

Israel: Report on the Observance of Standards and Codes

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ISRAEL

Report on Observance of Standards and Codes

Prepared by the Monetary and Capital Markets and European Departments

Approved by José Viñals and Reza Moghadam

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This report presents the Report on Observance of Standards and Codes (ROSC) for the financial sector prepared in connection with the IMF Financial Sector Assessment Program (FSAP) Update mission, which visited Israel in November 2011. The mission appreciates the cooperation received from the authorities. The authorities have commented on these reports and the underlying detailed assessments, and their reactions are included.

The following detailed assessments of financial sector standards were undertaken: the Basel Core Principles for Effective Banking Supervision (BCP) by Messrs Bayle and Shapiro; the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) assessed by Messrs. Savage and Wehrhahn; the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation assessed by Messrs. Lindner and Rodgers; and the Basel Committee on Payments and Settlement (CPSS) Core Principles of Systemically Important Payments Systems (CPSIPS) by Mr. Mann.

In general, the level of observance of these standards is high, based on strong institutions, a pro-active approach, and a comprehensive regulatory framework. Most of the enhancements suggested in the 2001 assessment have been put in place. The authorities are actively pursuing a program to strengthen regulations and supervisory practice. Going forward, priority areas include:

- For banking, the regulation and supervision of interest-rate risk, market risk, and liquidity risk; and flexibility and autonomy in personnel management and budgets;
- For insurance, cross-border supervisory cooperation and information-sharing; and group supervision and regulation.
- For securities market oversight, coverage of currently unregulated broker-dealer activity; and some over-the-counter (OTC) derivatives activity.
- For payments systems, oversight of the payments system; strengthening the multilateral net settlement systems; and business continuity and disaster recovery mechanisms that integrate payment system functions with central bank and financial sector systems.

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GLOSSARY

AML/CFT	Anti-money laundering/combating the financing of terrorism
ACH	Automated Clearing House
BOI	Bank of Israel
BCA	Paper-Based Clearing House
BCP	Basel Core Principles
CAR	Capital adequacy ratio
CLS	Foreign currency settlement system
CMISD	Capital Markets, Insurance, and Savings Division
CPSS	Committee on Payment and Settlement Systems
CT1	Core Tier 1
DGS	Deposit guarantee scheme
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commission
ISA	Israel Securities Authority
LTS	Long-term savings
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NBFI	Nonbank financial institution
NIS	New Israeli shekel
NPL	Nonperforming loan
PCA	Prompt corrective action
RTGS	Real-Time Gross Settlement
RWA	Risk-weighted assets
TASE	Tel Aviv Stock Exchange
TASE-CH	Tel Aviv Stock Exchange Clearing House
Zahav	Hebrew acronym for real time credits and transfers system

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Summary

1. **Banking sector regulation and supervision is generally in line with international standards and stringent** The authorities take a pro-active approach to supervision and correcting incipient problems, and regulations are generally up to date. In some areas, the authorities' regulation and practice goes well beyond the standard. Most remaining deficiencies relative to the standard are being addressed or are of relatively low materiality. Principle areas for improvement include the regulation and supervision of interest-rate risk, market risk, and liquidity risk; and flexibility and autonomy in personnel management and budgets to attract and retain financial sector experts with the required skill mix.

B. Information and Methodology Used for the Assessment¹

2. **The assessment of implementation of the Basel Core Principles for Effective Banking Supervision (BCP) was conducted in November 2011 within the framework of the Financial Sector Assessment Program Update for Israel.** A BCP assessment requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision. The assessment team received the full cooperation of its counterparts and all information require

3. **The assessment has been conducted in accordance with the Core Principles (CP) Methodology published in October 2006 by the Basel Committee on Banking Supervision (BCBS) and involved a qualitative assessment of each CP.** It assessed compliance with both the "essential" and the "additional" criteria, but assigned ratings solely on the basis of compliance with the "essential" criteria. The assessment has been prepared on the factual situation at the time of the mission, but the assessors have taken notice of regulatory initiatives that were in train but had yet to be completed or implemented.

C. Institutional and Macprudential Setting and Market Structure

4. **The main financial institutions are banks and insurance companies.** Following the Bachar reform—that began in mid-2005 and forced banks to divest most non-commercial banking activities, such as mutual funds, insurance, pension, and provident funds—the banks today focus on traditional banking business. Nonetheless, banks still play an important financial intermediary role, with their assets amounting to about 140 percent of GDP. Most banks have relatively little overseas activity; dollarization has been greatly reduced. Foreign

¹ The assessors were Thierry Bayle (Banque de France) and Joel Shapiro (formerly of the U.S. Federal Reserve).

institutions play a minor role, and with a few exceptions, foreign ownership of Israeli institutions is limited. The banking and insurance sectors are highly concentrated.

5. Financial supervision responsibilities in Israel are shared among several agencies.

The Bank of Israel (BOI) and specifically its Banking Supervision Department (BSD) headed by the Supervisor of Banks is responsible for prudential oversight of banks. BOI is responsible also for payments system oversight. The Israel Securities Authority (ISA) oversees the securities sector, while the Commissioner of Capital Markets, Insurance, and Savings (CCMIS) at the Ministry of Finance (MOF) mainly deals with the insurance and pension sector. The Tel Aviv Stock Exchange (TASE) has some supervisory responsibilities for its members. There exist memoranda of understanding (MOUs) among BOI, ISA, and CCMIS outlining information sharing agreements. The practice of cooperation seems to be broadly satisfactory for normal times—when interactions between sectors are anyway limited—but may be over-stretched in times of crisis or weak in anticipating common vulnerabilities. Cooperation and information exchange were indeed intensified on an ad hoc basis during the global crisis.

6. The global crisis affected Israel’s economy, but no domestic financial institution got into serious difficulties during the crisis.

Banks have weathered the storm relatively well, in part because their conservative management; limited inter-connectedness due to the small interbank and wholesale funding markets; lack of complex asset and securitized markets; and strong and intrusive bank supervision. Some insurance companies made losses, as did many investors in the various funds, and the corporate bond market suffered especially large falls in prices. The authorities preempted the spread of financial stress with a slew of crisis-intervention measures. For example, the BSD tightened bank supervisory measures in areas of reporting, capital, and liquidity.

7. At the time of the mission, the health of the financial sector was generally satisfactory.

The average capital ratio for major Israeli banks reached 14 percent, while the Tier 1 capital ratio stood at around 8.5 percent. Banks profitability declined sharply in 2008, but has since recovered as loan loss provisions have decreased and net interest income has increased. Banks remain mainly deposit-funded, with customer deposits exceeding loans. Financial soundness indicators for insurance companies are currently generally satisfactory.

D. Preconditions for Effective Banking Supervision

Sound and sustainable macroeconomic policies

8. Israel has a solid institutional framework supporting the conduct of sound macro-economic policies.

Monetary policy is based on an inflation targeting framework, and the BOI’s independence has been recently strengthened following the enactment of the 2010 BOI Law. Budgetary policy too has been strengthened in recent years, with the establishment of a fiscal rule that gives credibility to the authorities’ fiscal consolidation plan.

A well-developed public infrastructure

9. **The Israeli legal framework for the financial sector and more generally is comprehensive and regularly updated.** The judicial system, including that for bankruptcy and the enforcement of property rights, is well-developed. The legal background and regulatory and institutional framework dealing with weak banks are stipulated in the Banking Ordinance, 1941, although there is no legal provision dedicated to bank bankruptcy.

10. **The auditing and accounting rules applicable to financial institutions generally comply with international standards.** Listed companies and most nonbank financial institutions have applied International Financial Reporting Standards (IFRS) since 2008. The Israeli banking system reports under BSD's directives and Israeli General Accepted Accounting Principles (GAAP), which is close to U.S. GAAP, with some IFRS elements for non-core activities. The Israeli legislative framework with regard to the audit profession requires internal and external auditors to be independent in both fact and appearance. The Banking Ordinance, 1941 requires the appointment of internal auditor in a banking corporation, and stipulates the governance of the internal auditor, who is subjected to specific sections of the Internal Audit Law. Furthermore, the Companies Law and the Accountants Law assure the independence of external auditors.

11. **The payment and settlement system is reliable and efficient.** The BOI regulates Israel's payment systems. It operates the Zahav system (a real time gross settlement system), which is considered to be secure and fast. The Zahav system is linked to banks' paper-based clearing house (BCH), the automated clearing house (Masav), and the Tel Aviv Stock Exchange (TASE) clearing house.

Effective market discipline

12. **Competition is encouraged and the market is open to foreign participation.** There are no significant non-prudential barriers to entry by domestic or foreign firms.

13. **The corporate governance of financial institutions in Israel is governed by the Companies Law and the Securities Law.** In addition, sectoral legislation has been introduced to regulate the operation of each financial sector, such as banks (the Banking Licensing Law, the Banking Ordinance, 1941, the Banking (Service to Customer) Law and the BOI Law).

14. **The basic principles of financial reporting are laid out in the Securities Law.** The law addresses the content of a prospectus, the prohibition against the use of insider information, and the penalties applicable for the breach of the law. The Banking Ordinance, 1941 and BSD directives set out the contents of annual and quarterly financial reporting by banks.

Public safety nets

15. **Israel does not have formal deposit insurance.** However, in the past, the government and the BOI provided an extensive degree of *de facto* protection to depositors. For the non-systemic bank failure cases in 1985 and 2001, the BOI compensated depositors almost in full. In the severe financial crisis of the early 1980s, the government nationalized the system, and depositors did not suffer any losses.

Legal framework for supervision

16. **The Israeli legal framework for banking supervision comprises legislation and regulation at various levels.** The primary legislation that underpins the power of BOI Governor and Supervisor to supervise and regulate banks is the BOI Law, the Banking Ordinance, 1941, the Banking Licensing Law, and the Banking Service to Customer Law. To implement prudential requirements, BOI Supervisor has the power to issue Proper Conduct of Banking Business Directives, instructions, and letters.

E. Main Findings

17. **Objectives, independence, powers, transparency, and cooperation (CP1):** There is a comprehensive set of laws and directives governing the supervision of the banking industry, although some of the legislation is old. The BOI has a great deal of *de jure* and *de facto* independence, and accountability mechanisms are in place. The influence of the MOF in the salary scale of BOI employees risks compromising its independence and raises questions about the long term maintenance of supervisory capacity.

18. **Licensing and structure (CPs 2–5):** The legal framework is clear relative to the types of banking and non-banking activities in which banking corporations may engage. While there have been few license applications in recent years, the legal framework, policies and processes are in place to evaluate the application for a bank license. The transfer of ownership is well defined in the law, and there are explicit definitions for controlling interests, although these are contained in a policy rather than in law. The conditions for the acquisition of a non-bank financial institution in Israel could be set out more formally.

19. **Prudential regulation and requirements (CPs 6–18):** The regulatory framework is fairly comprehensive, but dense and complex. The capital adequacy framework is based on international standards for standardized approaches to credit, market and operational risk in Pillar I. Pillar II is a significant component of the capital adequacy requirements, though the process is somewhat informal. Credit and most other risks are subject to close and intensive scrutiny. BOI exerts close oversight of concentrations (single name, sectoral, geographic, collateral, and product). Areas for improvement include the regulation and supervision of interest-rate risk in the banking book, market risk, and liquidity risk.

20. **Methods of ongoing banking supervision (CPs 19–21):** BOI has implemented a risk-based approach to supervision, which is evolving as the supervisors gain experience with it. There is a mix of on-site and off-site supervision, with an extensive level of communication and cooperation between the two groups. There is an extensive array of reporting requirements for banks that provides a wide range of data and risk management information, both on a consolidated and unconsolidated basis. Appropriately, the information is used in the supervision process to evaluate risk and for other objectives.

21. **Accounting and disclosure (CP 22):** Disclosure requirements are very strict, and external auditors are employed to ensure that disclosure rules are adhered to. The authorities are planning to transition the banking system solely to IFRS standards.

22. **Corrective and remedial powers of supervisors (CP 23):** At present there is a restrictive list of available remedies in the law, such as eliminating dividends, but the supervisor should be able to apply remedial measures that reflect the level and severity of the deficiencies. Expansion of powers and strategies concerning the resolution of a problem bank is under consideration, which would enable BOI to have the time and the power to develop more creative approaches to resolving a bank than exists in the law at present.

23. **Consolidated and cross-border banking supervision (CPs 24–25):** The BOI has developed an overall satisfactory program of consolidated supervision, but there is a gap in the supervision of certain securities-related activities engaged in by banking corporations. The BOI engages in host-home country relationships commensurate with the size and complexity of the operations of Israeli banks operating abroad. Foreign bank operations in Israel are at a relatively low level, and home-host relations are more ad hoc in nature, reflecting the size and materiality of these banking operations.

24. **Table 1 summarizes the main findings.**

Table 1. Israel: Summary of Compliance with the Basel Core Principles

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	There is a comprehensive set of laws and directives governing the supervision of the banking industry. The legal framework provides sufficient supervisory tools to require banking corporations to comply with laws and directives, and there are adequate provisions in the law to facilitate consolidated and cross-border supervision. Certain provisions of the law should be more flexible to enable the Supervisor of Banks to respond in an appropriate manner, including provisions relating to the expansion of permissible activities, developing appropriate enforcement actions for deficiencies in banks, and responding to the intervention in a problem bank.
1.1 Responsibilities and objectives	The set of laws and regulations is comprehensive. However, banking laws have not been amended as promptly as would be desirable (e.g., regarding banks' engagement with certain derivatives products). Decades of amendments have led to a somewhat piecemeal set of provisions.

