Size, 2005 (percent)**

Bank	Complaints <sup>b</sup>	Justified complaints <sup>c</sup>	Total assets <sup>d</sup>	Number of branches	Deposits of the public <sup>d</sup>
Hapoalim	38.6	45.3	35.3	34.3	34.7
Leumi	23.7	14.8	32.5	26.7	32.9
Discount	14.2	15.9	14.2	16.7	14.2
First International	8.3	7.7	9.1	10.7	9.3
Mizrahi-Tefahot	15.2	16.3	8.9	11.6	8.9
Total	100.0	100.0	100.0	100.0	100.0

<sup>a</sup> Excluding subsidiaries.

<sup>b</sup> That were classified (justified, partly justified or unjustified).

<sup>c</sup> Including complaints which were found to be partially justified.

<sup>d</sup> At December 2004 prices.

SOURCE: Public Enquiries Unit of the Banking Supervision Department.

## **b. Bank charges**

Activity in the area of bank charges during the year reviewed focused on the charges known as “the package deal” – an arrangement which led to an appreciable reduction in the cost of managing a current account, especially for customers with a medium or low level of activity in their accounts. The “package deal” as agreed by the Knesset Finance Committee and whose final version was compiled by the Supervisor of Banks, went into effect on December 1, 2005, and applies to individual customers. Under this arrangement, various bank charge tracks were offered and the line fee (a fee for each single banking operation) was abolished. Also abolished were fixed account management fees and these were replaced by minimum account management fees for customers who did not conduct a specific quota of transactions. The package deal also includes a considerable reduction in various charges which, in the Banking Supervision Department’s opinion, could hinder the transfer of an account to another bank. The Supervisor of Banks’ directive concerning the transfer of activity and the closure of a customer’s account, intended to increase the competition in the banking system, went into effect concurrently.

## **c. Standard contracts**

On June 10, 2004, the Standard Contracts Court issued a ruling on a petition to revoke discriminatory terms in the contract for managing a demand deposit at Bank Leumi. In its ruling, the court accepted most of the arguments presented by the Attorney-General and the Bank of Israel, and ordered that the numerous discriminatory clauses in that contract be revoked. Since an appeal against the ruling was submitted, the matter is pending at the Supreme Court, and court processes in respect of the appeal were submitted at the beginning of 2005. The Supervisor of Banks recently ordered all the banking corporations to amend their demand deposit contracts as stipulated in the court ruling in all those clauses in respect of which none of the parties had submitted an appeal.

On February 2, 2006, the Standard Contracts Court issued a ruling on the petition to revoke discriminatory terms in Bank Hapoalim’s contract for the provision of banking services by means of the Internet and mobile telephone. During recent years, banking service by Internet and mobile telephone has become commonplace throughout the world, including in Israel. Many customers use the service and it has long since become a basic service. In its ruling, the court accepted most of the Bank of Israel’s arguments concerning the discrimination inherent in clauses of the contract, and ordered the discriminatory clauses to be revoked or changed.

An additional two petitions to revoke or change discriminatory terms in a standard contract have been filed, with respect to the First International Mortgage Bank’s housing loan contract and Bank Tefahot’s bank guarantee under the Law of Sale (Apartments) (Assurance of the Investments of Apartment-Buyers) of 1974.

## 8. INFORMATION AND FINANCIAL REPORTING

### a. Information and Reporting Unit

Every year the Information and Reporting Unit receives about 4.1 million items of information from the 121 entities supervised by the Supervisor of Banks; these come in the form of 481 different reporting tables and are converted into accessible and reliable data available to the Supervisor, employees in the various units of the Banking Supervision Department, other employees in the Bank of Israel, and the general public. With the aid of the data the unit monitors the banks' adherence to the various quantitative restrictions imposed by the Banking (Licensing) Law and the provisions of the Proper Conduct of Banking Business Regulations; in addition, the unit prepares new regulations for reporting to the Supervisor of Banks, updates existing regulations in order to improve the data available to the supervisory authority, and uses these data to scrutinize the activity and stability of the banks.

The information is submitted to the Bank of Israel via a state-of-the-art automated system incorporating logical checks which enable the banks to verify the data before they are dispatched. These information systems are updated on an ongoing basis. To date, the data which have accumulated in the databases of the Banking Supervision Department account for over 19.5 million items of information in the statistical systems, and another 28.8 million items in the individual systems deriving from changes in the directives, updates, adjustments of the data, and computer upgrades. The unit dispatches aggregate data to the banks as feedback, and the banks use these as a managerial tool as well as for comparative purposes.

