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TECHNICAL ASSISTANCE REPORT— CONSULTATIONS ON THE WORK OF THE BANKING SUPERVISION DEPARTMENT OF THE BANK OF ISRAEL

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CONSULTATIONS ON THE WORK OF THE BANKING SUPERVISION DEPARTMENT OF THE BANK OF ISRAEL

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Contents **Page**

GLOSSARY

BCP	Basel Core Principles for Effective Banking Supervision
BoI	Bank of Israel
BSD	Banking Supervision Department
ECB	European Central Bank
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GDP	Gross domestic product
IMF	International Monetary Fund
IT	Information technology
KRIs	Key risk indicators
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
OECD	Organization for Economic Co-operation and Development
SME	Small- and Medium-sized enterprise
SREP	Supervisory review and evaluation process

PREFACE

At the request of the Bank of Israel (BoI), a technical assistance mission visited Jerusalem during April 4–14, 2016. The mission discussed issues related to the effectiveness and efficiency of the Banking Supervision Department (BSD), and the overall environment for the conduct of banking supervision. The mission was led by Antonio Pancorbo (MCM), and included Joaquín Gutiérrez (former Banco de España) and John Laker (former Australian Regulation Prudential Authority).

The mission met with Governor Karnit Flug, Dr. Hedva Ber, the Supervisor of Banks, and senior officials of the BoI. The mission also met with senior officials of the Ministry of Finance (MoF), members of the joint MoF-BoI Committee on Increasing Competition in the Banking and Financial Services (the Strum Committee), as well as senior executives from the major banks and other third parties. This report presents the mission's assessment and main recommendations.

The mission wishes to express its appreciation for the authorities' collaboration, hospitality, and openness during the discussions. The mission would also like to thank market participants and other stakeholders who generously shared their time and insights. The mission expresses its gratitude to Mr. Herman Litman, Advisor to the Supervisor of Banks, for his dedication in facilitating the work of the mission.

EXECUTIVE SUMMARY

Banking supervision in Israel follows a very rigorous and comprehensive approach. Supervisory practice at the BSD of the BoI parallels and at times exceeds in many respects the standard practices observed in other developed countries, both in the scope of regulation and the intensity and depth of risk assessments. This explains the success of the BoI in maintaining financial stability during the global financial crisis and has resulted in substantial benefits to the Israeli economy and its society as a whole. In a difficult geopolitical environment, the BSD continues to be a critical contributor to the promotion of financial stability in Israel.

The BSD follows a conservative and cautious supervisory engagement model, predicated on a low tolerance for bank failure. Regulations are demanding in terms of entry requirements and prior approval processes (some related to conformity with global standards), and ongoing supervision is intensive. However, it faces resourcing pressures. The cost of compliance appears to be relatively high. The mission commends BSD's current efforts to update and prioritize the regulatory framework to reduce regulatory burdens and facilitate competition and innovation.

Notwithstanding the robustness of the regulatory framework and the high quality and rigor of the BSD's supervisory approach, the mission sees opportunities to streamline the current engagement model. A key first step would be a fuller articulation of the BSD's risk appetite, in the form of a *Risk Appetite Statement*. Giving this statement operational content would guide the prioritization of risk issues and the related allocation of supervisory resources, thereby enhancing the BSD's risk-focused strategic objectives. It would also support a productive engagement with banks' boards and senior management, without compromising the BSD's robust assessment of banks' risk management and capital levels. In addition, the mission provided technical suggestions on actions that may assist the BSD in becoming more forward-looking and resource-efficient, and recommendations on dealing with current staffing pressures.

The mission was conducted against the backdrop of considerable political pressure on the BSD in the discharge of its prudential responsibilities. In addition, some of the proposals, as discussed in this report, of the joint MoF-BoI Committee on Increasing Competition in the Banking and Financial Services (the Strum Committee), if enacted, could affect the financial system in ways that would be potentially destabilizing and have called into question the role of the BSD in supervising nonbank credit institutions. The centerpiece of the reforms is the separation of two credit card companies from the two largest banks and the possible separation of the third card company from its two mid-sized bank owners. This is intended to address the problem of bank inefficiencies and lack of contestability in the small- and medium-sized enterprises (SMEs) and consumer lending markets in Israel. However, separation of all three card companies could, in the short term, make a significant dent in the profitability (and competitive muscle) of the mid-sized Israeli banks, and lead to higher retail interest rates and fees. Over time, the reforms could generate a "race to the bottom" form of competition through lower lending standards.

Leaving the supervision of the newly created credit card companies with the BSD, which the Strum Committee recommends, would ensure that the stability implications of the reforms will be carefully managed without compromising competition objectives. The mission strongly supports this particular recommendation. It would guarantee continuity of high-quality supervision but, more importantly, would preserve the close and effective working relationship between the BSD and the monetary policy and payments departments of the BoI, which has been fundamental to financial stability in Israel.