Core Principle	Comments
1.2 Independence, accountability and transparency	The BOI has a great deal of de jure and de facto independence, and accountability mechanisms are in place. The influence of the MOF in the salary scale of BOI employees potentially compromises its independence and raises questions about the long term maintenance of supervisory staff capacity.
1.3 Legal framework	The Banking Ordinance, 1941, and the Banking (Licensing) Law, 5741 – 1981 provide an overall satisfactory legal framework for the supervision of banks, and are complemented with a compendium of detailed directives.
1.4 Legal powers	The Supervisor of Banks has sufficient powers in the law, and an appropriate range of tools, to require banks to comply with banking laws and regulations.
1.5 Legal protection	There are adequate protections in the law to indemnify bank supervisors against litigation in the proper conduct and execution of their responsibilities as bank supervisors.
1.6 Cooperation	A satisfactory framework for cooperation on supervisory issues and the exchange of information exists between BOI and other financial regulators in Israeli and important foreign supervisors. Cooperative efforts and the exchange of information with other Israeli financial regulators are maturing, as reflected in the establishment of the Liaison Committee.
2. Permissible activities	The legal framework is clear relative to the types of banking and non-banking activities in which banking corporations may engage. However, BOI must interpret the meaning of banking activities very broadly in order to enable banking corporations to engage in new products as they are introduced in the market. The interpretation of the law enabling banks to engage in derivative products is one such example of a broad interpretation of the law.
3. Licensing criteria	The infrastructure is in place in terms of the legal framework, policies and processes to evaluate such applications.
4. Transfer of significant ownership	The transfer of ownership is well defined in the law, and there are explicit definitions for controlling interests, although these are contained in a policy rather than in law.
5. Major acquisitions	The law governing the acquisition of non-bank financial companies is very restrictive, as it limits the type of such companies in which a bank may operate. With the exception of companies that may be engaged in permissible banking activities, there are only three such activities permitted. The limitations governing a bank's investment in shares of a non-financial company, at 15 percent of equity capital is somewhat generous; reducing the exposure to one such company relative to a bank's capital would encourage greater diversity in the investment portfolio and reduce risk.
6. Capital adequacy	<p>The capital adequacy framework is based on international standards for standardized approaches to credit, market and operational risk in Pillar I, with add-ons in some areas (such as credit concentration risk) and an emphasis on core capital. Pillar II is a significant component of the capital adequacy, though the process is somewhat informal.</p> <p>Banks use the “standardized approach” in determining risk weights. Thus, risk weights do not vary greatly with economic conditions.</p>

Core Principle	Comments
7. Risk management process	The regulatory framework is fairly comprehensive, but dense and complex. BOI is commended for its current efforts towards a more principles-based rulebook in this area. The upcoming reform should be the opportunity to further specify the principle of segregation of functions and to treat settlement risk.
8. Credit risk	Based on a large number of detailed directives and supervisory guidance, credit risk is subject to close and intensive scrutiny. The BOI is encouraged to move towards a more comprehensive regulation of this risk, with a view to incentivizing banks to develop and upgrade their internal ratings systems.
9. Problem assets, provisions, and reserves	Rules on problem assets, provisioning, and reserves are fully adequate. Further harmonization of the rules relating to assets classification and provisioning is under way. However, the accounting definition of impaired debts does not allow one to identify separately the debts to borrowers that are unlikely to repay, regardless of any collateral recollection.
10. Large exposure limits	Based on comprehensive regulation, BSD makes sure that management correctly defines, measures, monitors, and controls large credit exposures or concentrations of other kinds (by sectoral, by geographic area, by collateral and by product). This oversight could helpfully be enhanced, at least in the Pillar II context, by paying more attention to the correlation of risks.
11. Exposure to related parties	The definition of related parties is strictly delineated, but does not leave much discretion to the Supervisor.
12. Country and transfer risks	BOI exerts proactive oversight of these risks.
13. Market risks	<p>For capital purposes, only standardized methods are allowed, whereas for risk management purposes, VaR models-based and stress test methodologies are widespread.</p> <p>Yet, BOI has not committed sufficient resources to challenge the adequacy of banks' trading book eligibility policies, the reliability of their data information systems, valuation methodologies and internal models. It is strongly recommended to get the independent capacity to do so.</p> <p>Furthermore, the assessment of banks' exposure to market risks is biased by the amalgamation thereof with exposure to interest-rate risk in the banking book.</p>
14. Liquidity risk	BOI performs intensive and on-going oversight of banks' exposure to liquidity risk. However, this oversight is based on information that is calculated on a solo basis only. Regulatory limits apply only to overall liquidity, without breakdown by major currencies, and only over a one-month horizon. BOI devotes relatively few resources to on-site examination of the reliability of information systems and models that banks use for measuring liquidity risk.
15. Operational risk	<p>The rules are scattered across a large number of directives, which fail to provide a comprehensive view of the relevant principles for assessing, monitoring and managing the operational risk, and even result in some loopholes.</p> <p>The compulsory reporting requirements currently focus on events, do not include the related material losses. Relatively few resources are allocated to on-site examination of this risk.</p>

Core Principle	Comments
16. Interest-rate risk in the banking book	There are no specific regulatory provisions regarding the interest-rate risk in the banking book, except that banks have to measure it internally and to disclose it. BOI does not receive any specific reporting on this risk. Rather, it performs an assessment of a bank's exposure to interest-rate risk that arises from its whole balance sheet, i.e., including its trading book exposures.
17. Internal control and audit	The legal and regulatory framework is characterized by a piecemeal approach to the regulation of internal control and audit function, which does not ensure full consistency. Hence BOI's initiative to make the rulebook comprehensive is highly commended. Some gaps will need to be filled; in particular the scope of compliance function will need to be expanded.
18. Abuse of financial services	<p>Needed amendments to the legal framework are expected to be passed shortly.</p> <p>BOI's supervisory practice seems well-suited and has given rise to sanctions due to breaches of the Law. However, sanctioning breaches of BOI's directives has not yet been demonstrated.</p> <p>The intensity and depth of the information-sharing with foreign supervisory authorities have not yet been tested.</p> <p>Anti-money laundering/combating the financing of terrorism (AML/CFT) provisions and practice are generally of a high standard. A new regulation to complete and harmonize the regulatory framework was in the process of being issued at the time of the assessment.</p>
19. Supervisory approach	BOI has implemented a risk-based approach to supervision, which is evolving as the supervisors gain experience with it. A critical component to its success is to make the process more efficient so that it can be more pro-active and fully effective, an issue well recognized by the authorities.
20. Supervisory techniques	There is a mix of on-site and off-site supervision, with an extensive level of communication and cooperation between the two groups. In that regard, the process is fully integrated. The risk assessment products, both on-site and off-site are of high caliber but are in some cases duplicative and need further streamlining.
21. Supervisory reporting	There is an extensive array of reporting requirements for banks that provides a wide range of data and risk management information, both on a consolidated and unconsolidated basis. Appropriately, the information is used in the supervision process to evaluate risk and for other objectives.
22. Accounting and disclosure	Disclosure requirements are very strict, and external auditors are employed to ensure that disclosure rules are adhered to. Accounting standards require a combination of U.S. GAAP and IFRS accounting standards. The preponderance of assets, known as core assets, which are principally earning assets, is accounted for under U.S. GAAP. The authorities are planning to transition the banking system solely to IFRS standards by 2013 or later.

Core Principle	Comments
23. Corrective and remedial powers of supervisors	Remedial powers could be made more flexible relative to the supervisory toolkit available for early intervention. At present there is a restrictive list of available remedies in the law, such as eliminating dividends, but the Supervisor should be able to apply remedial measures that reflect the level and severity of the deficiencies. Expansion of powers and strategies concerning the resolution of a problem bank is under consideration, which would enable BOI to have the time and the power to develop more creative approaches to resolving a bank than exists in the law at present.
24. Consolidated supervision	BOI has developed an overall satisfactory program of consolidated supervision. Nonetheless, there is a gap in the supervision of certain securities activities engaged in by banking corporations. The underwriting activities ostensibly are under the supervision of the ISA, and an agreement needs to be worked out on the approach to supervising these entities more closely (notwithstanding their relatively low level of activity). Also, closer scrutiny of intercompany and affiliated company transactions would be valuable.
25. Home-host relationships	BOI engages in host-home country relationships commensurate with the size and complexity of the operations of Israeli banks operating abroad. Formal written agreements governing cooperation and information exchange are in effect between BOI and the supervisors who host the preponderance of Israeli bank activities, although the agreement with one of the supervisors needs to be expanded to make it more comprehensive. Foreign bank operations in Israel are at a relatively low level, and home-host relations are more ad hoc in nature, reflecting the size and materiality of these banking operations.

F. Recommended Action Plan and Authorities' Response

25. The following recommendations (Table 2) aim to suggest measures to further improve the banking supervision and regulation.

Table 2. Israel: Recommended Action Plan to Improve Effectiveness of Banking Supervision

Reference Principle	Recommended Action
1. Objectives, autonomy, powers and resources	The regulatory framework for risk management policies and practices lend themselves to a generally more principles-based approach rather than a rules-based approach. A somewhat more principles-based approach in the directives that provide guidance to the banking industry should be considered.
1 (1). Responsibilities and objectives	A formalized periodic review of banking law and regulation would ensure that the body of legislation and rulings remains up to date. A reorganization of laws and directives into a comprehensive banking law in connection with a review of the body of legislation and directives should be considered.

Reference Principle	Recommended Action
1 (2). Independence, accountability and transparency	The influence of the MOF over BOI's salary scale presents some challenges in recruiting and retaining staff. To counter the ramifications of this issue, some new strategies will have to be adopted. For example, the development of a comprehensive in-house training program, programmed rotation of staff across the BOI, seconding of staff to banking supervision agencies overseas, cash bonuses, and the hiring of retired bankers at an entry- or mid-level position.
2. Permissible activities	A provision should be added to Section 10 of the Bank Licensing Law that would enable BOI to approve the introduction of new banking activities in which the industry may engage. Under current practice, BOI must interpret the laws very broadly to accommodate new activities in the market.
4. Transfer of Significant Ownership	<p>At present, terms defining the control of a banking organization are contained in a policy, and as a matter of best practice, such issues typically are contained in laws or regulations.</p> <p>A directive should be considered that would require a bank to inform the Supervisor of Banks of a material fact that would compromise the suitability of a controlling owner of a bank.</p>
5. Major acquisitions	<p>Reducing the permissible investment in a non-financial investment to 5 percent of a bank's capital should be considered, to encourage further diversification and reduce risk.</p> <p>The acquisition of non-bank financial companies located in Israel should be subject to more formal criteria similar to those established for the investment in a financial company located in a foreign jurisdiction.</p>
6. Capital adequacy	<p>More BSD resources should be dedicated to the independent checking of properness of capital adequacy reporting.</p> <p>The supervisory review and evaluation process (SREP) should be strengthened to make it more forward-looking and prescriptive, and ensure more timely response from banks, especially when Internal Capital Adequacy Assessment Process (ICAAP) is judged insufficiently prudent.</p> <p>The Supervisor should be empowered to require the controlling shareholders to increase banks' capital.</p>
7. Risk management process	The regulatory framework should be streamlined (move from a piecemeal approach to a comprehensive one).
8. Credit risk	<p>Regulation concerning credit risk management should be updated in the near term, with a view to making it more comprehensive.</p> <p>This opportunity should be taken to incorporate guidelines for sound internal rating practices in order to upgrade the banks' credit risk management practices, to strengthen BSD oversight of credit risk and forward-looking capacity and, in the longer term, pave the way for an implementation of advanced approaches for capital purposes as well.</p>

Reference Principle	Recommended Action
9. Problem assets, provisions, and reserves	<p>The consistency of applicable rules should be ensured (Directive 314 and new Reporting to Public directives).</p> <p>The Supervisor should consider requiring banks to submit information that will clearly single out the assessment of a borrower's ability to repay from that of collateral collection.</p>
10. Large exposure limits	<p>The oversight of concentration risk should be enhanced by assessing more systematically the potential concentration risk that may arise from distinct but correlated exposures.</p> <p>Banks should be incentivized to devote more attention to concentration of risk factors, beyond single-name concentration, and incorporate such analysis in the context of ICAAP/SREP processes.</p>
11. Exposure to related parties	<p>BSD's powers should be extended in respect of exposures to related parties by providing the Supervisor more discretion to apply the definition of such parties, deduct from a bank's capital such exposures, or require collateralization of them.</p>
13. Market risks	<p>The resources devoted to market risk in on-site examination should be increased in order to enhance the independent assessment of the reliability of data processing, the adequacy of the models' design and implementation, and the prudence of valuation methodologies.</p> <p>The off-site assessment of bank's exposure to market risks should be disentangled from that of interest-rate risk in the banking book, whether in the framework of the Risk-Based Supervision (risk cards) or that of the SREP</p>
14. Liquidity risk	<p>Current oversight is based on information that is calculated on a solo basis only. The regulatory limits only apply to overall liquidity, and could usefully be extended to breakdown by major currencies, and with a longer time horizon.</p> <p>The adequacy of this oversight is very conditional on the reliability of reported information, which depends itself of banks data processing and assumption-driven internal models. More resources should be devoted to checking the quality of this reported information that not only supports BSD's own oversight but also is said to drive the bank's management of liquidity risk</p>
15. Operational risk	<p>The regulatory framework on the basis of a Basel II-compliant definition of operational risk should be streamlined.</p> <p>This opportunity should be taken to draw more attention of banks and BSD to all sources of operational risk, since current oversight seems too much focused on operational risk relating to information technology (IT) and/or internal control over financial reporting</p>
16. Interest-rate risk in the banking book	<p>A specific regulation should be introduced regarding the treatment of interest-rate risk in the banking book</p> <p>The assessment of this risk should be disentangled from that of market risk in the SREP framework (consider interest-rate risk in the banking book on a stand-alone basis)</p>

