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Israel: Selected Issues

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ISRAEL

Selected Issues

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Approved by European Department

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I. Fiscal Institutions and The Political Economy in Israel[1]

A. Introduction

1. **Israel's fiscal performance improved considerably following the stabilization program of 1985, but the public debt remains a concern**. Fiscal deficits have been persistent and sizable over the last two decades and the public debt is high by international standards. Moreover, successive attempts to contain deficits and bind fiscal outcomes on a multiyear basis have met with limited success.

2. **The main institutional mechanism to control fiscal outcomes, the Deficit Reduction Law (DRL), lacks credibility and stability**. Its credibility has suffered because fiscal targets set under the DRL have been missed repeatedly. Initial targets have been missed in 9 out of 14 years since the enactment of the law in 1991.[2] The stability of the DRL has been disrupted by repeated amendments, including as of late. But it has also been buttressed by the adoption of an expenditure growth ceiling, although this has already been modified several times.

3. **These developments suggest that Israel is struggling to achieve time-consistent fiscal policies**. Accordingly, this paper addresses two questions. First, is there evidence for political-economy distortions to Israel's fiscal policy? Second, what institutional changes could help in limiting these distortions? The 1992 reform of electoral laws and ongoing debates suggest that the reform of the political infrastructure continues to pre-occupy policymakers.[3] *However, reform of the political system is not what this paper is about and the results should thus not be interpreted as advocating changes to the political infrastructure. In fact, all political systems—presidential or parliamentarian—have struggled with political economy biases to fiscal policy and all have implemented some fiscal governance mechanisms to counter these biases. These mechanisms are a key topic of this paper.*

4. The paper is organized as follows: Section B presents some data on Israel's political system and an empirical analysis of the relation between fiscal policy and the political infrastructure; Section C presents some options for reducing political economy distortions through reforms in the budget process and institutions; and Section D concludes.

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[1] Prepared by Mario Catalán.

[2] The DRL was enacted in 1991. The DRL's initial targets were missed in 1994−96, 1999, 2001−05. However, in 1994, 2004, and 2005 the initial targets were revised and actual deficits were below the revised targets.

[3] The reform allowed the direct election of the prime minister, and the May 1996 elections were conducted under the new system. However, the new system was abolished in 2001, and in the 2003 and 2006 elections the Prime Minister was nominated by the Knesset. Empirical analysis of the fiscal implications of the electoral reform is not yet available.

B. Data and Empirical Analysis

5. **The design and implementation of economic policies depends on the incentives of policymakers, and even well-intended governments may end up pursuing unsound policies**. Optimal fiscal policy is frequently viewed through the prism of intertemporal tax smoothing, with the net present value of spending equal to the net present value of revenues. With this in mind, the budget is maintained in structural balance, but deficits can arise from the free play of automatic stabilizers. However, the literature shows that a plethora of inter-related factors—fragmented governments, a high number of spending ministers acting independently, proportional electoral systems, electoral uncertainty, and short-government duration—can all act to generate sub-optimal, time-inconsistent fiscal policy.[4] These can be traced to two fundamental problems:

- First, according to the standard *common pool model*, politicians who represent different groups and vested interests have few incentives to constrain their spending demands given that the costs are shared by the population as a whole. This externality can also explain deficit biases and delayed stabilization.

- Second, politicians may have a *shorter-term view* than the general public, especially if they are concerned with securing re-election. Relevant evidence for Israel on political business cycles is in Ben-Porath (1975) and Klein (2004).[5] Voters may also fail to fully understand the intertemporal budget constraint, particularly long-term costs related to changes in entitlement programs.

6. **In some ways, Israel's political environment is prone to cause deficit and spending biases, consistent with the high public debt**. Data covering the 17 legislatures and 31 governments over 1949−2006 suggest (Figures 1−4):

- Governments are fragmented—the number of parties in government coalitions is highly variable, and so is the leading party's share of ministers, which fluctuates between 0.4−0.7.

- The number of spending ministries is high and has increased over time.

- Government duration is typically short, averaging 22 months, and highly variable.

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[4] See, for example, Roubini and Sachs, 1989; Grilli, Masciandaro, and Tabellini, 1991; Alesina and Perotti, 1995ab; Alesina, Roubini, and Cohen, 1999; Kontopoulos and Perotti, 1999; Annett, 2002; Milesi-Ferretti, Perotti, and Rostagno, 2002.

[5] Brender (1999) also finds evidence of pre-electoral manipulation by local governments in the 1998 campaign, but he argues that it hurt rather than helped the incumbents thanks to reforms that enhanced transparency and accountability.

- Government coalitions typically increase their representation shares in the Knesset by gaining the support of (smaller) parties, rather than through gains in share of large parties.

7. **A key feature of the political setting is the high degree of fractionalization**. One index of fractionalization—the probability that two Knesset members chosen at random belong to different parties[6]—actually increases sharply since the 1990s (Figure 5). Another index—the probability that two ministers chosen at random belong to different parties in the coalition—exhibits no clear trend (Figure 6).

8. **More generally, the degree of proportionality in Israel's parliamentary system may give rise to deficit and spending biases, if international evidence is of any guidance**.[7] Grilli and others (1991), for example, note that government debt and primary deficits tend to be much larger in representational and highly proportional democracies than in majoritarian ones. Israel's democracy is representational, as the Knesset has 120 representatives for a single electoral district. It is an outlier among industrial democracies in terms of its degree of proportionality: only the Netherlands has a more proportional system than Israel (Table 1).

9. **Econometric evidence corroborates the presence of political economy distortions to fiscal policy**. A number of parsimoniously-specified regressions relate the fiscal balance over the period 1950−2005 to measures of the economic cycle (GDP growth; output gap); dummies for special events (conflicts) with significant effects on the fiscal balance; time trends and lagged dependent variables; and a variety of political economy variables (Tables 2−3).[8] The results suggest that automatic stabilizers have not been allowed to have a significant, countercyclical effect. Moreover, the number of spending ministries, the degree of fractionalization in the Knesset, and, to a lesser extent, the number of parties in the coalition, are significant determinants of Israel's fiscal performance: their effects go in the

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[6] The index is given by $1-\sum_{i=1}^{N} T_i^2$, where T_i is the i th party's decimal share of the vote in the Knesset and N is the number of parties. This definition is based on Rae (1967).

[7] Bingham Powell (1982), and Grilli and others (1991), identify the degree of proportionality of a parliamentary democracy with the number of representatives per electoral district, and define systems with less than five representatives per district as majoritarian, and those with five or more as representational.

[8] Notice that there can be feedback from the budget balance variable to some of the political variables. This may explain why the effects associated with cabinet fractionalization, the government's majority margin in the Knesset, the Prime Minister's duration, and the leading party's share in the coalition, while having the right sign, are not significant. In principle, eliminating this feedback with instruments should strengthen the conclusions. A more complex approach would be to estimate a system of equations that jointly explain political developments and fiscal policy.

direction that is consistent with theoretical and empirical evidence in the literature on political economy biases to fiscal policy.

C. Reform to Reduce Political Economy Biases to Fiscal Policy

10. This section discusses two approaches to countering political economy biases to fiscal policy by strengthening fiscal governance: (i) transparency in budget preparation; and (ii) better fiscal institutions.

Budget transparency and analysis

11. **A 2003 fiscal IMF ROSC made suggestions for improvements in budget preparation, a number of which have not been implemented**. Specifically, the ROSC recommended that the budget contain a medium-run fiscal scenario based on unchanged policies, including a revised projection for the year in course; a listing of all the policy changes and their fiscal impact; and a systematic analysis of the impact of shocks and forecast errors on the budget. In addition, the ROSC advocated that the small, remaining extra budgetary funds be consolidated, international accounting and reporting standards adopted (notably a broader definition of the public sector), and the expenditure classification system be brought up to date.