The Strum Committee proposals are complex and their implementation has not yet been fully planned. They involve not just the sale of credit card businesses, but also changes in the ownership structure of the clearing and settlement infrastructure, the establishment of a bank deposit insurance scheme, and the introduction of a resolution regime. A separate initiative will see the establishment of a new Capital Markets, Insurance and Savings Authority. Implementation of the various reforms will make considerable demands on the resources of the BSD, which are already stretched, and will obviously distract from its ongoing prudential responsibilities. It will be important that, whatever final form they take, the reforms are sensibly staged and take full account of their potential implications for macroeconomic policy settings and financial stability in Israel.

Table 1 below summarizes the main recommendations of the mission and provides cross-references to the parts of the report where such recommendations are elaborated.

Table 1. Main Recommendations

Main Recommendations	Priority/ Time frame[1]
The authorities should take the steps necessary to ensure that the BSD's operational independence as part of the BoI is respected (paragraphs 10–13).	High/ Immediate
The BoI, through its representatives, should ensure that the Strum Committee's proposals to reform the banking system are based on timely data, including cross-country comparisons, and rigorous cost-benefit analysis (paragraph 20).	High/ Immediate
Develop a *Risk Appetite Statement* to give operational content to the BSD's low tolerance for bank failure (paragraph 42).	High/ Medium term
Finalize the streamlining of regulations to open the way for bank activities, competition and innovation, without compromising stability (paragraph 39).	High/ Medium term
Enhance the scope of risks covered in the risk cards (paragraphs 43–45).	Medium/ Medium term
Enhance the forward-looking approach of the SREP (paragraphs 46–49).	Medium/ Medium term
Address workload and staff skill requirements through additional specialists in key risk areas and access to mid-career professionals (paragraphs 51–52).	Medium/ Immediate
Update the management information system (paragraphs 53–54).	Medium/ Medium term

[1]"Immediate" is within six months; "Medium-term" is six months to three years.

I. INTRODUCTION

1. **The Israeli banking system is in sound financial condition, having weathered the global financial crisis without serious mishap**.[1] Israeli banks seem to be conservatively managed and are well capitalized, with good asset quality and consistent profitability. Returns on equity are around OECD averages.[2] However, cost-to-income ratios are relatively high and there is room for the Israeli banking industry to improve its efficiency.[3] Even though loan loss provisioning ratios are currently very low, the banks' level of exposure to the booming Israeli housing market, through mortgage lending and credit to the construction and real estate industry, is seen as a major source of systemic risk.

2. **The Israeli banking system is highly concentrated and has long been characterized by lack of contestability (the existence of a credible "competitive threat" regardless of the number of participants).** Five locally owned banking groups account for around 95 percent of banking system assets and the two largest groups for over 60 percent of assets. Concentration is higher than in other advanced economies.[4] No new banks of substance have entered the retail banking system in Israel for almost half a century. The banking groups focus on traditional banking business in Israel and have only limited cross-border operations; from 2005, banks were required to divest most non-commercial financial activities such as mutual funds, insurance, and pension funds. Concerns about the lack of contestability in SME and consumer lending and about banking efficiency have prompted a series of official inquiries into competition in the Israeli banking system. The Strum Committee, which is currently finalizing its recommendations, is the latest in this series of inquiries. Its recommendations are discussed in Section III below.

[1] Total assets of the Israeli banking system were about US$356 billion as of the end of 2014, representing approximately 116.5 percent of GDP. The structure of the Israeli banking system is discussed in Chapter 1 of BoI's "Israel's Banking System - Annual Survey, 2014":
www.boi.org.il/en/NewsAndPublications/RegularPublications/Pages/skira14.aspx

[2] As of December 2015, banks reported Core Tier 1 and total regulatory capital ratios of 9.2 percent and 14.2 percent, respectively (up from 7.6 percent and 13.6 percent at the end of 2010). BSD regulations only allow the standardized approaches of the Basel capital framework. Banks reported a conservative risk-weighted to total assets ratio of 74.1 percent. The net loans-to-deposit ratio stood at a prudent level of 86.5 percent, with low levels of more than 90 days past due (2.2 percent) and problem loans (3.7 percent). Coverage of problem loans with provisions stood at 64.7 percent, with a low annual cost of credit losses of 15 basis points.