Reference Principle	Recommended Action
17. Internal control and audit	<p>The legal and regulatory framework related to internal control and audit could usefully be streamlined.</p> <p>The opportunity of the upcoming revision of this regulatory framework could be taken to fill the gaps in respect of:</p> <ul style="list-style-type: none"> • the organizational structure (segregation of critical functions, such as business origination, payments and settlements, reconciliation) • the scope of the compliance function • the ability of a bank's internal audit to access any outsourced functions.
18. Abuse of financial services	<p>The adequacy of policies and processes that banks have put in place to meet high ethical and professional standards and prevent them from being used for criminal activities should be ensured on a consolidated basis.</p> <p>The new AML/CFT regulation should be adopted and implemented.</p>
19. Supervisory approach	<p>Increased efficiency could be sought in the application of the risk-based supervision program. Elimination of duplicative processes and methods could be considered to streamline the risk-based products that are produced.</p>
20. Supervisory techniques	<p>While the supervisory process can be made more efficient, there is a need to expand the staff so that full implementation of risk-based supervision can be effected. Added staff also would facilitate implementation of Basel II and other important initiatives that have been undertaken.</p>
21. Supervisory reporting	<p>With the full conversion to IFRS under consideration, the authorities should obtain plans and monitor the progress of the banks during the conversion period to ensure that they will be ready for the conversion on the designated date.</p>
22. Accounting and disclosure	<p>The rotation of external auditing firms has been under consideration, but has not been acted upon. Such a requirement could have the benefit of creating some competition in the industry, as there are a minimal number of firms providing these services at present.</p>
23. Corrective and remedial powers of supervisors	<p>The powers granted with respect to supervisory actions under Section 8C of the Ordinance are explicit and prescriptive with respect to the application of supervisory actions. The provision should be amended to enable the Supervisor of Banks to apply supervisory actions commensurate with the deficiencies in the bank.</p> <p>While the Supervisor may take remedial actions against a bank's affiliated companies, and there are various protections in the law against abusive practices, there is no explicit power to ring-fence a bank. A regulation that governs relations with affiliates and the nature and type of intercompany transactions as well should be considered.</p> <p>The authority granted under Section 8D of the Ordinance needs to be expanded and strengthened to afford the Supervisor of Banks with the flexibility to apply an appropriate strategy in the event intervention in a problem bank is warranted.</p>

Reference Principle	Recommended Action
24. Consolidated supervision	A more detailed and operational agreement should be reached with the ISA on the supervisory approach to the securities-related activities housed in nonbank subsidiaries (such as asset management and underwriting).

Authorities' response

26. **The Israeli authorities want to express their appreciation to the IMF and the assessment team for their comprehensive work.** The FSAP has been a useful exercise. The worldwide experience of the IMF and the use of a common methodology have delivered a useful insight into the current state of banking regulation and supervision of the banking sector in Israel.

27. **The authorities welcome the overall assessment that indicates a high level of observance of the BCP in Israel.** Notwithstanding this good result, the developments in the global financial sector, in general, and in the Israeli financial and banking sectors, in particular, continue to call for supervisory actions. The recommendations of the IMF are therefore well received and will be considered carefully by the authorities in their continuous efforts for strengthening supervision.

28. **Generally, the authorities share the views expressed in the assessments of the BCP.** With regard to market risk (CP 13) and interest-rate risk in the banking book (CP 16), the authorities acknowledge the gaps between Israeli regulatory practices in these risk areas and the Basel methodology and accept the recommendations. However, the authorities believe that their practices are effective and commensurate with the low volumes and the characteristic of the activity in the trading books of Israeli banks. It should be emphasized that the BSD covers interest-rate risk, though the coverage does not necessarily differentiate between the banking book and the trading book. The authorities will devote more supervisory attention to market risk and to interest-rate risk through the on-site process, and will issue a regulation specifically concerning interest-rate risk in the banking book.

29. **Furthermore there are a number of recommendations and comments where the authorities would like to respond as follows:**

- CP 1, regarding principle-based approach or rule-based approach; the authorities seek to reach a right balance between these approaches. Experience shows that the principle-based approach is not right in some areas as it leaves too much discretion to the banks. The authorities adopt the principle-based approach in all areas that are suitable to this approach.
- CP 5, regarding investment limitation in non-financial companies; the authorities will consider the recommendation to set a lower regulatory limit on the investment in one such company.

- CP 6, regarding capital adequacy; while authorities agree with the recommendations, they would like to respond that the Supervisor of Banks announced that he will adopt Basel III; even before the formal adoption, BSD required that hybrid instrument should already comply with Basel III. The work on Basel 2.5 is in process. Until now, BSD has preferred not to issue a formal request to a bank to strengthen its capital base following supervisory review of bank's internal assessment. However, following this supervisory review, BSD conducted a dialogue with some banks which resulted in strengthening the capital adequacy of those banks. The authorities feel comfortable from the capital adequacy perspective with the implementation of the standardized approach in pillar I calculation complemented by a rigorous implementation of risk sensitive forward-looking pillar II calculation. In addition, BSD encourages banks to continue their progress in implementing Basel II standards for internal rating systems.
- CPs 10, 11, 23, and 24, regarding intra-group transaction and related parties; the Supervisor is empowered to regulate such transactions. Furthermore, the current regulation and supervision covers these issues adequately, considering other limitations on banking groups' structure and ownership. Nevertheless, the authorities will consider strengthening the regulation in this area including relevant ring-fencing arrangements.
- CP 14, regarding liquidity risk; updating regulation will soon be issued and will refer to the issues raised in the assessment, although most of these issues are already covered by BSD's supervisory practices. In particular, BSD currently examines through the on-site process the quality of the data used by banks for their internal models, and checks their logic through off-site process. Moreover, BSD will devote more resources to the validation of reported data in the liquidity as well as in other areas.
- CP 15, regarding operational risk; shortly after the mission a new regulation concerning operational risk management was issued, implementing the recommendation to streamline the regulatory framework. However, even after issuing the new regulation, other regulations continue to include elements of operational risk due to the nature of these risks, and so will Basel's paper on this issue, as it refers to Basel's other documents. BSD covers various operational risk aspects through off-site and on-site processes. Moreover, staff from the designated operational risk on-site unit will strengthen its participation in other on-site units' examinations in order to cover operational risk aspects of these examinations.
- CP 23, regarding corrective and remedial powers of the Supervisor; the authorities share the assessors' recommendations and comments. The Supervisor operates under very old legislation that clearly needs to be updated to the best practice standards. BSD is in the process of preparing proposals to amend a legal framework for bank

resolution, giving the BOI flexible resolution tools in dealing with banks that have reached a level of significant deterioration but are still solvent.

- CP 24, regarding consolidated supervision; the authorities accept the comments related to securities activities (those performed by asset management and underwriting subsidiaries). BSD will map the existing gaps and will act to close them in cooperation with the Israeli Security Authority.

II. INSURANCE CORE PRINCIPLES

A. Summary

30. **Insurance sector regulation and supervision is generally in line with international standards and stringent** The authorities generally take a pro-active approach to supervision and correcting incipient problems, and regulations are generally up to date. In some areas, the authorities' regulation and practice goes well beyond the standard. The regulation and supervision of the insurance, pension fund, and provident funds is generally of a high standard, but cross-border supervisory cooperation and information-sharing needs to be strengthened. MOUs and regular communication with supervisors of jurisdictions with significant investment in the Israeli insurance sector should be in place. On the same token, communication channels should be established with supervisory agencies where Israeli insurers operate. Policies with regard to group capital adequacy, reinsurance and risk concentration, internal control mechanisms, and risk management systems are not fully articulated, nor are there specific requirements for group-wide reporting, and the holding companies escape adequate supervision.

B. Information and Methodology Used for the Assessment²

31. **This assessment of the Insurance Core Principles (ICPs) was carried out in November 2011 within the framework of the FSAP Update for Israel.** The IAIS Methodology approved earlier in October 2003, together with an IMF/World Bank Template based on this Methodology, was employed in preparing this assessment. The assessment was conducted with regard to the circumstances in place and the practices employed in November 2011.

32. **The assessment is based solely on the laws, regulations, and other supervisory requirements and practices that are in place at the time of assessment.** Ongoing regulatory initiatives are noted by way of additional comments. **The assessment made use of the authorities' self-assessment** and other pertinent information provided, such as relevant laws and regulations and responses to a detailed questionnaire, and detailed discussions with

² The assessment was carried out by Rodolfo Wehrhahn, Technical Assistance Advisor, Financial Sector Oversight Division, Monetary and Capital Markets Division, IMF, and Lawrie Savage, Supervisory Consultant.

the authorities and market participants. The assessors are grateful for the full cooperation extended by all and in particular for the outstanding support provided by authorities.

C. Institutional and Market Structure

33. **Regulation and supervision of the insurance industry in Israel is the responsibility of the Capital Markets, Insurance and Savings Division (CMISD) of the MOF.** The Minister of Finance (Minister) bears the political responsibility for supervisory oversight of the Israeli insurance system. The insurance supervisor is the Commissioner of the CMISD of the MOF. The supervision of insurance companies in Israel is based on Israel insurance law, regulations, circulars and instructions. Legal requirements governing insurance companies originate in particular, in the company law and the insurance law. The principal legislation for the supervision of insurance is The Control of Financial Services (Insurance) Laws 5741-1981.

34. **CMISD oversees 23 insurance companies, 11 “new” pension funds, 18 “old” pension funds, 65 management fund companies, altogether having total assets of almost NIS 1 trillion as at June 30, 2011.** Five large insurance companies account for 90 percent of the insurance premium in the country. Most insurers are composite companies, i.e., they transact both, life and non-life business. All of the “big five” insurers are industry leaders in both life and non-life business. One major insurer is foreign-owned.

35. **The Bachar reform began in mid-2005, forcing banks to divest most non-commercial banking activities, such as in mutual funds and provident funds.** As a result, the non-bank financial sector has grown rapidly, now playing a larger role in credit markets. Managed assets in the long term savings business have been growing at an annual rate of more than 20 percent per annum over the past several years.

36. **Most life insurance sales are with regard to unit linked products, where the purchaser bears the investment risk.** In general, therefore, the life insurance industry tends to have stability of income based on asset management fees. Traditional life insurance products such as term and endowment policies do not constitute a large part of the market.

37. **Non-life insurance accounts for about 50 percent of total premiums, and motor premium makes up about 50 percent of that total.** The latter class of business appears to be marginally profitable, although local accounting practices may have the effect of deferring income recognition and thereby reducing the apparent returns when premiums are growing.

38. **The Israeli insurance sector was hit hard by the financial crisis, but soundness indicators have since recovered.** The Israeli stock market fell by 51 percent, sharply impacting companies’ earnings in 2008. However, the equity markets bounced back much more quickly than most other international markets and by the end of 2009 had actually reached pre-crisis levels. An unanticipated impact of the financial crisis, however, was that a

performance based fee arrangement, common in the Israeli market and applicable to significant blocks of run-off business, gave rise to a drag on life insurers' future earnings.

D. Preconditions for Effective Insurance Supervision

Sound and sustainable macroeconomic policies

39. **Israel has a solid institutional framework supporting the conduct of sound macro-economic policies.** Monetary policy is based on an inflation targeting framework, and the BOI's independence has been recently strengthened following the enactment of the 2010 BOI Law. Budgetary policy too has been strengthened in recent years, with the establishment of a fiscal rule that gives credibility to the authorities' fiscal consolidation plan.

A well-developed public infrastructure

40. **The Israeli legal framework for the financial sector and more generally is comprehensive and regularly updated.** The judicial system, including that for bankruptcy and the enforcement of property rights, is well-developed.

41. **The auditing and accounting rules applicable to financial institutions generally comply with international standards.** Listed companies and most nonbank financial institutions have applied International Financial Reporting Standards (IFRS) since 2008. The Israeli legislative framework with regard to the audit profession requires internal and external auditors to be independent in both fact and appearance. Furthermore, the Companies Law and the Accountants Law assure the independence of external auditors.

42. **The payment and settlement system is reliable and efficient.** The BOI regulates Israel's payment systems. It operates the Zahav system (a real time gross settlement system), which is considered to be secure and fast. The Zahav system is linked to banks' paper-based clearing house (BCH), the automated clearing house (Masav), and the Tel Aviv Stock Exchange (TASE) clearing house.

Effective market discipline

43. **Competition is encouraged and the market is open to foreign participation.** There are no significant non-prudential barriers to entry by domestic or foreign firms.

44. **The corporate governance of financial institutions in Israel is governed by the Companies Law and the Securities Law.** In addition, sectoral legislation has been introduced to regulate the operation of each financial sector.