Each year the unit handles over 2,000 requests for information from various economic entities. The unit publishes (both in hard copy and on the internet) the maximum interest rate on the 'gray market,' the average interest rate for calculating the mortgage banks' early repayment fee, and the following publications:

(i) Annual Information on the Banking Corporations, a booklet<sup>2</sup> containing information about Israel's banking system covering a five-year period; (ii) Current Information on the Banking Corporations, a loose-leaf binder containing up-to-date information received during the year about Israel's banking system; (iii) Main Data on the Activity of Each Bank, a quarterly publication comparing the banks on the basis of the information culled from their financial statements to the public.

In cooperation with the Financial Statements Unit, the unit checks the banks in order to verify reports and examine the reliability of the data received by the Banking Supervision Department. Identifying faults in the examination and internal checking process enables the reporting systems and the data submitted by the banks to be improved.

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<sup>2</sup> This information is also available on the Bank of Israel's website, [www.bankisrael.gov.il](http://www.bankisrael.gov.il), under 'Publications and Information.'

The unit's employees participate in cross-sectional analyses, including examining the suitability of investors and assessing preparations for compliance with the provisions of Basle II.

## **b. Financial Statements Unit**

The unit deals with two main subjects:

### *1. Regulation*

The guidelines for preparing reports to the public, which define rules for preparing the banking corporations' reports to the public (both annual and quarterly; the annual report comprises the report of the board of directors, the management's review, a statement regarding disclosure, the report of the board of directors and the management on their responsibility for the annual report, and the banking corporation's financial statement), as well as topics associated with the work of the banking corporation's internal auditor.

### *2. Conducting audits, at the level of the entire system and of the individual banking corporation, on the following subjects:*

- a. Financial reporting to the public by the banking corporation;
- b. Banking corporations' reports to the Supervisor of Banks (in cooperation with the Information and Reporting Unit).

In addition, and as a complement to the above spheres, the unit deals with ongoing topics which concern financial reporting by the banking corporations (responding to banks' requests, handling problems which arise, issuing instructions to specific banks as well as to the system as a whole, etc.).

In 2005 the unit completed the regulation process and formulated guidelines for preparing reports to the public on the following subjects:

- a. Accountancy handling of pending claims, in accordance with US Accountancy Standard no. 5.
- b. Disclosure procedures in accordance with section 302 of the Sarbanes-Oxley Act regarding the effectiveness of monitoring, the procedures for disclosure in reports, and changes in the internal auditing of financial statements.
- c. Updating the accountancy handling of derivatives and hedging activities, in accordance with US Accountancy Standard no. 149.
- d. Adopting the rules set out in the updates to the Securities Regulations and the following guidelines published by the Securities Authority:
  - (i) Description of the corporation's business and information regarding the future;
  - (ii) Minimum disclosure regarding assessments of their value and rules regarding their incorporation;

- (iii) Reporting on directors with financial and accounting skills;
- (iv) Disclosure concerning the internal auditor.

In 2005 the unit published a series of questions and answers clarifying the way the guidelines for preparing reports to the public should be implemented with regard to the following subjects:

- (i) Loan-loss provision against housing credit;
- (ii) Disclosure on activity segments.

In 2005 the unit formulated a directive stating that the banking corporations should implement section 404 of the Sarbanes-Oxley Act; thus, starting with the financial statement for 31.12.2008, the banking corporations' statements should include a declaration regarding the management's responsibility for and assessment of the internal auditing of the financial statement, as well as the accountant's opinion of the management's assessment.

Concurrently, the treatment of the following main regulatory topics connected with the banking corporations' financial statements continued: accountancy handling of transactions involving the transfer of financial assets, including buy-back transactions, loans of securities and securitization; bringing the rules regarding the measurement and disclosure of problem debts and loan-loss provision into line with US practice; adapting disclosure to the regulations of stratum 3 of Basle II and International Financial Statement Standard no. 7 (FRS 7); accountancy handling of structured notes; disclosure of exposure to foreign countries; establishing disclosure regarding sensitivity to interest-rate changes on fair value (in the framework of the consultancy procedure with Professor Galai).