Table 1. Political Fractionalization in Israel and Industrial Economies

	Democracy 1/	Representatives per District 2/	Fractionalization 3/			
			1960-64	1965-76	1980-90	Avg. 1960-90
Australia	Pa-M	1	0.63	0.61	0.59	0.61
Austria	Pa-R	6	0.54	0.54	0.59	0.56
Belgium	Pa-R	7	0.63	0.76	0.86	0.78
Canada	Pa-M	1	0.62	0.63	0.52	0.59
Denmark	Pa-R	10	0.72	0.79	0.81	0.79
France	Pr	1	0.69	0.71	0.68	0.69
Germany	Pa-M	2	0.58	0.57	0.66	0.61
Greece	Pa-R	6	0.59	0.68	0.55	0.61
Ireland	Pa-M	4	0.62	0.61	0.64	0.62
Italy	Pa-R	19	0.73	0.73	0.75	0.74
Japan	Pa-M	4	0.54	0.60	0.63	0.60
Netherlands	Pa-R	150	0.77	0.84	0.73	0.78
New Zealand	Pa-M	1	0.51	0.49	0.49	0.49
Portugal 4/	Pr	14	na	0.68	0.66	0.67
Spain 4/	Pa-R	7	na	0.76	0.62	0.69
Switzerland	Pa-M	na	0.79	0.81	0.82	0.81
UK	Pa-M	1	0.50	0.48	0.53	0.50
US	Pr	1	0.44	0.61	0.48	0.53
Israel 5/	**Pa-R**	**120**	**0.81**	**0.74**	**0.73**	**0.75**

Source: reproduced from Grilli and others (1991), and augmented by the author with Israel.
1/ Pr = Presidential democracy, Pa-M = Majoritarian Parliamentary Democracy, Pa-R = Representational Parliamentary Democracy.
2/ Number of legislators in the popular house of the legislature, divided by the number of electoral districts.
3/ Probability that two legislators chosen at random belong to different parties.
4/ The fractionalization index 1965-76 corresponds to years 1975 and 1976 only (dictatorship prior to then).
5/ Fractionalization indices are matched to periods as follows: 1960-64 (5th Knesset), 1965-76 (average of 6th to 8th Knessets), 1980-90 (average of 10th to 12th Knessets).

Table 2. Regression Analysis

Explanatory variables	Regressions: dependent variable is budget balance (percent of GDP) 1/										
	1	2	3	4	5	6	7	8	9	10	11
Constant	11.789	12.036	11.512	2.795	1.154	1.356	7.310	-0.749	-1.428	-1.043	-1.363
	(3.31)*	(3.99)*	(3.35)*	(2.53)**	(1.29)	(0.77)	(2.49)**	(-2.28)**	(-2.79)*	(-1.56)	(-0.84)
Trend	0.005	0.005									
	(0.34)	(0.38)									
Budget balance (-1) (percent of GDP) 2/	0.126	0.123	0.123	0.264	0.235	0.308	0.227	0.355	0.321	0.362	0.345
	(0.30)	(1.10)	(1.07)	(2.27)**	(1.86)***	(2.35)**	(1.68)***	(2.54)**	(2.09)**	(2.52)**	(2.74)*
GDP growth (percent)	0.050	0.050	0.046	0.038	0.030	0.065	0.071	0.062	0.063	0.065	0.062
	(1.52)	(1.52)	(1.48)	(1.20)	(0.99)	(1.70)***	(1.95)***	(1.60)	(1.74)***	(1.72)***	(1.69)***
War dummy 3/	-0.194	-0.017	-0.214	0.053	0.217	0.217	-0.026	0.191	0.026	0.127	0.174
	(-0.33)	(-0.28)	(-0.33)	(0.06)	(0.28)	(0.29)	(-0.04)	(0.22)	(0.03)	(0.14)	(0.21)
Political Variables:											
Number of Ministries	-0.218	-0.219	-0.198	-0.179							
	(-2.62)**	(-2.61)**	(-3.37)*	(-2.87)*							
Number of parties in coalition					-0.312						
					(-2.08)**						
Cabinet fractionalization						-3.401					
						(-1.14)					
Knesset fractionalization	-11.003	-11.225	-10.954				-10.467				
	(-2.68)**	(-3.23)*	(-2.70)*				(-2.77)*				
Government's majority margin in Knesset								-0.108			
								(-0.04)			
Prime Minister Duration (months)									0.011		
									(1.20)		
Government duration (months)	0.003		0.003							0.009	
	(0.19)		(0.23)							(0.55)	
Leading party share in coalition											1.129
											(0.43)
R-squared	0.359	0.358	0.358	0.260	0.274	0.218	0.278	0.191	0.211	0.195	0.196
Durbin-Watson	2.067	2.063	2.062	2.060	2.000	2.090	2.099	2.121	2.116	2.138	2.114

1/ All regressions cover the sample period 1951-2005. The t-statistic values are reported in parentheses, and are based on the Newey-West covariance estimator.
The symbols (*), (**), and (***) indicate significance at the 1, 5, and 10 percent levels.
2/ The budget balance includes net credit, and corresponds to "grand total" numbers reported in the Statistical Abstract of Israel (several issues).
3/ The dummy variable is 1 in the years 1956, 1967, 1973, and 1982, and 0 in other years.

Table 3. Regression Analysis

Explanatory variables	Regressions: dependent variable is budget balance (percent of GDP) 1/										
	1	2	3	4	5	6	7	8	9	10	11
Constant	12.741	13.000	11.619	3.467	1.807	3.097	10.043	0.512	-0.012	0.196	-0.036
	(3.30)*	(3.88)*	(3.14)*	(2.10)**	(2.44)**	(1.73)***	(3.73)*	(0.98)	(-0.01)	(0.41)	(-0.02)
Trend	-0.012	-0.011	-0.009	-0.014	-0.021	-0.039	-0.038	-0.041	-0.036	-0.045	-0.040
	(-0.71)	(-0.68)	(-0.60)	(0.59)	(-1.30)	(-2.62)**	(-3.33)*	(-2.46)**	(-1.80)***	(-2.42)**	(-2.53)**
Budget balance (-1) (percent of GDP) 2/			0.097								
			(0.83)								
GDP gap (log GDP - HP log GDP)	8.862	8.661	7.818	9.650	4.425	8.268	9.006	10.466	10.927	10.993	9.421
	(1.19)	(1.20)	(0.97)	(1.32)	(0.70)	(1.11)	(1.16)	(1.36)	(1.38)	(1.33)	(1.24)
War dummy 3/	-0.328	-0.301	-0.324	0.011	0.150	0.016	-0.332	-0.028	-0.141	-0.204	-0.032
	(-0.54)	(-0.47)	(-0.50)	(0.01)	(0.18)	(0.02)	(-0.45)	(-0.03)	(-0.15)	(-0.22)	(-0.04)
Political Variables:											
Number of Ministries	-0.193	-0.193	-0.187	-0.189							
	(-2.26)**	(-2.23)**	(-2.29)**	(-1.72)***							
Number of parties in coalition					-0.307						
					(-1.85)**						
Cabinet fractionalization						-3.975					
						(-1.48)					
Knesset fractionalization	-11.943	-12.170	-10.739				-12.110				
	(-2.79)*	(-3.26)*	(-2.53)**				(-3.55)*				
Government's majority margin in Knesset								1.068			
								(0.37)			
Prime Minister Duration (months)									0.009		
									(0.76)		
Government duration (months)	0.036		0.005							0.020	
	(0.23)		(0.32)							(1.15)	
Leading party share in coalition											1.207
											(0.40)
R-squared	0.347	0.346	0.353	0.209	0.250	0.220	0.318	0.185	0.193	0.199	0.187
Durbin-Watson	1.862	1.865	2.044	1.515	1.556	1.591	1.835	1.534	1.527	1.518	1.513

1/ All regressions cover the sample period 1951-2005. The t-statistic values are reported in parentheses, and are based on the Newey-West covariance estimator.
The symbols (*), (**), and (***) indicate significance at the 1, 5, and 10 percent levels.
2/ The budget balance includes net credit, and corresponds to "grand total" numbers reported in the Statistical Abstract of Israel (several issues).
3/ The dummy variable is 1 in the years 1956, 1967, 1973, and 1982, and 0 in other years.

Political Determinants of Deficit and Spending Bias—Israel

Short and variable government duration.

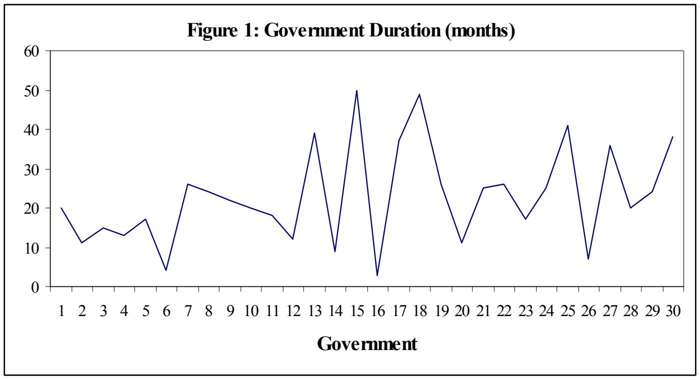

Figure 1: Government Duration (months)

High and variable government fragmentation.