45. **The basic principles of financial reporting are laid out in the Securities Law.** The law addresses the content of a prospectus, the prohibition against the use of insider information, and the penalties applicable for the breach of the law.

E. Main findings

46. **The review suggests that there is a high degree of compliance with the IAIS Core Principles.**

47. **CMISD exhibits best practices in several areas.** For example, with regard to ICP 14, Preventive and Corrective Measures, the Commissioner can issue instructions on virtually any topic, so that appropriate preventive or corrective measures can be put in place. Also in connection with ICP 26, Information Disclosure and Transparency Toward the Market, the amount of information required to be made public is extremely comprehensive. The Division has made great progress over the last three years in the implementation of a modern supervisory framework for insurance supervision. A risk-based approach is widely demonstrated and a formal insurer risk assessment process is well advanced. Staff members are motivated and have high levels of knowledge. The powers of the Commissioner are very comprehensive, and they are frequently utilized to deal with instances of non-compliance and process improvement within companies.

48. **Supervisory cooperation and information sharing needs to be strengthened in order to attract foreign investors and to facilitate international expansion of local insurers.** It appears that on the domestic front there are reasonable structures in place to make sure that there will be adequate cooperation between Israeli supervisory agencies. However, cross-border information sharing needs to be developed to capture risks that could materialize from overseas. MOUs and regular communication with supervisors of jurisdictions with significant investment in the Israeli insurance sector should be in place. By the same token, communication channels should be established with supervisory agencies wherever Israeli insurers operate. This will allow CMISD to receive early warning signs of events that eventually could impact the financial soundness of the home insurer.

49. **Current regulations provide insufficient tools to supervise groups effectively.** The importance of groups in the Israeli financial sector is a well known fact, as is the complex structure of some of the larger groups. At present, the CMISD does not have formal policies with regard to group capital adequacy, reinsurance and risk concentration, internal control mechanisms and risk management systems, nor are there specific requirements for group wide reporting. Work is already underway to strengthen this aspect of the insurance supervisory system but we recommend that high priority be given to continuing these efforts. This will help to ensure that the supervisor is in a position to know with a high degree of certainty how risks may be developing throughout the ownership groups that include Israeli insurers. The law should be amended to provide CMISD with greater authority to access the holding companies and generally to more closely adhere to international standards relating to group-wide supervision.

50. **The effort to advance supervision and regulation to a level of international best practice needs to be paced with the industry structures.** The large number of positive

reforms introduced in recent years and currently in the pipeline, including preparation for the introduction of Solvency II, represents a burden on the industry sector that could generate operational risk. Supplementing the supervisory staff with seasoned professionals with operational risk backgrounds would place CMISD in a better position to evaluate the operational difficulties and risks that have to be overcome by insurers in responding to new measures. Cost benefit assessment before the introduction of new substantial regulation is recommended.

51. A few additional areas where improvement would be desirable are summarized below:

- Most insurers in the Israeli market are composite companies, i.e., transacting both life and non-life insurance. While the law requires careful separation of the two businesses within a single corporate entity, experience in other countries has demonstrated that when companies have to be liquidated, significant legal problems can arise under the composite company model. It is recommended that the law be changed to prohibit the composite structure and that a plan be put in place to deal with the existing situations, even if there has to be a lengthy period for implementation. An alternative would be to prohibit new composites and to strengthen the law so as to provide greater certainty about separation in the case of liquidation.
- Most insurance agents are employees of agencies that are owned by insurance companies. This can give rise to confusion in the public mind as to where the loyalties of these intermediaries may truly lie, even if the ownership relationship is disclosed. CMISD could consider increasing transparency by requiring changes to the current ownership structure or by requiring changes in the protocols for the labeling of various categories of intermediaries.
- Fraud is an area that CMISD has effectively addressed, but its actions have been limited to the situation of fraudulent activities within an insurance company. Fraudulent action by insurance consumers is common in most countries, resulting in measurably higher costs for the insuring public. We suggest that the laws be amended to require more, and more effective, actions by insurers to limit the cost of insurance claim fraud.

52. Table 3 summarizes the assessment.

Table 3. Israel: Summary of Compliance with the ICPs

Core Principle	Comments
1. Conditions for effective insurance supervision	The supervisory system and the legal system are very well integrated, to the benefit of insurance consumers. While improvements can always be made, conditions for effective supervision seem to be very well established.
2. Supervisory	The objectives of supervision cover prudential and market issues. Detailed

Core Principle	Comments
objectives	<p>objectives are communicated more directly to the public by way of the CMISD web site. These objectives are further broken down into a number of sub-goals, including transparency of products and fairness to the public, accountable institutions and distributors, stable institutions and markets, healthy competition and promoting financial awareness by consumers.</p> <p>The timeliness of the Report has not always been exemplary (the 2010 Report became available only in November of 2011) but the agency says that steps are being taken to improve this situation.</p> <p>Much financial information is readily available to consumers via the CMISD website.</p>
3. Supervisory authority	<p>Although CMISD has significant powers, many of which can be exercised in a relatively unfettered manner, the CMISD is not fully independent in the sense envisioned by the Standards. CMISD is a Division of the MOF, it does not have an independent budget or audited financial statements which could enhance the transparency and flexibility of its operations.</p>
4. Supervisory process	<p>The CMISD has put in place clear and transparent processes with regard to its regulatory framework. The extent to which it makes information available to the insuring public is very good, both through its own web site and by its requirement for insurers to present key information to their clients.</p> <p>In the course of discussion it was evident that, for most insurers in Israel, moral suasion is still an effective supervisory tool. Although the framework seems very comprehensive, the CMISD often finds that it does not have to resort to formal powers: if the supervisor makes it known to the managers or board of an insurer that it thinks changes are required, then that advice will be taken very seriously by the entity concerned.</p> <p>CMISD should, as part of its established internal processes and insofar as possible, conduct a cost/benefit analysis prior to recommending the adoption of new regulations and in judging how rapidly to phase them in.</p> <p>CMISD may want to consider the establishment of working groups with the professional associations of auditors and actuaries. The objective would be to ensure these groups are kept apprised of CMISD interests and concerns with regard to the professions and to encourage mutual solutions to important issues, including the development of professional standards which will enable CMISD to put greater reliance on the input from auditors and actuaries as part of the supervisory framework. From the other side, CMISD would benefit by being better informed of emerging issues for auditors and actuaries and being able to ensure that the professional organizations are taking account of the supervisory perspective.</p> <p>CMISD could also work to place greater reliance for research and other input on the insurance industry itself.</p>

Core Principle	Comments
5. Supervisory cooperation and information sharing	<p>There are no established working relations with relevant international supervisors. This is deemed to be a limitation in the supervision.</p> <p>To ensure that collaboration with foreign supervisors is not overlooked, it is recommended that CMISD include in its various early warning procedures, an internal requirement that when an insurer that is a subsidiary of a foreign insurer reaches a certain level of risk (commonly measured by the company's position with regard to the capital adequacy requirement), the home supervisor will be contacted (1) to advise the home supervisor of the situation and (2) to ascertain the financial condition and soundness of the parent insurer.</p> <p>It is also recommended that CMISD require foreign owned insurers to submit on an annual basis a copy of the supervisory filing that is submitted to the home supervisor.</p>
6. Licensing	<p>The law should be changed so that at least for the future, composite insurers will not be licensed.</p> <p>In the future, CMISD may want to require that business plans be reviewed by an experienced professional such as an actuary or independent auditor, who could attest to the reasonableness of the underlying assumptions and to the fact that in his or her opinion the business plan could reasonably be attained. Such an approach would bring another set of eyes to the review process in support of the review to be carried out by CMISD.</p>
7. Suitability of Persons	<p>For the future, CMISD should seek an amendment of the law to include the independent auditor in the list of entities to which the fit and proper provisions apply.</p>
8. Changes in control and portfolio transfers	<p>In the limited number of situations with changes in control and transfers of business the CMISD has appropriately applied the regulation to protect consumer interests effectively.</p>
9. Corporate governance	<p>The corporate governance requirements, covered by a series of circulars from the Commissioner, are very detailed, but this can sometimes be a disadvantage. When that is the approach taken, it is difficult to come up with a list that is truly exhaustive. It is therefore suggested that when possible, the law should be amended to supplement the detailed listing of requirements with some additional, more general principles for board compliance.</p>
10. Internal Controls	<p>The implementation of recent regulation strengthening internal controls and allocating accountability to the board is welcome. As the companies become more familiar with the new rules, a stronger focus on the supervision of the boards' role in this area should be given. This will become even more relevant with the introduction of Solvency II in 2013.</p>
11. Market	<p>The CMISD conducts sophisticated and thorough market analysis.</p>

Core Principle	Comments
Analysis	
12. Reporting to supervisors	Outsourced activities are currently not subject to CMISD monitoring and we suggest that specifically with regard to core activities of institutions, this area should be monitored more closely.
13. On-site inspection	<p>While this area fully complies with international standards, we think that best practice could in the future include: (1) somewhat greater emphasis on comprehensive company-wide inspections and somewhat less emphasis on the highly targeted inspections that are mainly carried out at present, (2) closer cooperation and information sharing with the independent auditor, (3) holding an exit meeting with insurance company management after the inspection to ensure there have been no miscommunications, prior to commencing work on the Division's report. An additional suggestion is to improve efficiency and effectiveness by reducing the frequency of inspections that use relatively few person days but spread over a number of months, and instead applying most of the person days to a single, more extended visit at the company. Taken together, we think these changes would also help to reduce regulatory burden for industry members.</p>
14. Preventive and corrective measures	<p>The law's general empowerment of the Commissioner to issue any instructions that may be required to safeguard the position of policyholders provides a complete range of possible preventive and corrective measures. In the few cases where it can be argued that more specific powers are required (such as a requirement to increase the capital base of an insurer) there are plans to modify the law to include the desirable power. In addition, the assessors were provided with a number of recent examples to demonstrate that the preventive and corrective powers are actually being utilized to protect policyholders and members of the public.</p> <p>When possible, the law should be amended to allow CMISD to demand additional capital at any time the Commissioner believes that such action is necessary to protect the interests of policyholders.</p> <p>CMISD is working to develop a formal ladder of intervention which will include control levels that can trigger various types of intervention (i.e., preventive and corrective measures), escalating as an insurer's position becomes more serious. At present, with no general ability to require capital increases, and a lack of formally stipulated intervention measures related to overall financial viability, the agency is not able to exercise defined strategies that can be applied on a market-wide basis. The introduction of a ladder of intervention will also ensure greater consistency in the supervisory process and make the process much more transparent to market participants.</p>
15. Enforcement or sanction	<p>In light of the extensive powers granted to the Commissioner, the requirement to report annually to the Ministry of Justice is an important control instrument.</p> <p>For minor breaches of compliance, rather than imposing fines, companies are normally required to correct their procedures. For serious offences, significant</p>

Core Principle	Comments
	<p>finances can be levied; depending on the circumstances, they may include personal fines to officers and directors. These approaches help to reinforce a risk based approach to supervision. (See also ICP 23.)</p>
<p>16. Winding-up or exit from the market</p>	<p>The law takes account of the special nature of insurance contracts and the insurer's obligations to policyholders. Thus, policyholders rank ahead of other creditors and within the range of policyholder claimants, varying preferences are able to be established. Taken together, these provisions ensure that as far as practical there will be limited disruption to the provision of benefits to policyholders.</p> <p>The last insurance company wind-up was in 1991. Although the large market share of this failed insurer was over 30 percent, policyholders did not lose money and policies continued without interruption with other insurers.</p> <p>Notwithstanding the above, it should be borne in mind that some insurance companies belong to (nonfinancial) conglomerates. If such a conglomerate got into serious financial difficulties, its resolution may be complex and protracted. Hence, it may be useful to consider introducing amendments to legislation explicitly allowing the ring fencing of insurance companies belonging to a conglomerate that is being resolved. (See also ICP 15).</p>
<p>17. Group-wide supervision</p>	<p>There are reasonable arguments why group wide supervision may be of less significance in Israel than is the case in many other markets. Nevertheless, one cannot know with any certainty that the issue of group interconnectedness will not suddenly become important in a particular case. At present there are a number of the Essential Criteria that are not satisfied with regard to this ICP. It appears that the situation will be rectified in the relatively near future as new laws and regulations are put in place to facilitate the Solvency II regime. However, there should be some level of supervisory authority with regard to holding companies, at least to the extent of providing CMISD with detailed financial and ownership information.</p> <p>It is suggested that in the future, CMISD require each of its supervised institutions to file a complete organizational chart for the group, showing every entity controlled by the institution's controlling shareholder, including both direct and indirect interests. This should form a part of the information that is sworn to by the company's signing officers in the affidavit that accompanies the filing. The receipt of this annual document would provide CMISD with an authoritative source for all corporate inter-relationships and would help it to more effectively pursue the principles of group-wide supervision.</p>
<p>18. Risk assessment and management</p>	<p>The focus on the role of the board will need further intensity as Solvency II is introduced.</p> <p>One of the Essential Criteria requires that the risk management policies and risk control systems be appropriate to the complexity, size and nature of the insurer's business. In a number of the circulars on different subjects there is specific provision for reduced scope of application for small companies. However, the circular with regard to the functions of the chief risk officer (CRO) does not seem to</p>