The audits conducted in the course of 2005 focused on the following subjects:

- (i) Proper disclosure in the annual report to the public;
- (ii) The risk-based capital ratio;
- (iii) Proper disclosure of activity segments;
- (iv) The detailed report of the internal auditor;
- (v) Dealing with occasional accountancy issues—outsourcing of automated systems and guarantees for provident fund members.

## 9. CHECKS WITHOUT COVER

At the end of 2005 there were 176.770 restricted accounts, an increase of 0.7 percent over 2004, and the number of restricted customers was 99,760, a 1.2 percent increase. Note, however, that the number of restricted customers and customers restricted under aggravated circumstances was lower in 2005 than in 2004 (Table 2.5); the rise in the number of restricted accounts and customers was due to special restrictions (by both the Execution Office and the Rabbinical Court), rather than to an increase in the number of checks without cover which, as stated, fell slightly.

The number of customers restricted under special circumstances—persons with files in the Execution Office and men who have refused their wife a divorce—went up by 12.5

**Table 2.5**

**Restricted Customers and Accounts, 2003–05**

	2003	2004	2005	Percent change on 2004
Restricted accounts	168,722	175,540	176,770	0.7
<i>of which</i> For checks returned	105,434	105,050	102,682	-2.3
Restricted customers	97,481	98,605	99,760	1.2
Under ordinary circumstances <sup>a</sup>	40,848	36,411	35,071	-3.7
Under aggravated circumstances <sup>b</sup>	32,198	32,448	31,230	-3.8
Under special circumstances <sup>c</sup>	24,435	29,746	33,459	12.5

<sup>a</sup> A restricted customer under ordinary circumstances is a customer with one restricted account; such customers may operate other accounts, but may not open new accounts.

<sup>b</sup> A restricted customer under aggravated circumstances is a customer with two accounts restricted in the same year or who has an account restricted for the second time within three years; such customers may not draw checks on any account.

<sup>c</sup> A restricted customer under aggravated circumstances is a customer who has had all accounts restricted by the head of the Bailiff's Office or by the Rabbinical Courts (for a period of up to 5 years).

SOURCE: Reports to the Supervisor of Banks.

percent in 2005 compared with 2004, and amounted to 33,459; the increase stemmed primarily from the greater number of persons with files in the Execution Office.

The increase in the number of enquiries addressed to the Bank of Israel via the internet continued in 2005, and amounted to 144,000—a 14.3 percent rise over 2004. There was also an increase in the number of enquiries via the Telemesser answerphone service, and these amounted to 27,600—up by 10 percent over 2004; this trend is consistent with the Supervisor of Banks' policy of making information available to the public by automated means (Table 2.6).

**Table 2.6**

**Public Enquiries and Complaints Regarding Checks without Cover, 2004-05  
(End of year figures)**

	2004	2005	Percentage change in 2005
In writing	1,283	1399	9
Appeals to courts	794	805	1.4
Via answerphone	25,000	27,600	10
By phone to the Unit	6,000	7,000	16.7
To Bank of Israel web site	126,000	144,000	14.3

SOURCE: Reports to the Supervisor of Banks.

## 10. PROHIBITION OF MONEY LAUNDERING: LEGISLATION AND REGULATION (2005)

### **a. Legislation and Regulation**

During 2005 the Banking Supervision Department, in cooperation with the Legal Department, worked to amend the Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporations), 5761-2001 (henceforth, the order). The purpose of this was to incorporate within the order the obligations to which banking corporations are required to adhere under the Prohibition of the Financing of Terrorism Law, 5765-2005, as well as to include in it the legal obligations which arise from the Prohibition of Money Laundering Law, 5760-2000 regarding credit card companies which are auxiliary corporations.

### **b. Examinations, and Sanctions Committee**

In the course of 2005 the series of examinations undertaken with the object of ensuring that the legislative restrictions regarding the prohibition of money laundering were implemented continued. This was done for both the banks and for the trust companies controlled by them, and their readiness to implement those sections of regulation no. 411 of the Proper Conduct of Banking Business Regulations concerning recognition of customers and identification of irregular transactions was examined.

As well as taking steps to amend lacunae discovered in the course of the examination, cases where grave infringements were discovered were brought before the Sanctions Committee for Banking Corporations Regarding the Prohibition on Money Laundering.