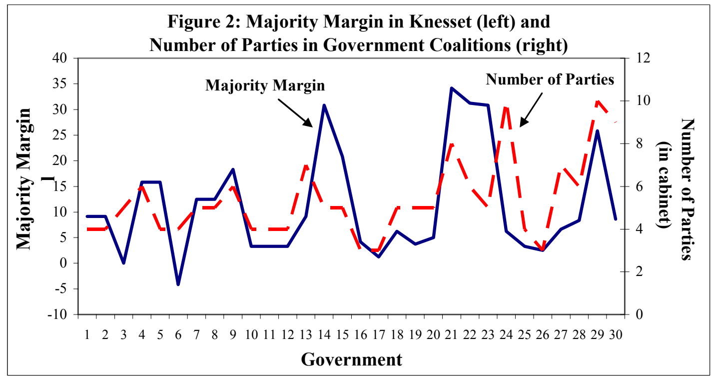

Figure 2: Majority Margin in Knesset (left) and Number of Parties in Government Coalitions (right)

High and variable government fragmentation.

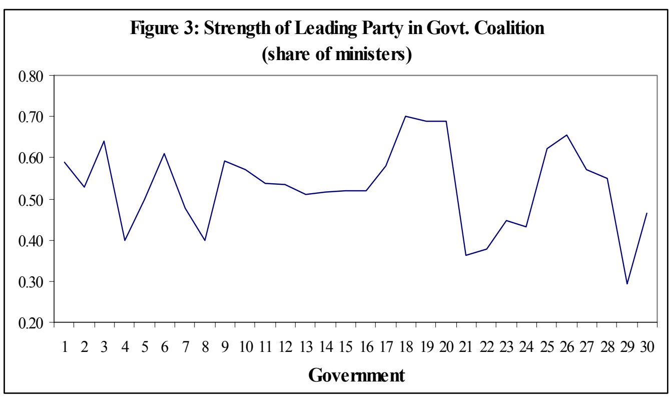

Figure 3: Strength of Leading Party in Govt. Coalition (share of ministers)

High number of spending ministries, and increasing over time.

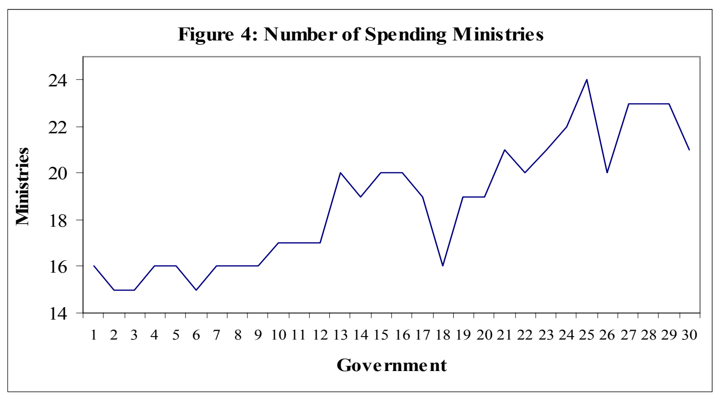

Figure 4: Number of Spending Ministries

Fractionalization in the Knesset has increased since the 1990s.

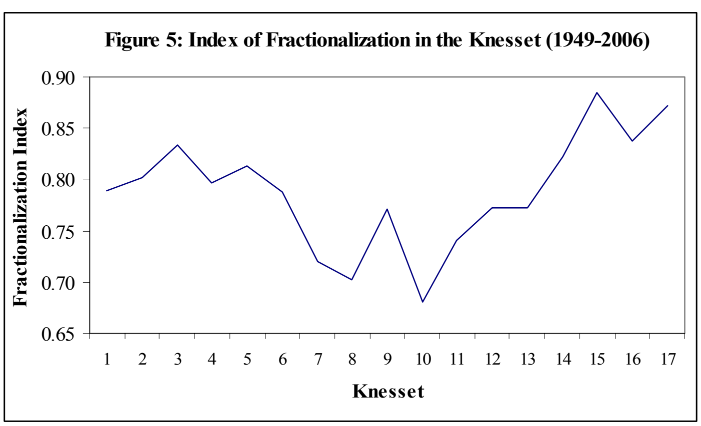

Figure 5: Index of Fractionalization in the Knesset (1949-2006)

Fractionalization in government cabinets is highly variable and exhibits no clear trend.

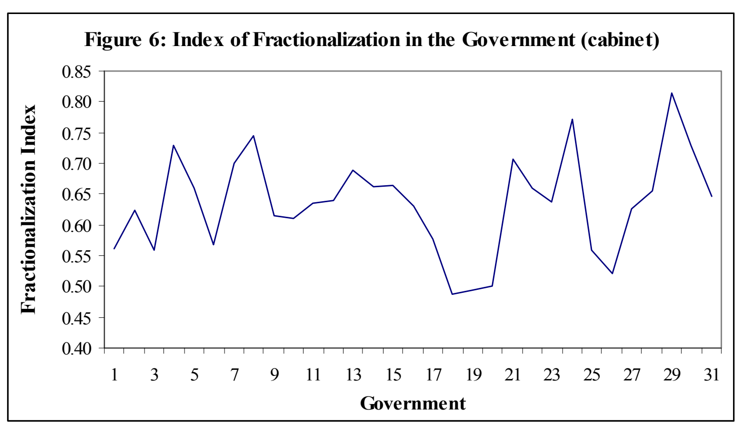

Figure 6: Index of Fractionalization in the Government (cabinet)

12. **The adoption of these proposals would bring budgetary transparency and analysis in line with best international practices and this would help in addressing the common pool problem**. An examination of budget documents in countries with highly transparent practices and advanced budget analysis—New Zealand, Australia, Canada—reveals areas for improvement in Israel that are very similar to those identified by the ROSC (Table 4).[9] Specifically, budget transparency and analysis could be enhanced by:

- Including detailed statements of long and short-term fiscal policy goals.
- Presenting a detailed breakdown of ministries' budgets and policy goals (including medium-term projections consistent with the central scenario).
- Including detailed information on transfers and other fiscal transactions between the central and local governments.
- Including detailed mid-year execution data and revised projections for the year in course, and supplementary appropriations to specific ministries or agencies.
- Listing all budgetary measures and quantifying their effects.
- Reporting the revenue and expenditure sensitivities with respect to the economic scenario underlying the central projections.
- Quantifying the macroeconomic and specific fiscal risks to the central scenario.
- Listing contingent liabilities—and, whenever possible, the corresponding contingent amounts—and provisions and charges against future budgets.
- Describing the quantitative methodologies and/or fiscal models used to obtain the fiscal projections;
- Presenting estimates of cyclically adjusted balances to facilitate the evaluation of the fiscal stance and the play of automatic stabilizers.

[9] All relevant budget documents for these countries are available online at: New Zealand: http://www.treasury.govt.nz/budget2006/; Canada: http://www.fin.gc.ca/budtoce/2006/budliste.htm; Australia: http://www.budget.gov.au/.

Table 4. Transparency of budget documentation in selected countries

	Israel	New Zealand	Australia	Canada
Policy statements				
Detailed statement of long and short-term fiscal policy goals		x	x	x
Budget speech in parliament	x	x	x	x
Year in course				
Revised projections to year in course 1/		x	x	x
Supplementary appropriations to year-in-course budget		x	x	
Budget year				
Central macroeconomic scenario in budget year 2/	x	x	x	x
Baseline fiscal projections (central scenario)	x	x	x	x
Fiscal sensitivities: linkage revenue-macroeconomic scenarios.		x	x	x
Detailed agencies and ministries budgets and policy goals		x	x	
Listing of measures and budgetary effects				
revenue		x	x	x
expenditure		x	x	x
Risks to central scenario				
macroeconomic risks and non-central scenarios		x	x	x
specific fiscal risks 3/		x	x	x
Medium and long term				
Long term fiscal projections 4/		x	x	
Contingent liabilities 5/		x	x	
Disclosure of provisions and charges against future budgets		x	x	
Other				
Detail of fiscal relations with sub-national governments			x	x
Description of fiscal model underlying projections		x		
Cyclically-adjusted balance estimates		x		

1/ These include mid year updates of fiscal indicators and rest-of-the-year projections.
2/ It includes underlying assumptions about the domestic and international economies.
3/ It also includes specific policy decisions under active consideration by the government at the time of the finalisation of the forecasts.
4/ In the case of New Zealand, long-term projections are presented at least every 4 years, and cover the following 40 years.
5/ New Zealand and Australia classify them into quantifiable and non-quantifiable.