Core Principle	Comments
	include any such differentiation. This could be remedied at a future date.
19. Insurance activity	The quality of reinsurance is monitored not only through rating but also using other sources of information. The concentration and counterparty risks call for risk capital charges. The exposure to the reinsures as well as the total exposure of each reinsurer to the market is followed and recommendations can be issued to address excesses.
20. Liabilities	<p>The use of Liability Adequacy Testing (LAT) to assess the level of liabilities is a positive initiative. However, the parameters and methodology needs to be defined and not freely left to the criteria of the companies that might use insufficient or inadequate methods. The LTS products that allow for a variable commission in dependence of the performance of the investments is and example where a liability provision for the adverse performance of the investments was missing.</p> <p>Although CMISD works closely with most of the life insurers using various stress testing methodologies, there is no legal requirement for companies to stress test their balance sheets under different economic scenarios. This should be remedied at a future date.</p>
21. Investments	The introduction of prudent person supervisory approach in tandem with a clear accountability of the board and the requirements of setting up a professional investment committee is a positive development.
22. Derivatives and similar commitments	Taking into consideration the current level of development of the derivatives market in Israel, a conservative supervisory approach is recommended. The current tight limitation of the use of derivatives for hedging purposes should be kept under review as the market develops.
23. Capital adequacy and solvency	<p>The current solvency regime is an enhanced Solvency I regime that has some risk sensitive elements, like market consistent valuation of assets, market risk, reinsurance credit risk and concentration risk charges for example. However, calibration of the risks still needs attention.</p> <p>Stress testing needs further development and the introduction of standardized stress testing as well as technical provision stress testing is recommended.</p> <p>With the introduction of Solvency II planned for 2013, the full observance of this principle will be achieved.</p> <p>CMISD is working to develop a formal ladder of intervention which will include control levels that can trigger various types of intervention (i.e., preventive and corrective measures), escalating as an insurer's position becomes more serious. At present, with no general ability to require capital increases, and a lack of formally stipulated intervention measures related to overall financial viability, the agency is not able to exercise defined strategies that can be applied on a market-wide basis. The introduction of a ladder of intervention will also ensure greater consistency in the supervisory process and make the process much more</p>

Core Principle	Comments
	transparent to market participants.
24. Inter- mediaries	<p>For agents owned by insurance groups, transparency in the interests represented should be enhanced. One approach to providing the insuring public with greater clarity regarding the interests of intermediaries, would be to require that consumers give “informed consent” when dealing with agents that are owned by an insurer and recommending a product that is underwritten by that insurer. More generally, CMISD could consider increasing transparency by requiring changes to the current ownership structure or by requiring changes in the protocols for the labeling of various categories of intermediaries.</p>
25. Consumer Protection	<p>Consumer protection provisions are generally strong. A cooling off period for products sold under pressure, such as direct sales and credit card or loan linked products, should be introduced.</p> <p>As best practice in the dealing with consumer complaints we suggest that the relevant circular be amended in future to include the following refinements:</p> <p>Board to appoint internal ombudsman who is a senior officer of the company;</p> <p>All claimants notified of contact details for internal ombudsman when claim information is received by insurer, plus clearly shown on company web site;</p> <p>Complainants to first approach insurer with complaint details. Insurer has fixed period to resolve (say up to 30 days);</p> <p>If not possible to resolve within that period, insurer provides insured with “final position letter” explaining why insurer is not prepared to resolve to consumer’s satisfaction, plus notice of contact details for complaint to CMISD.</p> <p>Then, if contacted, CMISD investigates, offers mediation service along with other services offered at present.</p> <p>Final resolution can be to the court system</p>
26. Information, disclosure and transparency towards markets	The amount of information required to be made public is very comprehensive.
27. Fraud	<p>Steps should be taken as soon as possible to deal in the law with consumer claim fraud. This should include the clear labeling of insurance consumer fraud as a criminal offence and should require boards of directors to put in place policies with regard to measures intended to detect and reduce claim fraud. In most countries over-stated claim filings, phony claims and similar misconduct, adds considerably to the cost of insurance, which must be borne by all policyholders.</p> <p>Consideration should be given to providing for more extensive use of industry data bases to detect insurance fraud, similar to the system that has been developed in</p>

Core Principle	Comments
	connection with the Motor Bodily Injury product, with due regard for confidentiality.
28. Anti-money-laundering, combating the financing of terrorism	Anti-money-laundering, combating the financing of terrorism (AML/CFT) provisions and practice are generally of a high standard. A new regulation to complete and harmonize the regulatory framework was in the process of being issued at the time of the assessment.

F. Recommended Action Plan and Authorities' Response

53. **The following recommendations (Table 4) aim to suggest measures to further improve insurance supervision and regulation.**

Table 4. Israel: Recommendations to Improve Observance of the ICPs

Core Principle	Recommendation
ICP 2 – Supervisory objectives	The time lag to publication of the Annual Report should be reduced.
ICP 3 – The supervisory authority	Consider an independent budget for the CMISD or audited financial statements which could enhance the transparency of its operations.
ICP 4 – Supervisory Process	<p>CMISD should, as part of its established internal processes, conduct a cost/benefit analysis prior to recommending the adoption of significant new regulations.</p> <p>CMISD could work to make greater reliance for research and other input on the insurance industry itself. Many jurisdictions have found that the establishment of industry/supervisory working groups, coordinated through the industry association, can have powerful benefits by increasing the knowledge base of the supervisor when addressing important industry issues.</p>
ICP 5 – Supervisory collaboration and info sharing	<p>A stronger working relationship with relevant international supervisors should be established.</p> <p>It is recommended that CMISD includes in its various early warning procedures, an internal requirement to communicate with international supervisors given certain conditions.</p> <p>It is recommended also that CMISD require foreign-owned insurers to submit on an annual basis a copy of the supervisory filing that is submitted to the home supervisor.</p>
ICP 6 – Licensing	<p>The law should be changed so that, at least for the future, composite insurers will not be licensed.</p> <p>Additional protection would be afforded investors in unit linked funds by</p>

	requiring as a condition of licensing, formal segregation of assets by having them held by the insurer “in trust” for the investors.
ICP 7 -- Suitability of persons	The law should be amended to include the independent auditor in the list of entities to which the fit and proper provisions apply.
ICP 9 - Corporate governance	An over-arching requirement of duty, skill and care should be implemented.
ICP 12 – Reporting to the supervisor and off-site monitoring	Regulation to more closely monitor outsourced providers should be introduced.
ICP 13 - On-site inspection	<p>The frequency of comprehensive inspections should be increased. Cooperation and information sharing with the independent auditor should be enhanced. An exit meeting with insurance company management after the inspection should be held, to ensure there have been no miscommunications, prior to commencing work on the Division’s report.</p> <p>The frequency of inspections that use relatively few person days but spread over a number of months should be reduced, applying most of the person days to a single, more extended visit at the company.</p>
ICP 14 - Preventive and Corrective Measures	<p>Regulation that allows for a formal ladder of intervention should be introduced.</p> <p>The law should be amended so that, as a corrective measure, additional capital can be required at any time the supervisor deems it necessary, rather than only during the initial five years of operation.</p>
16 Winding-up or exit from the market	It may be useful to consider introducing amendments to legislation explicitly allowing the ring fencing of insurance companies belonging to a conglomerate that is being resolved.
ICP 17 - Group-Wide Supervision	<p>Regulation should be included to allow at least basic supervision of the holding companies of insurance companies.</p> <p>It is suggested that in the future, CMISD should require each of its supervised institutions to file a complete organizational chart for the group, showing every entity controlled by the institution’s controlling shareholder, including both direct and indirect interests.</p>
ICP 18 - Risk assessment and management	<p>The focus on the role of the board will need to intensify as Solvency II is introduced.</p> <p>Proportionality principle should also apply to the CRO requirements.</p>
ICP 20 – Liabilities	Standards on the use of LAT should be developed and introduced.
ICP 22 – Derivatives and similar commitments	The current tight limitation of the use of derivatives for hedging purposes should be kept under review as the market develops.

ICP 23 - Capital adequacy and solvency	Solvency II, adapted to Israel, should be introduced. Stress testing should be developed further, and standardized stress testing by companies as well as technical provision stress testing should be introduced.
ICP 24 – Intermediaries	To provide the insuring public with greater clarity regarding the interests of intermediaries, consumers should provide “informed consent” when dealing with agents that are owned by an insurer and recommending a product that is underwritten by that insurer. With informed consent, the consumer signs a document indicating knowledge and understanding of the relationship between the agent and the insurer. In general, consider (1) changes to the current ownership structure, or (2) more clearly defined intermediary naming protocols (i.e., whether an agent mainly represents one insurer, with ownership or sponsorship ties to that insurer; broker represents more than one insurer but with no ownership or sponsorship connection), all to achieve greater market transparency. Standards regarding service levels to clients should be implemented vigorously.
ICP 25 - Consumer Protection	Introduce a cooling off period for products sold under pressure, such as health insurance and credit card or loan linked products, should be introduced. Insurers should be made more directly responsible for their products and actions by assigning them the initial responsibility for dealing with complaints; the CMISD would handle complaints which cannot be resolved by the insurers.
ICP 27 - Insurance fraud	Regulation to require boards of directors to put in place policies with regard to measures intended to detect and reduce claim fraud should be introduced. In keeping with best international practice, consideration should be given to providing for more extensive use of industry data bases to detect insurance fraud, similar to the system that has been developed in connection with the Motor Bodily Injury product, with due regard for confidentiality.
ICP 28 – AML, CFT	The new regulation should be adopted and implemented.

Authorities’ response

54. We would like to express our most sincere thanks for your efforts as the entire CMISD staff has found the FSAP process highly beneficial. Consequently, we expect the review to expedite ongoing development efforts and to be useful in designing future regulation and supervision processes. We have found the IMF staff's comments comprehensive and knowledgeable, and would like to thank them for their intensive efforts and for the detailed and thoughtful report.

55. In general the CMISD agrees with the assessment. We would like, however, to clarify or to add comments on some specific points in the report:

- ICP 5 – Supervisory collaboration and information sharing: The CMISD works to improve supervisory cooperation and information sharing with counterparties. In particular the CMISD is already in the process of signing MOU's and joining the MMOU with foreign counterparties, and this year's work plan calls for the completion of the process within 2012.
- ICP 6 – Licensing: The CMISD is examining ring-fencing existing life insurance assets to enhance their protection according to the IMF-FSAP recommendations. Additionally, the CMISD is considering necessary changes to the law to allow full separation of life and non-life business in new insurance companies.
- ICP 12 - Reporting to the supervisor and off-site monitoring: The CMISD will release later this year outsourcing guidelines that, *inter alia*, will reflect the IMF-FSAP recommendations.
- ICP 17 - Group-Wide Supervision: The CMISD is aware of the necessity to improve its group supervision regulation. This issue will be dealt with as part of the adoption of Solvency II regulatory paradigm as the CMISD is waiting for a publication of global supervisory standards in this matter.
- ICP 23 - Capital adequacy and solvency: The CMISD is finalizing its regulatory procedures based on international standard and principles of Solvency II.
- ICP 24 – Intermediaries: The CMISD intends to improve transparency in pension and insurance distribution through strengthening the Advice Law and improving the information provided to pension savers.

III. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. Summary

56. **The overall level of compliance with the IOSCO principles is high. The regulatory regime is well developed and in most respects is comparable to that in major jurisdictions.** For the most part, it is compliant with international standards, and regulation, and oversight by the Israel Securities Authority (ISA) is robust and effective. There remains a significant gap in the regulation of broker-dealers. Two points are notable in that regard:

- broker-dealer activity can be undertaken without falling within the regulatory framework, if the activity neither involves membership of the stock exchange or the provision of advice services to retail clients, nor a licensed bank; and
- certain over-the-counter (OTC) derivatives activity, including the sale of products to retail investors, can take place outside the regulatory regime.

B. Information and Methodology Used for the Assessment³

57. **The assessment of the IOSCO Objectives and Principles of Securities Regulation was conducted in November 2011 within the framework of Financial Sector Assessment Program Update for Israel.** A previous assessment was undertaken in 2001, since when a number of regulatory and market developments have changed the regulatory framework significantly. It should be noted that the assessment takes place against a background of continuing change in the legislative framework and the regulatory environment for securities regulation.

58. **The assessors relied on number of sources in carrying out the assessment, including:** a review of the relevant legislation, a self-assessment and other material prepared by staff of the ISA, detailed discussions with the staff of the ISA and other regulatory authorities, a range of market participants and representative bodies, and other experts in the securities market in Israel. The assessors thank the staff of the authorities for their participation in the process and for their comprehensive self-assessment. Staff of the ISA was particularly generous in making themselves available for discussions that were helpful and frank, and in providing requested information and copies of the relevant legislative and regulatory texts.

59. **The assessment was conducted based on the IOSCO Objectives and Principles of Securities Regulation and the associated methodology adopted in 2003, as updated in 2008.**⁴ An assessment of Principle 30, which deals with securities settlement systems, was not carried out as part of this assessment. A review (but not a formal assessment) of Israel's clearing and settlement system was carried out as part of the overall FSAP assessment.

60. **During the assessment, the new principles adopted by IOSCO and published in June 2010 were also discussed.** Discussions about them were informal and not part of the assessment. Those discussions are reflected in this report.