In 2005 the Sanctions Committee decided in cases concerning three trust companies. The committee found that the trust companies had breached certain provisions of the Prohibition of Money Laundering Law. In one instance the committee was content to send a warning in writing, and did not impose a financial penalty. With regard to the other two trust companies, fines of NIS 500,000 and NIS 350,000 were imposed because of deficiencies in their preparedness to deal with the subject.

The main deficiencies concerned processes of identifying and verifying identity when customers opened an account, including obtaining a statement from the beneficiary and the account holder, and keeping identification documents. Deficiencies were also found in the processes of transferring reports to the Authority for the Prohibition of Money Laundering, reports regarding the extent of the transaction, and reports on irregularities in activities.

## **Appendix 1**

### **Activities of the Banking Supervision Department in 2005**

#### **30 January**

Since debit cards are an important means of payment in Israel, and resort to them is growing, a Proper Conduct of Banking Business regulation was formulated in order to regulate the activity of banking corporations and credit card companies with regard to operating a debit card system (credit cards), as follows:

1. Rules for issuing, delivering, renewing, and canceling credit cards were formulated, together with a method for handling continuing transactions after a card has been cancelled;
2. The particulars of the data given within the framework of the monthly statement;
3. Proper disclosure requirements were imposed on the way points and/or stars are accumulated, and the issuer is forbidden to extend credit on points and/or stars.
4. Clear-cut and more transparent rules were determined for customers in conversion transactions settled between foreign currency and NIS.

The regulation went into effect on 30.9.2005.

#### **1 February**

In the wake of international legislation linking the war against financing terrorism with the ban on money laundering, the Proper Conduct of Banking Business regulation regarding the prevention of money laundering and financing of terror, and the identification of customers was amended. The main changes are as follows:

1. The board of directors of a banking corporation must determine a policy as regards the prohibition on money laundering and financing terror which will also address the need to monitor threats to launder money and finance terror deriving, inter alia, from new technologies, particularly those which enable transactions to be performed anonymously, e.g., via the internet or a mobile phone, while taking steps to preclude such threats.

2. Banking corporations must determine procedures for dealing with the risk inherent in depositing checks in the context of the prohibition on money laundering and financing terror, while addressing, inter alia, checks made out to someone else, the depositing of a large number of checks which are not consistent with the activity in the customer's account, and checks drawn on banks outside Israel.

3. A list of high-risk countries and territories, to and from which the transfer of money requires heightened supervision, was drawn up.

The amendments to the regulation went into effect on 1 July 2005.

#### **8 February**

In the context of deviations from the credit framework in current accounts, a Proper Conduct of Banking Business regulation was drawn up with the object of minimizing the uncertainty caused to both customers and banking corporations as a result of this.

The regulation states that banks must determine a credit framework for each customer which is appropriate for his or her requirements, repayment ability, and collateral; this must be done on the basis of a documented analysis, so that the framework may be accepted by an approved credit authority within the bank. The framework agreement shall clarify the obligation of both parties—the customer and the bank—to act solely within the approved framework, without departing from it.

The bank will be entitled to make an additional narrow credit framework available to the customer, provided the customer is apprised of this. No fee will be charged for a narrow framework of this kind, and the interest rates on it shall not exceed those determined for the last credit framework accepted by the customer in writing and signed by him.

The regulation regarding the management of credit frameworks in current accounts was due to go into effect on 1.1.2006, but in order to enable the banking corporations to reassess the situation at the initial stage of the regulation's assimilation the implementation of some of its clauses was postponed to 1.7.2006.

## **20 February**

A joint policy statement was issued by the Commissioner of Insurance and the Supervisor of Banks regarding the sale by a banking corporation of life and property insurance associated with housing loans. In accordance with this policy, a bank is not permitted to sell insurance itself or in its branches, but only via an insurance agency owned by it. For the purpose of selling insurance a bank may set up unmanned desks in its branches which are connected with the insurance agency by technological means, thereby enabling customers to undertake an insurance transaction directly with an insurance agent who is not physically present in the branch. The insurance shall be sold by accredited agents who have received appropriate training in the insurance sphere, and will provide the protection and proper disclosure required with regard to insured persons.