Improving institutions to strengthen incentives for sound fiscal policies

13. **More transparency and better analysis likely would have to be complemented by institutional reform to further strengthen policymakers incentives to take a longer-term view of fiscal policy**. The success with delegation of monetary policy to independent central banks has led some to argue that analogous mechanisms—e.g., fiscal councils—could play a useful role in promoting fiscal discipline. But, unlike monetary policy, fiscal policy has significant effects on intra- and inter-generational distribution of incomes and wealth and thus there are good reasons for leaving policy decisions in the hands of an elected government. However, the same does not hold for policy analysis and assessment.

The experience in other countries and Israel

14. **EU countries have adopted numerous tactics designed to curb political economy distortions to fiscal policy**. Some institutions have long legacies, but in many cases, countries adopted reforms during the 1980s and 1990s. The main governance structures that seem to contribute to fiscal discipline are:

- **Strong role for the finance minister within cabinet**. In some countries, this is a long-standing tradition (e.g., United Kingdom, France, Germany) while others have adopted reforms in this direction (e.g., Greece, Italy).

- **Coalition agreements that include negotiated fiscal contracts** (e.g., Netherlands, Finland, Austria, Ireland, Spain). This works best in diverse multi-party coalition governments.

- **Split ministries between different political parties**. This tactic is used to prevent capture of a ministry by any one political party, to mitigate the common pool problem (e.g., Austria, Finland).

- **Formal fiscal rules** (the Stability and Growth Pact, and national rules, e.g., in Germany, the Netherlands, Sweden, Denmark, and the United Kingdom). For the most part these are expenditure ceilings, used to cement coalition agreements, or "golden rules" for the deficit. Some countries also have balanced budget rules for lower levels of government.

15. **Israel has relied on similar mechanisms with some success**. The finance minister plays a strong role in the cabinet. After some consultation, the minister submits a single budget option to other ministers, who have only little time to accept or reject it en bloc before the cabinet's decision is made (reducing the influence of the finance minister, as some have been asking for, without introducing safeguards elsewhere risks undermining fiscal stability).[10] The latest coalition agreement includes specific fiscal targets for government spending and the budget deficit. And the DRL has served as a fiscal rule.

16. **The experience with the mechanisms in Israel has been mixed, although improving**. Various reasons could account for this. First, in the context of coalition talks there seems to be no agreement on a medium-term budget for each ministry. Second, for many years governments have tried to circumvent the constraints from the DRL by building budgets on overly optimistic revenue and growth projections, with the slippages then being blamed on the cycle— over the past few years this was no longer done and fiscal performance improved.[11] Third, the DRL was often not sufficiently specific or ambitious and there were no significant penalties related to breaching the law—again, as soon as an expenditure growth ceiling was introduced into the DRL, performance improved. However, following the recent conflict in the north the ceiling has been modified and its application suspended (due to temporary war-related expenditures) until 2009.

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[10] See, for example, Alesina and Perotti, 1996.

[11] Selim Elekdag, Natan Epstein, and Marialuz Moreno-Badía (2006).

Options for institutional reform

17. **In many EU countries a key avenue to strengthen incentives for better fiscal policy has been to rely on committees or independent fiscal agencies (FA)**. These have come in different guises (Table 5):

- **Independent entities, which help provide independent macroeconomic forecasts to underpin the budget**. This is done in Austria, Belgium (legally required), and the Netherlands, and is most useful to underpin a negotiated fiscal contract. In the Netherlands, the Central Planning Bureau (CPB) provides forecasts before elections that are used by political parties as the basis of platforms, and by coalition partners in the negotiation stage following the election. Evidence suggests that delegation of forecasting responsibility is an efficient way to address forecast biases.

- **"Inside committees", which help coordinate and centralize fiscal policy decisions**. These can come in various hues, including within cabinet, within parliament, and across political regions. In terms of the former, the United Kingdom has a tradition of using cabinet-level committees to arbitrate disputes between the finance minister and spending ministers, and to propose an aggregate spending target. Denmark and Sweden have institutionalized negotiations in parliament within a committee of select government and opposition representatives (given their penchant for minority governments). Spain's *Consejo de Politica Fiscal y Financiera* (CPPF) is made up of ministers from different levels of government, and the committee irons out subnational fiscal targets. More recently, France established the *Conseil d'orientation des finances publiques* (COFIPU) consisting of representatives of different levels of government (plus some independent experts) to coordinate medium-term objectives.

- **Third, "outside committees", which offer fiscal policy advice and recommendations, weighing on government decisions**. They often feature some combination of civil servants, central bankers, academics, and representatives of the social partners. Some are short-lived and provisional, designed to achieve a specific purpose, while others have a long institutional history. The temporary commission route was adopted by Ireland and Portugal at various times to navigate their adjustment programs, and included key central bank officials. On the other hand, Belgium's High Council of Finance (HCF) and Denmark's Economic Council are more broad based in terms of composition, and have long institutional histories. These bodies can propose fiscal targets which are accepted by the government, as was often the case with the HCF. More often, they perform a more informal advisory or watchdog role.

Table 5. Fiscal Councils: Institutional Design in Selected Countries

Country	Fiscal council		Roles and responsibilities
	Name	Institutional design	
United States	Congressional Budget Office (CBO)	- Operates at behest of Parliament; - Director appointed jointly by House and Senate speakers for four years with reappointment option.	- Focuses on fiscal policy; - Provides analysis of budget proposals; - Provides quantitative evaluation of adopted and pending fiscal measures.
Netherlands	Central Planning Bureau (CPB)	- Operates at behest of central government (Ministry of Economic Affairs), but provides independent assessments.	- Focuses on general economic policy, including fiscal.
Belgium	High Council of Finance (HCF)	- Secretariat held by the research department of the Ministry of Finance. Members are high level experts, including academics, members of the National Bank and representatives of the administrations.	- Focuses on regional fiscal policy, and its coordination with national fiscal policies. It has a "normative" policy assessment role.
	National Accounts Institute (NAI)	- Special purpose vehicle that coordinates the production of statistics and forecasts by Statistics Belgium, National Bank, and Federal Planning Bureau (FPB).	- The FPB provides macroeconomic forecasts underpinning the budget. It has a "positive" assessment role.
Germany	Financial Planning Councils (FPC)	- Coordinating body formed by the national and regional ministers of finance, as well as local representatives. Bundesbank representatives are also allowed to participate.	- Coordinates regional and central government fiscal policies. Negotiates agreements and plans to meet consolidated budgetary objectives.
	Working Party on Tax Estimates (WPTE)	- Formed by national and regional ministers of finance, and representatives of independent research institutes, the Federal Statistics Office, the Bundesbank, the Council of Economic Advisors, and local government associations.	- Its estimates and forecasts are the ones included in the multi-year budgetary plan.
Spain	Consejo de Política Fiscal y Financiera (CPFF)	- Coordinating body formed by the national and regional ministers of finance. It does not provide independent fiscal policy assessment. However, it facilitates peer pressure and monitoring that strengthens fiscal stability.	- Coordinates regional and central government fiscal policies. Negotiates agreements and plans to meet consolidated budgetary objectives.
France	Conseil d'orientation des finances publiques (COFIPU)	- Formed by members of parliament, representatives of municipalities, social organizations, and ministers.	- Assesses and coordinates public finances, determines conditions necessary for fiscal sustainability and recommends policy changes.

18. **Countries outside the EU have adopted similar strategies, notably recourse to independent agencies for impartial analysis of the government policies and their consequences**. These include the U.S. Congressional Budget Office (CBO), which plays a key role in the annual budgeting process and in budget monitoring; Japan's Fiscal System Council, which advises the finance minister on topics related to the budget (including on budget requests and proposals for new measures) and the government accounting system; and Korea's National Assembly Budget Office and Mexico's Center for the Study of Public Finances, which, like the CBO, are attached to parliament.

19. **The experience with commissions and FAs is that their effectiveness depends both on their mandate and the context in which they operate**.[12] The political cost of ignoring a body that provides technical analysis is smaller than ignoring normative assessments and recommendations, because the latter provide a benchmark against which the government's policies can be scrutinized in the public fora. Also, recommendations by an independent agency may well carry more weight than those by an ad-hoc commission but much depends on the reputation of the staffing and whether there is a specific audience with decision-making powers at the behest of which the reports are prepared. Crucially, as far as FAs are concerned, they have proved particularly useful whenever there was a clear, transparent fiscal benchmark—e.g., a fiscal rule or a coalition agreement/electoral promise—against which performance could be evaluated. In other words, there must be some initial political commitment to improving fiscal policy for commissions or agencies to be effective fairly quickly and it helps if this is expressed in the form of a rule.