C. Institutional Structure and Market Structure

Institutional structure

61. **The ISA is an independent agency responsible for the regulation of the securities sector, including exchange markets, capital markets, mutual funds, portfolio managers and advisers and marketers of securities.** Moreover, the Supervisor of Banks, located

³ The assessment was undertaken by Mr. Malcolm Rodgers (former Executive Director and Acting Commissioner of the Australian Securities and Investments Commission).

⁴ A new IOSCO methodology (including methodology for the assessment of new principles) was adopted in September 2011 but was not used for the current assessment.

within the BOI is responsible for regulation of banks and banking groups; the Capital Markets, Investment and Savings Division (CMISD), located within the MOF and responsible for regulation of insurance, and the retirement savings sector (pension and provident funds). In addition, the competition authority has broad responsibility for anti-trust issues, including in the financial sector.

62. **The Tel Aviv Stock Exchange (TASE) plays a significant role as a self-regulatory organization (SRO).** It has responsibility for the authorization (licensing) of stock exchange members, and for the supervision of their obligations under TASE rules and regulations. It also supervises trading activity on exchange markets, although the ISA has direct responsibility for detecting and responding to insider trading and other forms of market abuse.

63. **Given the role played by banks in Israel's securities market, it should be noted that a bank active in the securities market is subject to regulation by three different authorities:**

- prudential (stability) and consumer protection regulation by the Supervisor of Banks. This supervision is on a group-wide basis and extends to the subsidiaries of banks;
- direct regulation by the ISA in respect of insider trading and other forms of market abuse such as market manipulation. Banks that issue equities or debt, or engage in underwriting, takeover or merger activity, are also regulated by the ISA in respect of these capital market activities; and
- regulation by TASE (under the overall supervision of the ISA) in respect of compliance with TASE rules and regulations.

64. **TASE is the only exchange market in Israel.** It has a well-developed equities market with over 600 issuers, a corporate bond market with over 250 issuers, a government debt market, a derivatives market (dominated by trading in 2 option products, the TA-25 and the NIS/USD foreign exchange), and an institutional trading platform for debt securities that have not been publicly offered. TASE has 29 members, 15 of which are banks (including 3 foreign banks) and 14 nonbanks. Banks dominate brokerage activity on TASE markets, accounting for two thirds of all equity trading, 74 percent of bond trading and over 80 percent of derivatives trading.

Recent developments

65. **The Israel securities markets have undergone very significant change in recent years.** These changes and reforms fall under two broad headings, which are sometimes interrelated:

- changes flowing from the development of new products and activities. In particular, the corporate bond expanded about ten-fold as a share of GDP between 2004 and

2007, and was the sector of Israel's financial system experiencing the most significant impact from the global financial crisis; and

- changes brought about by major changes in policy which have had an impact on the structure of the securities markets. As a consequence of the financial crisis, additional reforms and regulations have been enacted, particularly impacting portfolio management and the bankruptcy process.

66. **The mutual fund and long-term savings industry has undergone extensive structural change over the past decade.** As a result of the Bachar reform, banks were forced to divest their holdings in mutual fund management firms. The transition period was short and in practice most of the divestment took place within the first year following ratification of the Bachar Law.

67. **Rapid growth occurred in a number of other product areas.** These include:

- the market for exchange traded notes (ETNs), which has grown rapidly since 2006. At the end of 2010, there were 437 ETN series (up from 133 in 2006);
- portfolio management activities, in which portfolios are managed for individual investors on a discretionary basis, have more than doubled since 2005. At the end of 2010, NIS 242 billion was managed in this way, up from NIS 103 billion in 2005.

68. **The mutual fund industry has undergone extensive structural change over the past decade.** Consolidation and competition marked the industry, precipitated by both the Bachar reform and the emergence of the Exchange Traded Note (ETN) market.

D. Preconditions for Effective Securities Regulation

69. **The general preconditions for effective regulation of securities markets appear to be in place in Israel.** The legal, accounting and audit systems supports the implementation of requirements and effective regulation of market participants. The commercial law is modern, as are corporate governance standards. The regulator has legally enforceable powers. The macro-economic environment has been positive over the last several years. The Israeli legal framework for the financial sector is comprehensive and regularly updated.

E. Main Findings

70. **Principles for the regulator (Principles 1–5): Within an overall framework organized regulation along institutional lines, the securities regulator works under a clear mandate, with its responsibilities and powers established by legislation.** The ISA has a high degree of operational independence, although some powers of a regulatory character are reserved for the minister of finance. A notable gap in the regulatory framework is the lack of coverage of broker-dealer activity that does not involve TASE membership or

the provision of advice services to retail clients; and some OTC derivatives activity (the issue is relevant to a lesser extent with regards to TASE member banks, which are supervised by the BOI). In addition, regulation of OTC derivatives activity, including the sale of products to retail investors, can take place outside the regulatory regime. Responsibility for supervision of the conduct of business obligations of members of the stock exchange is split between the TASE (for nonbank members) and the supervisor of banks (for bank members), with the securities regulator not having a direct role in this area, except for advice giving and marketing activities.

71. **Principles for self-regulation (Principles 6–7):** The TASE plays a significant role as an SRO, with responsibility for authorizing and supervising its members (which are not required to be licensed by the ISA), as well as supervising the conduct of its markets and clearing and settlement activities. Bank members of TASE are also regulated by the supervisor of banks, who is responsible for prudential supervision and the conduct of business obligations of bank members. Regulation of insider trading and other forms of market abuse is done directly by the ISA. TASE has adequate powers to supervise its members and markets, including powers to impose a range of disciplinary sanctions. The ISA has broad powers to supervise TASE's compliance with its responsibilities, although it has limited powers to act against members of the exchange except where they also hold an ISA license, unless market abuse is involved.

72. **Principles for enforcement (Principles 8–10):** The ISA has extensive and appropriate powers to obtain information and records, and can exercise these powers on a routine basis to ensure compliance with the laws it administers. Regulated entities are subject to detailed record keeping and retention requirements, including records relating to the identity of clients and records that enable the tracing of funds and securities. The ISA has responsibility for administering anti-money laundering and combating the financing of terrorism legislation in relation to portfolio managers and nonbank members of TASE. It has comprehensive powers to investigate both administrative and criminal violations of securities laws.

73. **Principles for cooperation (Principles 11–13):** Major changes have occurred in this area since the 2001 assessment. The ISA has power to share information both domestically and internationally on matters relating to its regulatory functions, including its investigative and enforcement activities. Concerning domestic cooperation, the authorities will need to continue to work towards enhanced exchange of information and analysis in the context of the development of a macroprudential framework. A precondition for sharing information internationally is the existence of a Memorandum of Understanding (MOU) with the relevant regulator. Government approval is required, but readily given for the signing of such MOUs.

74. **Principles for issuers (Principles 14–16):** Issues to the public of equity and debt securities require a prospectus approved by the ISA. Disclosure requirements for prospectuses are in line with IOSCO principles.⁵ Issuers submit annual and quarterly reports, and immediate reports about material developments. Financial statements must be prepared in accordance with IFRS (other than banks who must comply with standards set by the BOI). Auditors that conduct statutory audits are subject to the oversight of a registration authority and the relevant professional body. The framework requires that auditors be independent. Changes in control transactions are required to comply with disclosure requirements and obligations to treat shareholders equally.

75. **Principles for collective investment schemes (Principles 17–20):** Collective investment schemes (CIS) are subject to licensing by the ISA. The regulatory system sets eligibility standards, including integrity standards. The ISA does not currently have the power to examine the adequacy of internal management procedures at the time of licensing. Managers are subject to minimum capital requirements, and insurance requirements. All CIS must have a trustee who holds fund assets and supervises the actions of the manager. There are clear rules governing the legal form and structure of CIS. The ISA carries out a systematic program of on-site and off-site inspections. CIS must have a prospectus that complies with IOSCO Principles. Detailed rules apply to valuation of assets (including assets for which a market price is not readily available), and the pricing of units, and there is full transparency about these issues.

76. **Principles for intermediaries (Principles 21–24):** The ISA licenses portfolio managers, advisers and marketers of securities. The TASE authorizes its members. Potentially significant activity that does not fall within either of these two categories remains unregulated (including broker-dealer activity and OTC derivatives activities). For the entities it licenses, the ISA has power to ensure that minimum criteria are met. Licensees are subject to comprehensive ongoing requirements, and the ISA is systematic and active in monitoring compliance with these obligations. TASE licensees are subject to an authorization process. TASE supervision is focused primarily on nonbank members and their compliance with capital standards and systems that interact with exchange systems. Responsibility for supervising bank members' dealings with their clients rests with the supervisor of banks. Minimum capital and insurance standards apply to ISA licensees (though it does not address risks from outside the regulated firm), and risk based capital standards apply to nonbank members of TASE. . Capital standards for TASE members allow long term unsubordinated debt to count as capital; which is out of line with common international practice.

77. **Principles for secondary markets (Principles 25–30):** TASE is the only secondary market in Israel, and operates both securities and derivatives markets, and (through two

⁵ However, the 2006 “shelf prospectus” provision allows rapid issuance of a prospectus, which in practice may reduce the ability of underwriters to conduct a thorough analysis.

subsidiaries) clearing and settlement facilities for each type of market. It holds a license issued by the minister of finance and is subject to the supervision of the ISA, which has extensive powers to ensure TASE acts in accordance with regulatory requirements. Market participants are supervised by TASE and (for banks) the BOI.

78. **The following table summarizes the assessment:**

Table 5. Israel: Summary Implementation of the IOSCO Principles

Principle	Findings
Principle 1. The responsibilities of the regulator should be clearly and objectively stated.	<p>The responsibilities of the ISA and TASE are clearly established by law. The mandate is also well understood by market participants. Arrangements for cooperation and information sharing between the financial sector regulators exist, but there may be a need for further effort to ensure they work fully effectively in practice.</p> <p>A notable gap in the regulatory framework is the lack of coverage of broker-dealer activity that does not involve TASE membership or the provision of advice services to retail clients; and some over-the-counter (OTC) derivatives activity (the issue is relevant to a lesser extent with regards to TASE members banks, which are supervised by the BOI).</p>
Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.	<p>The ISA has a high degree of operational independence, although some powers of a regulatory character are reserved for the minister of finance, and the minister has control over staffing levels.</p> <p>The level of accountability to the government, parliament, and the public is high. Decisions of the regulator are required to be transparent and are amenable to judicial review, and the ISA is subject to comprehensive rules relating to procedural fairness.</p>
Principle 3. The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers.	The ISA has adequate powers and resources to carry out its regulatory functions, and has rulemaking authority, although this is time limited in one area.
Principle 4. The regulator should adopt clear and consistent regulatory processes.	The ISA has clear and consistent regulatory processes, and operates in a transparent way.
Principle 5. The staff of the regulator should observe the highest professional standards.	ISA members and staff are subject to integrity policies that ensure high standards of professional conduct and compliance with these standards is monitored effectively.
Principle 6 The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and to the extent	The TASE plays a significant role as an SRO, and members of the TASE do not require to be licensed by the ISA unless they engage in advisory or marketing activities.

Principle	Findings
appropriate to the size and complexity of the markets.	
Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	TASE is subject to regulatory oversight by the ISA. Its rulemaking requires approval and the ISA has an active oversight presence. TASE has the attributes required of an SRO and is bound by standards appropriate for a professional regulatory body. Its regulatory decisions are subject to judicial review.
Principle 8. The regulator should have comprehensive inspection, investigation and surveillance powers.	The ISA has comprehensive information gathering, inspection and surveillance powers. Regulated entities are subject to extensive record keeping and retention requirements.
Principle 9. The regulator should have comprehensive enforcement powers.	The ISA has extensive evidence gathering and other investigative and enforcement powers. Criminal sanctions are available for serious violations. Until recently, the ISA had only limited ability to impose sanctions for non-criminal violations, but it now has new powers (not yet fully operative), through an Administrative Enforcement Committee, to impose a broad range of sanctions.
Principle 10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and enforcement powers and implementation of an effective compliance program.	The ISA has a credible and effective supervisory and enforcement program. It is an active regulator and carries out well planned programs of supervision that include on-site and off-site reviews of regulated entities. It is also active in investigating and taking enforcement action for breaches of the legislation it administers.
Principle 11. The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.	The ISA has power to share information both domestically and internationally on matters relating to its regulatory functions, including its investigative and enforcement activities. It can share both public and non-public information with a minimum of procedural restrictions.
Principle 12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	<p>The ISA has domestic information sharing arrangements with other financial sector regulators.</p> <p>It is also a full signatory to the IOSCO multilateral MOU and has signed multiple MOUs with foreign counterparts.</p> <p>There is good evidence that these arrangements are working in practice.</p>
Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of	The ISA can provide effective and timely assistance to foreign regulators to assist them in their regulatory and enforcement activities. With one exception, the ISA does not have to have an independent interest in a matter on which a foreign regulator seeks assistance, or for the conduct being investigated to be a breach of law in Israel.