## **28 February**

According to amendment no. 13 of the Banking (Licensing) Law, 5741-1981 and of the Banking Order of 1941, an individual may not serve as an office-holder in a banking corporation unless the Supervisor of Banks has been informed of this at least sixty days before the individual assumes the office and the Supervisor has not announced his opposition to the appointment within this period. The position of the Supervisor of Banks must take into account the suitability of the candidate for the proposed office, including his or her business experience, integrity, and connections, of whatever kind, with the banking corporation or with an office-holder within it. The Proper Conduct of Banking Business regulation concerning the board of directors was subsequently amended, and a questionnaire for the candidate for an office in a banking corporation was added to it.

### **3 March**

In the wake of the publication of guidelines by the Securities Authority intended to ensure the reliability of the financial reporting of public companies—particularly in view of the crisis of confidence which affected the world’s leading capital markets—the regulations regarding reports to the public were amended as follows:

1. The regulation concerning minimal disclosure of value assessments determines rules for adding and revealing value assessments used for preparing financial statements, and the minimal data required to be included in the value assessment attached to financial statements.

2. The regulation regarding reporting on directors with accounting and financial skills details the criteria for examining such skills, and also determines disclosure provisions regarding the number of directors with such skills who serve on the board of directors.

### **30 March**

The license of Israel Agriculture Bank Ltd. was revoked.

The license of National Credit and Savings Bank, Netanya, Cooperative Association Ltd. was revoked.

### **12 April**

The license of Israel Mortgage Tefahot Bank Ltd. was revoked.

### **6 July**

The license of Eurotrade Bank Ltd. was revoked.

### **14 July**

In order to simplify and facilitate the procedures enabling customers to close their account in a bank or to transfer their activity to another bank, the Proper Conduct of Banking Business regulation regarding the transfer of activity and closure of an account by a customer was amended. According to the amendments, if a customer wishes to receive information in order to examine the possibility or worthwhileness of transferring his or her activity to another bank and closing the account, the bank is obliged to supply him with detailed and comprehensive information in writing about all his assets and commitments in the bank, as well as any other data required in order to make a decision about closing the account and implementing the decision (the payments to which the account is committed, standing orders, credits, etc.). The regulation relates to transactions within the bank account and to debit cards issued by the bank on that account. The regulation also determines the infrastructure enabling the bank to which the customer moves to undertake all the activities involved in transferring his or her activity.

Although this regulation went into effect on 1.12.2005, additional time will be needed to complete the automated preparations with regard to some of the changes.

## **24 August**

The Banking Regulations (Service to Customers)(Date of Credit and Debit of Checks) and the Banking Regulations (Service to Customers; Methods of Calculating Interest) were amended, as follows:

1. Following the closure of many bank branches on Fridays, and fears that this day would cease to be considered a banking business day, the definition of a banking business day was changed, and the new definition went into effect on the day the amendment was published.

2. The end of the banking business day was extended from 15.00 hours to 18.30 hours. The addition of hours of activity was intended to enable immediate final clearance in the RTGS system, which is programmed to function even when it is late. The longer business day will also enable coordination between the banking business day and the hours of activity of the banking corporations, thereby easing activities in additional spheres, such as those vis-à-vis the stock exchange. The extension of the business day went into effect on 21 February 2006.

## **5 December**

The following requirements arising from the Sarbanes-Oxley Act were incorporated in the guidelines for preparing reports for the public:

1. Disclosure measures in accordance with section 302 of the law regarding the efficiency of audits, procedures regarding disclosure in reports, and changes in the internal auditing of financial statements were specified.

2. Directives were issued which were intended to implement section 404 of the law regarding the management's responsibility for the internal auditing of the financial statement and the opinion of the internal auditor regarding the audit of the financial statement. These requirements will apply as of the banking corporations' financial statements of 31.12.2008.

## **18 December**

Until recently it was possible to withdraw cash on an ongoing basis only from the banking system, and the charges for this service were under supervision. Of late, other elements outside the banking system have begun to offer cash-withdrawal services, and the price of the service they provide is not under supervision. In order to enable the banking system to compete with the nonbanking entities offering cash-withdrawal services to the public, a Proper Conduct of Banking Business regulation was issued regarding the withdrawal of cash from automated cash points. Under the regulation, a bank which has ten or more branches and 10,000 or more current accounts shall enable its customers to withdraw cash by means of an ATM by placing an ATM on the outside wall of each of its branches, or at a distance not greater than five hundred meters from it.

# Banking Supervision Department

## Organizational Structure