20. **From a more practical point of view, there are various pros and cons for commissions and agencies**. Temporary commissions are easy to assemble and helpful in drawing attention to particular fiscal problems and the need for action. However, temporary commissions cannot follow-up on the response of policymakers. Permanent commissions could do so. However, they are not well-placed to deal regularly with a broad range of complex issues, notably all the intra- and inter-temporal fiscal implications of changes to the welfare state. FAs can do so because they have more resources but are therefore more expensive. Moreover, while a commission that meets regularly can attract reputable individuals from government, the central bank, academia, think tanks, or business—who can draw on technical support from their respective institutions—this might be much harder for a new agency that seeks permanent staffing. Accordingly, such an agency might take some time to build credibility and gain influence on public opinion and policies. Lastly, a commission of reputable individuals might find it easier than a new agency to engage a broad spectrum of society in the process of developing policy reform proposals. This, in turn, can help in building support for change.

Reform in the Israeli context

21. **In some ways the setting in Israel is propitious for a commission or an agency to operate successfully**. There is some significant support for a sound fiscal policy across the

[12] For a full discussion, see Kumar (2006).

political spectrum. Also, benchmarks against which performance can be evaluated do exist in the form of the DRL and the coalition agreement. What is required is support for a more medium-run orientation of fiscal policy in a political setting that, from various respects, resembles that in other countries that have successful fiscal commissions or agencies. These include Belgium, Denmark, and the Netherlands, all of which either feature a high degree of proportionality in the electoral system and/or considerable political fractionalization. And all, at some stage, struggled to reign in higher deficits and debt.

- One option would be to build a fiscal agency but this has the many aforementioned drawbacks. Alternatively, the tasks of such an agency could perhaps be performed by a more independent State Revenue Administration or Accounting General Department (both are presently within the MoF). However, neither of these has the full range of expertise necessary to do so and this would have to be remedied.

- Another option would be for the BoI to play a greater role in assessing fiscal policy for the public. The BoI already provides budget analysis in its fall Recent Economic Development Reports. This could be expanded, including through the regular production of long-term sustainability analysis. But involving the central bank into fiscal/welfare analysis and policy assessment and debate does not come without risks.[13] In Israel these are mitigated to some extent by the fact that part of the BoI Governor's mandate is to act as an economic advisor to the government.

- Alternatively, a nonpartisan committee with expert representatives could be formed. These could come from outside institutions (representatives from business, labor, think-tanks, academia, etc) but support from the MoF and the BoI could be considered as well. This committee could meet periodically to perform the most important tasks of a full-fledged agency and be accountable to the Finance Committee in the Knesset. It could be similar to National Economic Council that has been formed recently and that advises the Prime Minister, but with the focus on fiscal policy assessment rather than on poverty and employment.

22. **A nonpartisan committee could have different mandates**. One option would be a restricted mandate, limited to crafting macroeconomic and baseline (unchanged policies) revenue and expenditure projections to be used as inputs in the preparation of the budget; as well as doing the costing of budget proposals. More desirable would be a broader mandate

[13] On this point, see Buiter (2006) who argues that independent central banks should stay out of the public policy debate on matters other than monetary policy and the institutional arrangements for conducting monetary policy. The reason, he argues, is that central bank operational independence precludes substantive accountability; it is compatible only with a weak form of formal accountability: reporting obligation. According to Buiter, central bank independence will only survive if it is viewed as legitimate by the polity and its citizens. A necessary condition for this is that the central bank restricts its activities and public discourse to its natural core mandate: price stability and the capacity and willingness to act as lender of last resort.

that includes positive and normative assessments of the fiscal policy stance over the cycle and vis-à-vis the DRL; advice on the design of the DRL; and, to the extent resources permit, some long-term fiscal sustainability analysis. Of course, none of these assessments would be binding for the government or the Knesset. But they could serve in strengthening the debate of fiscal issues in Parliament and thus accountability of the committee to the Knesset Finance Committee would be key. This would also address the concern that the Knesset's Finance Committee presently does not have the manpower resources to perform detailed and independent evaluations of the budget.

D. Conclusions

23. **There are many ways to improve fiscal governance in Israel**. Key will be improvements in budgetary transparency and analysis. However, both theoretical and empirical evidence from other countries and for Israel suggests that the political infrastructure in Israel might be distorting fiscal policy. Institutional reform could help counter the distortionary forces. Both theory and experience suggest that better institutions can improve the quality of fiscal policy. In particular, fiscal committees or agencies can help improve fiscal discipline, policy credibility, and serve a useful signaling role conducive to more stable expectations and less uncertainty. International experience suggests that there are many ways to proceed and the various options would need to be carefully explored bearing the Israeli context in mind.

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II. Financial Sector Supervision Structures: Assessing the Alternatives for Israel[1]

A. Introduction

1. **The global proliferation of new financial activities and instruments over the past decade has altered the financial sector environment in many countries, prompting some of them to reconsider the institutional structure of their regulatory and supervisory entities.** The debate over which model is best for organizing financial supervisory agencies has gained much attention in recent years as countries grappled with the need to adapt to a new financial environment.[2] The distribution of countries across supervision structures has been fairly even, with both advanced and developing countries represented in the spectrum of *single integrated* to *separate* supervision authorities. In recent years, however, more countries have adopted a system of integrated supervision by either creating a single integrated regulator for the entire financial system or merging some of the main supervisory functions.[3]

2. **International experience has yet to show that a particular regulatory structure is optimal and there seem to be advantages and disadvantages to any system.** Moreover, making the transition from one supervision structure to another can be highly disruptive because of the diversion of management resources, the structural reorganizations and the potential loss of staff, experience and focus during the process of change. Thus, while an existing structure may appear to be sub-optimal, the gain from moving to another system may not always be worth the cost of change.

3. **Israel is currently undergoing significant financial sector reforms that are fostering the supply of new financial services and instruments and the authorities need to consider how best to organize the financial supervision structure in response to these developments**.[4] Major changes to the way the government issues its debt and the removal of a range of legal and regulatory barriers to the development of capital markets have given rise to strong growth of new instruments. In addition, the government last year enacted legislation to force banks to sell their holdings in mutual and provident funds, many of which were bought by insurance companies. These changes have led to new participants offering new financial services and products under new rules, with financial advisers operating under a new regime. There is greater competition in the financial sector, which is welcome, but this has also created new supervisory and regulatory challenges.

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[1] Prepared by Richard Pratt and Natan Epstein

[2] See Llewellyn (2006), Martinez and Rose (2003), Mwenda and Fleming (2001) and Taylor and Fleming (1999) for a sample of international and historical perspective.

[3] See Table 2 in Cihak and Podpiera (2006), and Table 1 in Martinez and Rose (2003).

[4] See IMF Country Report 06/121 for extensive discussion on the recent capital market reforms in Israel.

4. **To meet the requirements of international standards, any potential restructuring in Israel must include**: (i) more independent supervision, supported by a strong governance structure, accountability and transparency; (ii) adequate resources for supervision, including a salary structure that enables the regulatory authorities to attract top-quality staff; (iii) a strong regulatory capacity; and (iv) fewer prudential gaps and a level playing field across financial service industries.

5. This paper is organized as follows; section B briefly reviews the key criteria for effective supervision and the models' main characteristics; section C discusses the pros and cons of the models, with some additional comments on the relationship of regulation with monetary policy responsibility. Section D briefly reviews the current supervision structure in Israel. Section E considers the advantages of different models for Israel. Section F concludes.

B. Financial Supervision Models

6. **The primary distinction made in the literature is between a model of stand-alone separate financial supervisory agencies and single integrated supervisory body.**[5] The former model encompasses different financial services sectors, such as banking, insurance, securities, all of which are subject to separate supervisory authorities with the most common form generally including banking supervision as a function of the central bank (France, Spain, and the United States are common examples of this approach). In the integrated model, all the supervisory functions are brought together under one umbrella organization. The UK's Financial Services Authority (FSA) is often cited as the classic example of this approach.