Principle	Findings
their powers.	
Principle 14. There should be full, timely, and accurate disclosure of financial results and other information that is material to investors' decisions.	Public issuers are subject to comprehensive disclosure requirements, including prospectus disclosure and annual, quarterly and immediate reporting requirements. Financial statements are prepared in accordance with IFRS. Strict rules apply to the timing of disclosures and reports. Preparers of disclosure documents and reports are required to take responsibility for them.
Principle 15. Holders of securities in a company should be treated in a fair and equitable manner.	There is a strong regulatory framework that requires fair treatment of securities holders. The Companies Law and the Securities Law facilitate shareholder decision making and protect the rights of minority shareholders, especially in groups with controlling shareholders. Takeovers and other change of control transactions are regulated to ensure equal treatment and full disclosure,
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality.	Israel has adopted IFRS in full and financial statements are of international quality. Audit standards appear to comply with international standards though they are not yet fully aligned with them. Auditors are subject to tight independence rules.
Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.	CIS are subject to authorization standards and ISA licensing. The ISA does not currently have the power to examine the adequacy of internal management procedures at the time of licensing. Managers are subject to minimum capital requirements, and insurance requirements. The ISA carries out a systematic program of on-site and off-site inspections.
Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	All CIS must have a trustee who holds fund assets and supervises the actions of the manager. There are clear rules governing the legal form and structure of CIS. Client assets are protected through their being held by a trustee.
Principle 19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	CIS must have a prospectus that complies with IOSCO Principles. The ISA approves prospectuses and has power to hold back or intervene if there is inadequate disclosure. CIS are also subject to regular reporting requirements, and their accounts must be prepared in accordance with Israeli GAAP.
Principle 20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme.	Detailed rules apply to valuation of assets (including assets for which a market price is not readily available), and the pricing of units, and there is full transparency about these issues.

Principle	Findings
Principle 21. Regulation should provide for minimum entry standards for market intermediaries.	Not all intermediaries are subject to an authorization process (see under Principle 1). Entities that are licensed are subject a minimum entry standards and subject to ongoing obligations. For entities it licenses, the ISA has comprehensive powers. TASE has similar powers with respect to its members. Advisers are fully regulated. The ISA has a systematic and active monitoring and compliance program for licensed entities.
Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	Licensed entities are subject to limited initial capital requirements. Nonbank members of TASE are subject to a full risk weighted capital regimes. ISA licensees must hold insurance designed to enable them to compensate investors. The capital requirements set for ISA licensees do not address risks from outside the regulated entity, though this is unlikely to give rise to serious problems given the nature of these licensees' activities. Unusually, long-term non-subordinated debt can count towards capital for TASE members (although in practice use of secondary capital is very limited).
Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.	Standards for internal organization and operational conduct apply to both ISA licensees and TASE members. For ISA licensees the requirement for an independent periodic evaluation of large portfolio managers' internal controls and risk management processes, while recently legislated for, is not yet implemented.
Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	Adequate procedures exist for dealing with the failure of a licensed intermediary or a TASE member. Insurance is available in the case of ISA licensees.
Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	TASE is the only secondary market in Israel, and operates both securities and derivatives markets, and (through two subsidiaries) clearing and settlement facilities for each type of market. It holds a license issued by the minister of finance and is subject to the supervision of the ISA, which has extensive powers to ensure TASE acts in accordance with regulatory requirements. Market participants are supervised by TASE and (for banks) the BOI.
Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair	The ISA is closely involved in TASE decision making processes and maintains an effective supervision program.

Principle	Findings
and equitable rules that strike an appropriate balance between the demands of different market participants.	
Principle 27. Regulation should promote transparency of trading.	Trading on TASE's markets is appropriately transparent.
Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	All forms of market abuse are prohibited by the Securities Law. The ISA has direct responsibility for detecting insider trading and other forms of market abuse. It uses an impressive technological system to assist it to detect all forms of market abuse.
Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	The management of large exposures, default risk and market disruption is achieved through the rules of TASE and its clearing houses.
Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	Not assessed. See CPSS assessment.

F. Recommended Action Plan and Authorities' Response

79. **The following recommendations aim to suggest measures to further improve securities regulation framework and supervision.**

Table 6. Israel: Recommended Action Plan to Improve Compliance with the IOSCO Principles

Reference Principle	Recommended Action
Principle 1. The responsibilities of the regulator should be clearly and objectively stated.	The authorities should work fast to close the gap in the regulatory framework that permits broker-dealer activity and OTC derivatives activity to take place outside the regulatory regime.
Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.	The ISA should receive the power to examine the adequacy of internal management procedures at the time of licensing.
Principle 21. Regulation should provide for minimum entry standards for market intermediaries.	The authorities should make sure that all intermediaries are subject to an authorization process (see under Principle 1).
Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	Consideration should be given to excluding long-term non-subordinated debt count from capital of TASE members.

Authorities' response

80. **The ISA would like to thank the IMF's staff for all their efforts and for their professional and hard work in Israel.** We have found the reports and comments provided to us very comprehensive and helpful, and the exchange of views as a useful and efficient process.

81. **The regulation of broker-dealer activity received high priority at the ISA.** The ISA has established an internal working group dedicated to examine and propose a legislative framework to regulate the broker-dealer activity in Israel. This process will be closely coordinated with the BOI.

82. **It should be emphasized that notwithstanding the differentiation between TASE member categories, all TASE members are currently subject to TASE rules pertaining**

to conduct towards customers, disciplinary violations, and compliance with TASE enforcement and with the general provisions pertaining to member obligations towards TASE.

83. **According to the data the ISA has, most of the OTC derivatives activity is performed in trading platforms within the banks.** The exposure of retail clients to OTC derivatives is limited by law, and their indirect exposure is also low (mutual funds are prohibited from investing in OTC derivatives, however ETNs are not).

84. **The ISA currently acts to extend liability of underwriters.** In addition to what was stated in the IOSCO Detailed Assessment, the amendment proposed by the ISA, if approved, will impose a mandatory duty to have an underwriter in every public offering, for the purpose of external due diligence.

85. **As to the comment of the assessor that the capital requirements set for ISA licensees do not address risks from outside the regulated entity (principle 22), the ISA believes that due to the specific regulation of these licensees, there is no need in changing the capital requirements and impose unnecessary burden on the industry.**

G. New IOSCO Principles

86. **In June 2010, IOSCO reviewed its Principles; 9 new Principles were added and one Principle removed (Principle 6).** Assessment of Israel's compliance with IOSCO Principles was against the old Principles and used the old methodology. However, brief discussions were held on the 'state of readiness' to implement the new Principles, using an analysis prepared by the Israeli authorities. A summary of each is below.

Table 7. Israel: Summary Implementation of New IOSCO Principles

Principle	Findings
<p>Systemic risk monitoring and perimeter of regulation:</p> <p>New Principle 6: The Regulator should have or contribute to a process to monitor, mitigate, and manage systemic risk, appropriate to its mandate.</p> <p>New Principle 7: The Regulator should have or contribute to a process to review the perimeter of regulation, appropriate to regularly.</p>	<p>A forum for cooperation on systemic risk issues has been set up. The forum was established at the instigation of the BOI and includes the Governor of the BOI, the ISA Chairman, and the Chairman of and Commission of Capital Markets Its mandate is the formulation of methods, measures and indicators for the timely identification of systemic risks related to the activity of the various financial entities, markets, instruments and the financial system; the articulation of measures to manage and minimize systemic risks, and to analyze their impact; the definition of the required data and indicators; the consideration of alternative courses of action to address crisis situations, and the analysis and assessment of the consequences of these alternatives.</p> <p>The forum has begun to meet and will continue to meet regularly.</p>

<p>Conflicts of interest:</p> <p>New Principle 8: The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.</p>	<p>A significant portion of ISA regulatory action is focused on the prevention (if possible), disclosure and management of conflicts of interest and misalignment of incentives.</p> <p>Regarding securitization, since, to date, securitization has not played any significant role in the Israeli market, particular problems associated with the securitization process have not arisen.</p>
<p>Auditor oversight:</p> <p>New Principle 19: Auditors should be subject to adequate levels of oversight.</p> <p>New Principle 20: Auditors should be independent of the issuing entity they audit.</p> <p>New Principle 21: Audit standards should be of a high and internationally acceptable quality.</p>	<p>The new Principles expand on Principle 16, accounting and auditing standards. The assessment here of Principle 16 implies that the elements of the new Principles are largely in place. In addition, to address perceived inefficiencies in the current regulatory framework, the ISA proposes to establish an appropriate institutional framework for the development and implementation of auditing standards, auditor independence, ethical conduct, quality assurance, and enforcement.</p>
<p>Credit rating agencies (CRAs):</p> <p>New Principle 22: CRAs should be subject to adequate levels of oversight. The regulatory system should ensure that CRAs whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.</p>	<p>A company applying to receive approval as a rating agency must file a written application to the Commissioner of Capital Markets (CMISD) and if approved must:</p> <ol style="list-style-type: none"> a. engage only in the rating of corporate debt, unless it receives the Commissioner's advance written approval to engage in another activity. In deciding whether to give such approval, the Commissioner considers whether the additional activity is liable to create conflicts of interest with the credit rating activities of the company; b. operate under know-how, guidance and support agreement with a recognized foreign credit rating agency for a period of at least five years. <p>Under this regime, other rules set out in circulars issued by the CMISD apply, including rules about ownership, liquid asset requirements, confidentiality, publication of ratings, governance, and the methodology used for rating (including use of a ratings committee).</p> <p>A new legislative proposal is being developed that would bring regulation and enforcement of rating agency activity under the authority of the ISA. The proposal covers transparency, independence, conflicts of interest and accountability issues and be similar in intent, scope and implementation to regulation in Europe and the US.</p>
<p>Analysts: New Principle 23:</p> <p>Other entities that offer investors</p>	<p>The current regulation of analytical research services is based on the concept that an analytical report expresses a position and often a recommendation regarding a certain investment, and taken to be</p>

analytical or evaluative services should be subject to oversight and regulation appropriate to the impact of their activities have on the market or the degree to which the regulatory system relies on them.	investment advice under the definition of the Investment Advice Law. Therefore, and subject to the exceptions stipulated in the Law, analysts are required to be licensed and are subject to most of the legal obligations set out in the Law.
Hedge Funds: New Principle 28: regulation should ensure that hedge funds and/or hedge fund managers/advisers are subject to appropriate oversight.	There is no specific regime for hedge funds in Israel but the Mutual Funds Law recognizes them as a possible investment category for mutual funds. However, in practice, Israeli mutual funds do not invest in hedge funds, and overall institutional investment in hedge funds is very small.

IV. CPSS CORE PRINCIPLES OF SYSTEMICALLY IMPORTANT PAYMENTS SYSTEMS

A. Summary

87. **The introduction in 2007 of a real time gross settlement high-value payment system, Zahav, and the enactment of a Payment Systems Law in 2008 and the BOI Law in 2010 were crucial steps in establishing a modern, robust payments system.** The challenge now is to complete development of oversight of the payment system, some aspects of the system's risk management and collateral arrangements, business continuity arrangements, and the pricing of services. There is a need to ensure that the multilateral net settlement systems that settle in Zahav benefit from the full protection of the law, and that the net settlement systems have suitable loss sharing agreements. The BOI needs to better define conditions for the provision of emergency liquidity assistance, including to elements of the payments system.

B. Information and Methodology Used for Assessment⁶

88. **The assessment of the CPSIPS was conducted in November 2011 within the framework of Financial Sector Assessment Program Update for Israel.** Zahav was assessed against the CPSS Core Principles on the basis of a review of an extensive list of documents provided by the BOI, which included a thorough and transparent self-assessment, the rules of Zahav, its participation agreements, pledge and other agreements, business continuity plans and risk assessments. Cooperation with the assessment was complete and open. Discussions were also held with participants of Zahav, including the foreign currency settlement system (CLS), which settles in Zahav the shekel side of foreign exchange trades settled by CLS. The main laws supporting the Israeli legal framework were reviewed, in

⁶ The assessment was carried out by Christopher Mann, an external technical expert in payments and settlement systems.

conjunction with IMF Legal Department and discussions with legal counsels where appropriate. Presentations were received from market participants and other bodies, such as the Israeli Securities Authority (ISA).

89. **The Israeli Securities Settlement System, which is the Tel Aviv Stock Exchange Clearing House (TASE-CH), was not been formally assessed as part of this FSAP; nor has it been subject to a self-assessment.** Nevertheless, some ancillary investigations were carried out in order to better understand potential risks to Zahav stemming from it. This was true also for the Masav (direct debit and credit automatic clearing house (ACH) plus card company settlement) and the BOI-owned and operated paper-based clearing house (BCH).

90. **The Zahav system was implemented in 2007 and the Payment Systems Law, which provides protection for the real time finality offered by Zahav, shortly afterward.** The Payment Systems Law provides the legal underpinnings for central bank payment system oversight, which has been recognized in the new legislation for the BOI, which came into effect in 2010. As a result, the setting up of a separate payment systems oversight function in the BOI, which was previously carried out within the ambit of banking supervision and subsequently in the Comptroller's Office, is still in progress; the project is scheduled to be completed in 2013. As a result, the "Responsibilities of the Central Bank in Applying the Core Principles for SIPS" have not been formally assessed. Nevertheless, some observations are made and recommendations offered in this key area; where issues arose elsewhere that were relevant to the creation of that function, they have been noted. The authorities are encouraged to move forward with the setting up of oversight, and to consider seeking a full assessment once it is complete, or is nearing completion.

C. Institutional and Market Structure

91. **The main financial institutions are banks and insurance companies; there is a large and active market in shares, corporate bonds, and government bonds; savers have available a variety of pension, provident, and mutual funds.** The BOI supervises banks and is responsible for payments system oversight. The ISA oversees the securities sector, while the Commissioner of Capital Markets, Insurance, and Savings (CCMIS) at the MOF mainly deals with the insurance and pension sector. The Tel Aviv Stock Exchange (TASE) has some supervisory responsibilities for its members.

92. **The general preconditions for effective regulation and reliable operation of the payments system appear to be in place in Israel.** The macro-economic environment has been positive over the last several years. The overall legal, accounting and audit systems are well developed. The commercial law is modern, as are corporate governance standards. The Israeli legal framework for the financial sector is comprehensive.

93. **Zahav is the only real time gross settlement (RTGS) system in Israel.** Four payment systems participate in the Zahav system: the Stock Exchange Clearing Houses (the Maof Clearinghouse and the Securities Clearinghouse), the Bank Settlement Center (Masav)

(an ACH), the BCH, and the CLS system. In addition to the BOI, the Postal Company, CLS Banks, and the 15 commercial banks are direct participants, either as online or offline participants.

94. **In 2010, a new law came into effect for the BOI (“the BOI Law”).** Among other changes, it followed up the requirements on the central bank enshrined in the 2008 Payments Systems Law. The 2008 Payment Systems Law established the oversight function of the BOI and provided for the finality and irrevocability rules applicable to payment systems; the new BOI Law requires, more widely, the BOI to “regulate the payment and settlement systems in the economy, with the goal of ensuring their efficiency and stability, including in accordance with the Payment Systems Law.” The Payments System Law specifically excludes the multilateral net payment system embedded in the TASE-CH and includes an indirect amendment to the Securities Law in consequence of which the ISA has responsibility for the oversight of TASE-CH according to principles which reflect those in the Payment Systems Law. There is a MOU between the BOI and the ISA covering coordination between them. Together with the creation of the Zahav system, and as part of the reform in the payment and settlement systems, the BOI also introduced a series of other changes and improvements into the existing payments systems, in order to bring them into line with accepted international standards.

D. Main Findings

95. **The following table (Table 8) summarizes the main findings:**

Table 8. Israel: Summary of Observance of the CPSS CPSIPS—Zahav

Core Principle/ Responsibility	Comments
Legal foundation	
CP I – The system should have a well-founded legal basis under all relevant jurisdictions	<p>In its current drafting, the legal framework governing the Israeli Payment System encompasses almost all of the building blocks necessary in order to meet the requirement of legal soundness. Nevertheless, some steps might be taken to widen its scope in order to cover the full range of issues needed to make it fully robust.</p> <p>Regarding the participation of foreign participants, specific imperative rules would appropriately be enacted to capture the legal risks associated with the possible implementation of foreign laws, especially if the latter do not provide for the same level of protection of Payment Systems.</p> <p>It would be useful to make explicit the equivalent protection available to TASE-CH in respect of its multilateral net settlement by changing paragraph 2 (a) of the Payment Systems Law.</p> <p>It is recommended that the Israeli Legislator considers enacting a general</p>

Core Principle/ Responsibility	Comments
	legal framework that would capture all collateral arrangements in the form of a pledge or a repo. Such law would facilitate the creation, enforcement and enforceability of all collateral arrangements entered into between financial institutions.
Understanding and management of risks	
CP II – The system’s rules and procedures should enable participants to have a clear understanding of the system’s impact on each of the financial risks they incur through participation in it.	<p>The Zahav Rules deal with a wide variety of legal, business and operational issues and include all the information required for the activity of participants in the Zahav system, in both normal and emergency situations. The system rules are updated at least annually.</p> <p>The rules of the Zahav system and the appendixes and ancillary documents are clear, complete and up-to-date and cover the full range of issues, including legal, operational and business issues. The information is clear and accessible to participants.</p>
CP III – The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.	<p>Settlement in Zahav is RTGS, with finality at the point of debit and credits—which are locked together—across payer’s and receiver’s settlement account in Zahav. In all circumstances, participants incur no credit (or liquidity) risk in the system. Settlement is final and subject to legal protection against the operation of insolvency laws.</p> <p>The system is currently awash with liquidity. As a result, there is little need for banks to use each other to manage their liquidity and the development of a, for example secured, interbank market may take some time just when it is needed at some point in the future when liquidity is less plentiful.</p> <p>Some modeling of the minimum amount of liquidity needed to enable all payments in Zahav to settle in a day would help identify a possible requirement for ‘start up’ liquidity to be placed on participants, again against the possibly tighter liquidity conditions in the future.</p> <p>The BOI might review the basis on which it provides emergency liquidity to TASE-CH against outright purchase of pledged assets to ensure risk is borne in the right quarter.</p> <p>The Banking Supervisor may wish to consider the size and management of intraday credit limits offered by direct participants to their customers, to ensure they neither act as a constraint on the smooth flow of payments to the system nor represent a source of instability by being too generous.</p>
Settlement	
CP IV – The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.	Zahav is an RTGS system, with finality protected by Law. Operating hours are long. Any unsettled payment orders sitting in the system at the close are cancelled and have to be resubmitted the following day.

Core Principle/ Responsibility	Comments
CP V – A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation	Does not apply.
CP VI – Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.	Settlement in Zahav takes place across participants' accounts in the books of BOI (Zahav accounts are liabilities of the central bank).
Operational reliability and efficiency	
CP VII – The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing	<p>The BOI has detailed and comprehensive business continuity plans for the Zahav System and its related systems, which are tested regularly. However, further work is required to integrate these plans and tests into an overall business continuity vision.</p> <p>In general, high quality business continuity arrangements are a critical part of any SIPS, and especially so for Israel. Establishing an agreed overall definition of what the optimal contingency arrangements should look like across all stakeholders, a ladder of increasingly demanding tests capable of delivering that state, a timetable for the achievement of each rung on the ladder and the allocation of the resources needed for a successful outcome should be given a high priority.</p> <p>The BOI is (unavoidably) vulnerable to its use of a third party supplier of the Zahav application software, for example, regarding the depth of expertise at its supplier and how widely that is held.</p> <p>A set of Internal Control Objectives should be drawn up with a view to their ultimate assessment to international standards for systems and controls.</p>

Core Principle/ Responsibility	Comments
CP VIII – The system should provide a means of making payments, which is practical for its users and efficient for the economy.	<p>Zahav is reliable and efficient. It provides the means for making high value payments, for the final settlement of multilateral net settlement systems, for the shekel leg of foreign currency deals settled in CLS and for central bank and government business.</p> <p>The central bank is encouraged to continue with the identification of all dedicated and shared costs of Zahav, to facilitate the review of the policy for the present not to recover any costs from some participants. This will enable investment decisions to be made in full knowledge of their financial impact and ensure the most efficient running of the system, balancing the needs of both the benefits to the wider economy, the participants, and the central bank as user, owner and operator.</p>
Access and governance	
CP IX – The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.	<p>Any financial sector institution is eligible for Zahav membership and not just those who make and receive payments. This has been used to enable TASE-CH to open an account to facilitate emergency procedures, for example, should collateral pledged to it need to be realized. Certain exemptions have been provided to CLS to enable its special requirements to be accommodated.</p> <p>Consideration could be given to extracting the high level membership and eligibility requirements in a general statement, which can be posted to the website and made publicly available.</p> <p>Membership of Zahav by nonbanks raises the question of conditions under which they may receive for emergency liquidity assistance from the BOI (The issue is addressed in the accompanying Financial System Stability Assessment).</p>
CP X – The system's governance arrangements should be effective, accountable and transparent.	<p>As noted against CP VIII, the arrangements would be more effective, accountable and transparent if the fully allocated costs were available. This would provide a benchmark against which strategic decisions can be taken by all parties, for example via the National Payments Council, about developments and future investments and as a means of management accountability for managing costs. Sharing the breakdown of costs with users, for example by staff, floor space, third party charges, information technology charges, and so on would provide a transparent method for an effective challenge process. This would be expected by users if they were asked to begin meeting a share of the costs in the future.</p>
Central bank responsibilities	

Core Principle/ Responsibility	Comments
Responsibility A – The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.	A specific payment system oversight function is in the process of being created, following the decision to make declarations in respect of various payment systems under the Payment Systems Law of 2008 and the new powers given to the BOI under the BOI Law 2010. The project is due to finish in 2013. Any review of this function would be premature and has not been conducted. This critical function needs to build itself up to full strength with all possible haste as it has a large amount of work to do if it is to be fully functional by 2013.
Responsibility B – The central bank should ensure that the systems it operates comply with the core principles	A specific payment system oversight function is in the process of being created, following the decision to designate various payment systems under the Payment Systems Law of 2008 and the new powers given to the BOI under the BOI Law 2010. The project is due to finish in 2013. Any review of this function would be premature and has not been conducted.
Responsibility C – The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.	Permission is given by the Payment Systems Act 2008 for the Governor to exempt a system from Central Bank oversight and this has been exercised in respect of CLS; and oversight of the TASE-CH multilateral net payment system has specifically been made the responsibility of the ISA. There exists an MOU between the BOI and the ISA covering their cooperation in this regard.
Responsibility D – The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.	Not assessed.

E. Recommended Action Plan and Authorities' Response

Recommended action plan

96. The following recommendations (Table 9) aim to further improve the operation and security of the payments system.

Table 9. Israel: Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs—Zahav

Reference Principle/ Responsibility	Recommended Action (Sequencing)
Legal foundation	
<i>CP I - Sound legal basis</i>	Cover foreign law risk—24 months Unify legal framework for the full range of eligible collateral—24 months Complete declarations for Masav and BCH—6 months Explore strengthening of finality in General Ledger settlement —36 months Make explicit the equivalent protection available to TASE-CH in respect of its multilateral net settlement by changing — 24 months
Understanding and management of risks	
<i>CPs II-III – Clear Rules and management of risks</i>	Encourage readiness of interbank market—12 months Model start-up liquidity in Zahav—12 months Consider “throughput” limits--6 months Review provision of BOI ELA to elements of the payment system—12 months Review support arrangements for TASE-CH—12 months Redesign Masav/BCH Loss sharing Agreement and modalities for its mobilization—12 months Review prudential liquidity requirements in light of liquidity use in Zahav—12 months
Settlement	
<i>CPs IV – VI Prompt settlement, use of central bank money</i>	None
Security and operational reliability, and contingency arrangements	
<i>CP VII – secure, reliable, adequate contingency arrangements</i>	Define optimal arrangements, test their working—24 months Integrate risk management—12–24 months Draw up internal control objectives and prove them—36 months
Efficiency and practicality of the system	
<i>CP VIII – practical and efficient</i>	Review strategy on pricing and make costs transparent—24 months
Criteria for participation	
<i>CP IX – fair and open access</i>	Make eligibility criteria publically available—12 months
Governance of the payment system	

Reference Principle/ Responsibility	Recommended Action (Sequencing)
CP X	Build and integrate Zahav business model and ensure minimum central bank subsidy—36 months
Central Bank Responsibilities in applying the CPs	
<i>Responsibilities A-D</i>	Apply Payment Systems Law to systems for which a declaration has yet to be made; get oversight fully operational, with highest priority, and suitably organized; make approach, principles and objectives publicly available—12–24 months

Authorities' response

97. We would like to express our appreciation to the IMF and the assessment team for their comprehensive report, and we welcome the recommendations for the Zahav (RTGS) system. The BOI has learned from the FSAP process, and we believe that it will contribute to the stability of Israel's financial system infrastructure in general, and to the stability of the Zahav system in particular. We are in the process of establishing an oversight function that will oversee the payment and settlement systems in Israel, and expect the process to be completed in 2013. We are confident that the recommendations of the IMF will assist the oversight team in its work.

98. As part of the evaluation of the Zahav system, recommendations were also made regarding other systems, such as the Paper-based Clearing House, Masav, and the Tel Aviv Stock Exchange Clearing Houses. We will be undertaking a detailed review of these issues as well and will adopt any changes necessary.

99. The BOI's response to the detailed recommendations follows:

CP1: The BOI will thoroughly study all the recommendations for amending the Payment Systems Law and other legal topics. After the necessity to accept the suggested recommendations is determined, the Bank will act toward their implementation. It should be emphasized that changes of this type require long periods of time for implementation. The General Ledger system serves as the last resort in the event of an application failure in the Zahav system. This is not a near real time automated system but rather a system that works in batches at the end of the day. Furthermore it does not include all the settlement mechanisms that exist in the Israeli RTGS system. Therefore it does not ensure final settlement at the end of the batch process.

CP3: We will examine and weigh the various issues raised in the recommendations and will implement any changes as needed. Please note that the Zahav system has a variety of tools that enable participants to manage liquidity, as well as tools that allow the BOI to regulate the transactions in the system during the day, such as variable pricing over the course of the day. We will ensure that the participants will be familiar with the liquidity

management tools that exist in the Zahav system along with the practical ways in which they can be used.

As is recommended, we will consider the size and management of intraday credit limits offered by direct participants to their customers. We will study what has been done in other countries in this area and will work to ensure that the implementation of the recommendation does not increase liquidity risk in the system.

CP7: The BOI has already begun implementing the main recommendations in this Principle.

A review and evaluation of all the controls—including, among other things, their quality, effectiveness and integration in the Zahav system—is carried out periodically by Internal Audit, in accordance with up-to-date and generally accepted standards and methodologies.

CP8: The BOI prepared a pricing module that includes all the activities of the Bank, and specifically the RTGS operation activities. The pricing module will be used as a basis for a justified pricing tariff when we change our current pricing policy.

CP9: We accept the recommendation and will work to implement it.

CP10: We accept the recommendation in principle. If, for example, we decide to collect hardware replacement costs from the participants, then we will proceed to implementing it.