7. **In practice, there are variations on the two *core* models.** A single agency could be totally integrated in its internal functions (for example with departments for licensing, supervision and enforcement, rather than by reference to financial sectors) or could be little more than a formal association of semi-autonomous sector-based departments. In addition, Australia and the Netherlands have adopted a "twin peaks" model, in which there are two integrated regulators, one of which is responsible for the prudential safety and soundness of all financial sector institutions and the other being responsible for the conduct of business.[6] Other countries, such as Canada and Belgium, have brought together the supervision of some financial services sectors, but not all.[7]

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[5] Fiechter (2006) summarizes the key features of an effective supervision system and discusses which model is most likely to reflect these features; Llewellyn (2006) and Martinez and Rose (2003) assess the broader pros and cons of the models. Kremers and others (2003) also describe the pros and cons of combining different supervisory activities within one organization.

[6] See Kremers and others (2003) for analytical comparison between the applications of the "twin peaks" models in the Netherlands and the U.K. See also Mwenda and Fleming (2001) for an overview of the U.K experience with single integrated financial services supervision.

[7] Fiechter (2006) highlights a "third model" for banking supervision, adopted by the United States, whereby a separated structure has evolved into a "two sets of eyes" approach under which a given financial institution is assessed by at least two separate supervisory agencies. Nonetheless, the relative

(continued)

8. **A number of key characteristics are typically associated with an effective and efficient supervisory function.** Before analyzing the pros and cons of each model, it is useful to examine more broadly the principal criteria against which an effective supervisory system can be judged. A regulator must be judged by results. Therefore, supervisory objectives are normally focused on:

a. the maintenance of systemic stability through prudential supervision, especially of banks;

b. the protection of customers, through the implementation of conduct of business regulations (as well as by maintaining the safety and soundness of financial institutions);

c. the maintenance of fair financial markets that work efficiently, primarily through oversight of organized markets and the imposition of ethical rules governing conflicts of interest and other matters in respect of exchange and over the counter trading;

d. the achievement of supplementary objectives such as investor education, defeating financial crime and, in some emerging markets, the development of the financial markets.

9. **Detailed objectives and principles for achieving these results have been established by the main standard-setting bodies—the Basel Committee for Banking Supervision (Basel), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO).** It is not possible here to undertake an analysis of all the principles but, for the purpose of assessing the effectiveness of different supervision structures, it is reasonable to focus on the following key elements:

a. **Independence, Accountability and Transparency.** Regulatory authorities should be able to withstand inappropriate political influence and pressure from financial institutions. They should be supported by a strong governance structure and legal protection for staff to conduct their official responsibilities. This independence should be balanced by robust arrangements for transparency and accountability to the government, industry, and public, for regulatory actions.

b. **Credibility.** Regulatory authorities should have a strong track record in achieving regulatory objectives by implementing and enforcing regulations in a proportionate manner.

c. **Adequate Resources.** There should be a stable funding structure that permits adequate quality and quantity of staff and other resources and an ability to withstand cyclical fluctuations in the industry. There should be an ability to carry out functions

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advantages of such variations can be best assessed by focusing on the two core models and extrapolating the merits and demerits.

without concern that any unpopular action could lead to unreasonable limitations on an authority's budget.

d. **Efficient Financial Regulatory Framework.** Regulatory authorities should hold down the costs of regulation, in terms of resources consumed by the regulator and the resources devoted to compliance by financial services institutions, and should be able to respond to changing market conditions.

e. **Positive Externality** Regulatory authorities should be able to meet any other broader objectives, for example with regard to reducing financial crime, enhancing investor education and developing innovative financial markets.

C. The Relative Advantages of the Core Models

Single integrated supervisor

10. **The main advantages a single integrated agency has are that it reflects the integrated nature of financial markets.** In particular:

a. it reflects more closely the nature of modern financial markets, where products offered by different sectors, whether banks, securities businesses, mutual funds or insurance businesses, have many common characteristics;

b. it is in a better position to assess the overall distribution of risks in financial markets, which sometimes involve institutions from different sectors having common ownership and where separate institutions transfer risks across and between sectors;

c. it may be able to use the experience in one sector to address weaknesses that may exist in the regulation of other sectors and thereby increase consistency, including less scope for regulatory arbitrage;

d. it is more likely to be able to address, in a consistent and cost-effective manner, common issues such as corporate governance, internal controls, risk assessments, ethical standards, the reduction in financial crime, investor education, and the development of innovation;

e. there may be synergies and economies of scale that reduce cost, which may be of particular value in smaller economies.

Separated supervisors

11. **Separated supervisory entities are likely to be more effective because they can focus on narrower objectives**:

a. they will be able to focus on a more limited set of regulatory objectives (whether this be fair and efficient equity markets, stable banks, soundly capitalized insurance businesses, or the provision of sound investment advice) and thereby avoid conflicts between objectives, enhance accountability and provide more effective delivery;

b. they may be better able to take full account of the unique characteristics of their sectors;

c. the smaller size of a given supervision function may enable separated regulators to move more quickly to address market malfunctions that affect their sector alone;

d. the existence of several authorities avoids the risk that a single integrated authority would be too powerful and lack accountability;

e. the focus on a single sector may mean that separated supervisory agencies attract staff with strong experience in specific sectors and thereby ensure that regulations are workable and have more credibility with the regulated community.

D. Financial Services Supervision in Israel

12. **Israel currently has a separated model for financial services supervision**. Banking supervision is conducted by the Bank of Israel (BoI). Securities markets and mutual funds are within the responsibility of the Israel Securities Authority (ISA), while insurance, pensions and provident funds are regulated by the Ministry of Finance (MoF). The following diagram shows the current model:

Current Structure					
	Prudential	Conduct of Business	Corporate Governance	Financial crime / customer education	Customer dispute resolution[8]
Banks	BoI				
Life and General Insurance	MoF				
Provident Funds					
Pension funds					
Mutual funds / Equity investments	ISA				

13. **The Israeli regulators have secured a number of regulatory objectives but a number of concerns remain about certain features of the regime.** A full assessment of the Israeli adherence to international standards would identify the strengths and weaknesses. There is no doubt that there are significant strengths. However, a number of issues need to be addressed. In particular:

a. The supervisory authorities do not all have sufficient independence. Regulation of pensions, provident funds and insurance is conducted from within the MoF. This conflicts with a central principle of both the IAIS and IOSCO that regulatory authorities should be operationally independent. The ISA does not have a general rule-making power that could be exercised without the consent of the MoF and the Knesset Finance Committee. The ISA and the Commissioner at the MoF do not have sufficient autonomy with respect to their budgets (even though the ISA is financed by the fees it levies on regulated entities), staff headcount, or salaries, while there are proposals to make the budget of the BoI subject to the annual approval of the Knesset.

[8] Issues relating to dispute resolution are discussed below in paragraph 30.

b. The supervisory authorities do not have sufficient resources. The resources of the ISA and, in particular, the Commissioner of Insurance are extremely limited. Neither the Commissioner nor the ISA have sufficient staff to make regular and detailed on-site visits to institutions. The ISA relies almost entirely on auditors to conduct on-site visits of mutual funds and this is a policy that carries risks. The Commissioner has begun to make visits to insurance companies but only on a five year cycle. He has not yet planned visits to pension or provident funds.

c. The supervisory authorities face a serious challenge in the form of rapidly developing financial markets, inconsistent regulatory standards, and, in some respects, insufficient powers and resources to enforce compliance. As noted below, there is a strong case for enhancing consistency through more formal cooperation, backed by memoranda of understanding or other agreements.

d. There is a continuing need to address cross-cutting issues such as the defenses against money laundering and investor education.

E. Alternative Models of Financial Services Supervision in the Israeli Context

14. **There are arguments in favor of the integration of Israel's regulatory structure.** The financial markets remain relatively modest in size, with 5 main banks and $190 billion in assets. Although there remains a legal ban on the mutual ownership of financial institutions in different sectors (indeed, Israel has passed legislation that moves in the opposite direction from world trends in this regard), some degree of indirect mutual ownership by institutions in different sectors may be possible and institutions in each sector can gain exposure to risks in other sectors. An integrated regulator may be better able to deal with the increasing dominance of the market for savings by insurance companies who have bought 40% of the mutual funds and a larger percentage of provident funds. It is likely that there will be increased use of more complex structured products such as asset backed securities and credit derivatives. An integrated regulator may be better able to ensure there are staff with specialism in such instruments.

15. **Moreover, there are many similarities in the products and services being sold by the separate financial institution**s. There are differences in the way products are structured and delivered which may continue to require specific regulatory requirements but many savings products perform in a similar manner and expose the investor to similar risks. For example:

a. Mutual funds, provident funds, the new reformed pension funds, and certain life assurance products are structured differently but have a number of very similar characteristics so far as the investor is concerned. While there are legal and tax differences and some differences in ancillary features, the central issue is that the investor chooses the risk/return pattern and bears the investment risk. However, the regulation of such products is split between the ISA and the Commissioner of Insurance. Different rules apply to different products and are enforced in a different manner.

b. The Commissioner of Insurance has proposals to enhance the extent to which savings can be switched between different product providers ("portability"). This is a welcome proposal to enhance competition. It will increase the liquidity risk of the product providers who will have to be required by the regulators to develop appropriate risk management tools.

c. According to insurance companies themselves, certain insurance products are similar in their behavior to bank deposits. There are bound to be some differences in regulation but the Commissioner of Insurance and the BoI need also to consider the similarities as far as the saver is concerned.

d. The portfolio investment management services offered by banks through their subsidiaries (and no doubt organized internally on a standardized basis) will look to the investor very similar to mutual funds and provident funds. The opeartion of mutual funds, provident funds, and bank portfolio management is split between different regulatory authorities.

e. Because they are no longer able to own mutual funds, banks are beginning to develop structured bank deposits that take on the characteristics of certain mutual funds but, while considered financial instruments for the purpose of investment advice regulation, will be subject to different regulation from those applied to such funds.

f. Insurance companies describe themselves as asset managers with continuing general insurance risks but are regulated by the Commissioner of Insurance, whereas other asset managers are regulated by the ISA.

g. The distribution of most investment products will be undertaken primarily by investment advisers employed by banks. But where some of these products are distributed by securities intermediaries, they will be subject to the ISA (indeed, the ISA also claims responsibility for the selling practices of bank advisers for mutual funds) and where they are distributed by insurance agents, they are subject to the Commissioner of Insurance.

h. Insurance companies are engaged in direct consumer and corporate lending. Although the Commissioner of Insurance has consulted the BoI on the appropriate regulations, the nature and depth of the requirements in terms of governance, internal controls, and capital requirements are not yet the same.

16. **The responsibility for regulating these products and services is shown in the following chart:**

	Banks	Insurance	Provident funds	Mutual funds	Pension funds	Equities / Bonds
Financial requirements	2	3	3	1	3	1
Conduct of business	2	3	3	1	3	1
Provision of advice / selling	2	3	3	1	3	1
Advertisements / prospectus requirements	2	3	3	1	3	1

1 - Securities Authority,
2 - The Bank Supervision department,
3 - The Capital Market, Insurance and Savings Division (Ministry of Finance)

In practice, the selling practices of bank advisers with respect to mutual funds would be subject to the ISA as well.

17. **If the Israeli authorities were to consider that a single integrated supervisory authority was the most appropriate solution in the short or long term, it might be illustrated like this:**

<table>
<tr><th colspan="6">Single Integrated Supervision</th></tr>
<tr><th></th><th>Prudential</th><th>Conduct of Business</th><th>Corporate Governance</th><th>Financial crime / customer education</th><th>Customer dispute resolution</th></tr>
<tr><td>Banks</td><td colspan="4" rowspan="5">Integrated Supervisor</td><td rowspan="5">Independent Agency or integrated regulator</td></tr>
<tr><td>Life and General Insurance</td></tr>
<tr><td>Provident Funds</td></tr>
<tr><td>Pension funds</td></tr>
<tr><td>Mutual funds / Equity investments</td></tr>
</table>

18. **On the other hand, Israel also benefits from some of the advantages of the separated model**. Israel's separated regulatory authorities have been able to develop specialisms in their particular fields. There is some interchange between the private sector and the regulators and the separate authorities have focused on delivering their more specific objectives.

19. **Changes to a regulatory structure can be very disruptive and in Israel's current circumstances there are arguments for building on the strengths of the present system in the short term.** Even if the development of Israel's markets is such that a single integrated regulatory authority would have substantial advantages in the longer term, the restructuring of supervisory organizations is a time-consuming and costly process. It will inevitably create a major diversion of management resources at a time when there is a need for enhancement of the consistency and effectiveness of regulation. There is a strong case for focusing on these more immediate challenges in the short term.

20. **In the meantime, less disruptive changes to the supervisory system could be considered.** The authorities should consider what form of structure they would wish to move towards in the longer term and bear that in mind when considering their shorter-term action. However, even if the authorities considered that an immediate move to an integrated regulator was not yet appropriate, there are useful alternatives to the *status quo*.

21. **There are strong grounds for enhancing the independence and accountability of the three supervisory authorities.** All international standard-setting bodies emphasize the importance of independence and accountability and it is important to reinforce these characteristics in Israel as soon as possible. The following actions would bring Israel closer into line with international practice:

a. removing responsibility for insurance, provident funds and pension funds from the MoF;

b. making arrangements for ensuring stable and adequate funding, for example by giving regulatory authorities power to set fees on license holders and to determine their budget, staff headcount, and salaries on the basis of the resulting revenues (subject to accountability as discussed below);

c. achieving greater harmonization of the regulations affecting products and services with similar characteristics, particularly mutual funds, provident funds, and the new pension funds;

d. giving the ISA power to determine operational rules (at a lower level than primary and secondary legislation) that would be binding on regulated entities and would involve penalties for non compliance (this would bring the ISA into line with the Commissioner for Insurance and the BoI);

e. requiring greater transparency in budget, salaries and headcount by the regulatory authorities with information published at least annually;

f. enhancing accountability by requiring, in addition to the publication of an annual report, regular public examinations of regulatory officials by members of the relevant committee of the Knesset and a value for money review by an independent third party;

Each country must adopt procedures that fit its legal and constitutional traditions. However, measures on these lines are common in other jurisdictions.

22. **All supervisory authorities should have sufficient resources.** Regardless of the short or long term structural changes the authorities may wish to adopt, there is an urgent need to add to the resources of the regulatory authorities so that they can:

a. implement Basel II for banks;

b. ensure that the regulation of insurance companies meets appropriate international standards of corporate governance, internal controls, and capital resources that match the risks they are taking on in the new Israeli market place;

c. bring the regulation, including governance, structure and disclosure requirements of provident funds and pension funds up to IOSCO standards, for example by upgrading the governance rules for provident funds and pension funds, by requiring a totally independent custodian of the assets, and insisting on simple "key features" documentation that spells out the risk / return characteristics of different products.

23. **Israel has two distinct categories of pension funds and these may demand different treatment.** Pension funds were reformed some years ago. There are older funds which are closed to new entrants and will gradually decline over time. New pension funds are similar to schemes in other countries with customers making regular contributions, with a view to building up sufficient savings to fund retirement. The investor has no guarantee of a specified pension, takes the investment risk and could, subject to the product and the investor's choice, make broad choices about risk and return. When the time comes for retirement, the investor should have a choice of annuity providers (although this choice is not always available and many pensioners are obliged to take the annuity provided by the pension fund). It is noted that pension funds provide a life assurance component but, in other respects, they are similar to mutual funds and provident funds and should be regulated in a similar manner. Older pension funds are in a different position and may be suitable for different treatment. They are not discussed further in this paper which focuses on the developing Israeli financial market.

24. **In respect of structural changes, there are changes short of a full merger into a single integrated body that are worth considering.** An early priority must be the removal of the responsibility for regulating insurance, capital markets and pensions from the MoF. The position of the Commissioner within the MoF is the most anomalous aspect of the current regime. Its position within the MoF makes it hard for the Commissioner to acquire sufficient resources and he is unable to have the flexibility he needs to compete with the finance industry for staff of the highest quality. There is good quality staff within the Commissioner's office but there is a much higher turnover than is experienced by the BoI and this can make it difficult to retain the necessary experience. Achieving early independence for the Commissioner is essential.

25. **The creation of a single integrated regulator would be disruptive considering separate IT, human resources, and other infrastructure, and there is a case for considering other integration models.** Canada and Belgium have merged insurance and banking supervision, while leaving securities as a separately regulated body. The Netherlands and Australia have created one regulatory authority for prudential supervision and another for the regulation of conduct of business (known as the "twin peaks" model).

26. **The "twin peaks" model has both advantages and disadvantages in the Israeli context.** Prudential supervision is concerned with the safety and soundness of an institution, whereas conduct of business is about an institution's relations with its customers. They are conceptually different. The model carries some of the advantages of unification in terms of consistency of regulatory requirements and enforcement, economies of scale etc.. However, the distinction between conduct of business and prudential supervision is not always so clear in practice. Smaller institutions frequently become insolvent because they have insufficient capital to meet claims for misselling. Moreover, there are other difficulties:

a. Virtually every institution has some issues relating to prudential supervision and some relating to conduct of business;

b. There are many issues that will be of interest to both regulators. Regulators are increasingly concerned with the corporate governance of regulated financial institutions and so both regulatory authorities would have an interest in risk management, policy development, internal governance, controls, internal audit, training etc..

c. Similarly, issues such as financial market development, investor education, anti-money laundering and financial crime reduction also fall to both regulatory authorities.

In effect, therefore, the model, almost by definition, demands that every financial institution is subject to regulation and supervision by two regulatory authorities. This can be burdensome for the institution and requires extensive coordination between the regulatory authorities. This may be the reason why only two countries have thus far pursued this model. In the Israeli context, it would require almost as much reorganization as full unification and would therefore be subject to similar constraints in the short term.

27. The twin peaks model, were it to be followed, can be presented as follows:

<table>
<tr><th colspan="6">Twin Peaks</th></tr>
<tr><td></td><td>Prudential</td><td>Conduct of Business</td><td>Corporate Governance</td><td>Financial crime / customer education</td><td>Customer dispute resolution</td></tr>
<tr><td>Banks</td><td rowspan="5">Reg auth 1</td><td rowspan="5">Reg auth 2</td><td rowspan="5" colspan="2">Reg auth 1 / Reg auth 2</td><td rowspan="5">Inde-pendent agency or either or both reg auths</td></tr>
<tr><td>Life and General Insurance</td></tr>
<tr><td>Provident Funds</td></tr>
<tr><td>New Pension funds</td></tr>
<tr><td>Mutual funds / Equity investments</td></tr>
</table>

28. **In practice, prudential issues tend to be the main focus of insurance and banking supervisors, whereas conduct of business is the main focus of securities regulators.** Another way to restructure supervision is thus the merger of insurance and banking, leaving securities regulation as a separate matter at least for the time being. This achieves many of the gains of the "twin peaks" model by creating one institution with a primarily prudential focus and another whose focus is primarily conduct of business. It removes some of the disadvantages of the "twin peaks" model by reducing the incidence of dual regulation of the same institutions. If the authorities were to consider that the need to achieve independence for the regulation of insurance, pension funds and provident funds was an important priority, they could pursue this avenue.

29. **There could also be advantage in introducing an independent dispute resolution mechanism for customers of financial institutions and removing these functions from regulatory authorities.** Many countries have created an "Ombudsman" to adjudicate on claims between customers and financial institutions. In Israel, much of this function is undertaken by the regulatory authorities. The current arrangement has the advantage in that the regulatory authorities are aware of the number of complaints against regulated institutions—which can be a highly effective leading indicator of serious management weakness in any institution. Moreover, the regulatory authorities become acutely aware of

issues that matter to customers. They can tailor their regulations to meet the abuses revealed by complaints. However, there are also disadvantages:

a. Complaints, even when justified, do not always arise because of breaches of regulatory rules.

b. Even where the complaint does concern a regulatory requirement, the regulator may be able to take regulatory action against the institution but may not have powers to enforce redress. This can be difficult to explain to the complainant.

c. Investigating customer complaints fairly is very resource intensive.

d. Customer complaints can often be the subject of Parliamentary pressure and responding to this can detract from the regulatory authority's other tasks.

e. A complaint can be an implicit criticism of a regulator – in that the regulator failed to prevent the action that led to the complaint. If the regulator is responsible for judging the complaint, there can be a perception of bias. Complainants whose complaints are not upheld will frequently assert that this is so and there are advantages in a totally independent complaints adjudication process.

f. Achieving proper redress for a customer is an important function and it should not be left to a regulatory authority to conduct in the margins of their task of regulating the systems and controls of regulated institutions.

It is for these reasons that some countries have established independent agencies. The Israeli regulatory authorities report that considerable resources are spent on this activity and this suggests that it would be advantageous to consider an independent agency in Israel. It would be essential to ensure that there was sufficient information flow to enable the regulatory authority to be aware of the trends of complaints and to take action to amend regulations and upgrade regulatory compliance where a complaint to an Ombudsman suggested a general failure of governance, control, or regulatory compliance.

30. **Whether or not any form of structural reorganization might be considered too disruptive at this time, a further alternative could be some transfer of responsibilities.** Mutual funds, provident funds and pension funds are all savings vehicles. The regulatory treatment in Israel is divided on the basis that mutual funds are short-term investments whereas pension funds and provident funds are (like insurance products) regarded as longer-term investments. In practice, however, the differences between pension funds, provident funds and mutual funds are probably not sufficient to justify the different regulatory treatment. For those investors who have held provident funds long enough to avoid any tax penalties on withdrawal, a provident fund is essentially identical to a mutual fund. Pension funds are investment schemes that attract tax benefits and which currently provide insurance as an ancillary feature. In many cases, they also require their members to buy annuities from them to provide a retirement income. However, the Commissioner of Insurance is enhancing the extent to which investors can move from one provider to another. It would also improve

competition if pension providers were obliged to allow pension fund members to buy insurance and annuities from other providers. If this were done, the pension funds, provident funds, and mutual funds would all become more like each other. All three are likely to be collective investment schemes (CIS) within the terms of the IOSCO definitions. IOSCO makes no long term / short term distinction in the rules that should apply to CISs and it is difficult to see the rationale for any departure from IOSCO standards for provident funds and the savings scheme element of pension funds. For this reason, there is a case for bringing the regulation of all three savings schemes together..

31. **Investors in short and long term vehicles require similar protections—** particularly in terms of legal structure, governance, asset segregation, and selling practices. Although the ISA meets the IOSCO standards in respect of mutual funds, the Commissioner of Insurance has told the mission in the past that he does not seek to do so in respect of other products. For example, there is no requirement for an independent custodian of assets held by provident funds and the requirements for full disclosure at the point of sale are not the same as for mutual funds. There could be advantage in transferring responsibility for the regulation of provident and the new pension funds to the ISA so as to achieve consistent treatment with mutual funds and other investments – at least when the arrangements to enhance portability and competition are in place.

32. **A combination of these interim measures could produce a structure as follows:**

<table>
<tr><th colspan="6">Interim Model</th></tr>
<tr><th></th><th>Prudential</th><th>Conduct of Business</th><th>Corporate Governance</th><th>Financial crime / customer education</th><th>Customer dispute resolution</th></tr>
<tr><td>Banks</td><td colspan="4" rowspan="2">Integrated authority</td><td rowspan="5">Inde-
Pendent agency</td></tr>
<tr><td>Life and General Insurance</td></tr>
<tr><td>Provident Funds</td><td colspan="4" rowspan="3">ISA</td></tr>
<tr><td>New Pension funds</td></tr>
<tr><td>Mutual funds / Equity investments</td></tr>
</table>

33. **So long as there are multiple supervisors, there remains a need for co-operation and co-ordination perhaps in the form of a financial services council.** Many countries with multiple regulators have introduced formal memoranda of understanding between the regulators and, in some instances, a formal council for discussing issues of mutual concern. Such a council could discuss the issues identified in this paper and the most appropriate regulatory structure for the longer term in Israel. The Israeli authorities are already drafting a memorandum of understanding and a formal council could be a useful additional step.

F. Conclusion

34. **The distinction between the different financial sectors is diminishing and this is reinforcing the need for changes in supervision, including its structure.** The changes increase the advantages of integrated supervision, particularly in the context of a financial market of modest size as is the case in Israel. However, such a change can be very costly in terms of management time.

35. **There are other changes in the short term that could be contemplated, if the cost of moving to a single integrated structure was considered too high to allow major regulatory restructuring in the short term**. Such changes could include the creation of an independent insurance agency, or the merger of banking and insurance, the transfer of responsibility for provident funds and new pension funds to the ISA, and measures to reinforce the independence and accountability of the supervisory authorities. The authorities could also choose different combinations of these measures, which all come with certain advantages and disadvantages.

36. **Overall, the development of the capital markets is creating substantial regulatory and supervisory challenges and with respect to the structure of supervision, there is no organizational silver bullet**. The broad assessment in this chapter is no substitute for a formal and detailed analysis of adherence to international standards and there are benefits to conducting a full assessment before proceeding with major change. However, it is evident that financial institutions are taking on more risks and it is therefore essential that they be required to upgrade their corporate governance and risk management systems. It is equally important that harmonized international standards are applied as appropriate to the increasingly varied activities of financial institutions. To achieve this, there is a need for early and significant strengthening of independence, accountability, and transparency of regulatory authorities. Furthermore, these authorities need to be furnished with adequate resources to attract the staff needed to supervise financial institutions, implement international standards, and enforce their regulations.

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