[3] As in many advanced economies, Israeli banks face a growing challenge to their business models in a scenario of low interest rates and high operational costs. Cost-to-income ratios averaged around 70.2 percent between 2012–2014 due, *inter alia*, to high headcount (averaging 39 staff per branch) and low coverage of operational expenses with fees (47.6 percent). As a consequence, pre-provision profits have continued to narrow, reaching 94 basis points on average assets at the end of 2014, including low provisioning costs (11 basis points on average assets). Due to recoveries of extraordinary charge-offs in 2011, net provisions represent only 11 percent of the reported pre-provision profits at the end of 2014.

[4] For example, see Figure 1.8 of Chapter 1 in "Israel's Banking System - Annual Survey, 2014" mentioned in footnote 1 above.

3. **The rest of this report is structured as follows**: Section II presents selected features of the BSD, paying special attention to its supervisory risk tolerance and operational independence; Section III discusses the current policy debate between stability and competition and how it might affect the BSD's statutory responsibilities; finally, Section IV evaluates the BSD's supervisory engagement model and makes recommendations to support a more forward-looking and resource-efficient supervisory approach, without compromising the high quality and rigor of supervision already achieved.

II. SELECTED FEATURES OF THE BANKING SUPERVISION DEPARTMENT

A. Overall Framework

4. **Financial supervision responsibilities in Israel are shared among several agencies.** The BSD, fully integrated into the BoI, supervises the seven locally owned banking groups operating in Israel. It also supervises four foreign branches and a subsidiary of a foreign bank, which have only limited (mainly wholesale) activities. The BoI is also responsible for payments system oversight. The Commissioner of Capital Markets, Insurance and Savings, currently under the MoF but in the process of becoming a stand-alone regulatory authority, deals mainly with the insurance and pension sector. The Israel Securities Authority oversees the securities sector while the Tel Aviv Stock Exchange has some supervisory responsibilities for its members.

5. **The BSD has a high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCP).** Banking regulations are detailed and prescriptive, with prior approvals required in a number of areas, and banking supervision is comprehensive and intensive. Since the 2012 BCP assessment,[5] the BSD has taken actions to implement its key recommendations, such as introducing prudential requirements for market and interest rate risks, and it has implemented the core elements of the Basel III regime. The BSD is considering the adoption of a recovery and resolution regime, consistent with the Key Attributes promoted by the FSB,[6] and has begun consultations with the MoF on the adoption of a bank deposit insurance scheme recommended in the Strum Committee's Interim Report.

6. **The mission welcomes progress in the establishment of a Financial Stability Committee.** The 2012 FSAP Update mission recommended a strengthening of the institutional framework for macroprudential oversight and policy setting by the formal establishment of such a committee. Agreement to do so was reached just ahead of arrival of the mission, and relevant legislation is being prepared. The new 10-member committee will allow for information exchange among its member institutions, viz. the BoI, MoF, and the other national regulatory authorities. The BoI Governor will be the chair and in this capacity will set the agenda; the MoF representative will be deputy chair. The committee will not be the mechanism for coordination in times of crisis, nor will it have responsibilities for competition in the financial system.

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[5] The IMF conducted a detailed assessment of the Basel Core Principles as part of the 2012 FSAP Update mission to Israel, see: https://www.imf.org/external/pubs/ft/scr/2012/cr1285.pdf.

[6] There are still no formal plans to perform an assessment of compliance with the FSB's Key Attributes.

B. Supervisory Stance and Risk Appetite

7. **The BSD has a conservative and cautious supervisory engagement model, predicated on a low tolerance to the failure of individual banks.** The BSD considers the five largest banks of systemic importance, and that the failure of any of the two smaller banks would severely diminish public trust in the stability of the Israeli banking system. Reflecting earlier banking crises in Israel and ongoing geopolitical tensions, the BSD pursues a mandate that gives priority to financial stability by mitigating major risks to the system. The BSD's supervisory stance also reflects the small size of the banking system in Israel and the absence, to date, of resolution tools and deposit insurance.

8. **Nonetheless, as part of its current strategic plan, the BSD is taking a number of initiatives to facilitate greater competition and efficiency in the banking system without compromising its safety and soundness objectives**. These initiatives include a simplification of some regulatory and supervisory requirements; a relaxation of entry requirements and a tailored regulatory regime for credit card companies converting to banks and for new *merchant acquirers*; and an active leadership role in addressing inefficiencies in the banking system, due in part to high and inflexible labor costs**.**

9. **The BSD's supervisory stance and risk appetite have been instrumental in developing a range of operational strengths, yet the approach is resource intensive.** As discussed in Section IV, these strengths include a robust Supervisory Review and Evaluation Process (SREP) that draws on inputs from all divisions within the BSD; a close working relationship between off-site and on-site staff to give a "four eyes" view on emerging risks; comprehensive assessments of specific risks; skilled and dedicated staff, often having many years of experience; and considerable interaction with bank boards and senior management. At the same time, the lack of a clearly articulated risk appetite for BSD has contributed to the development of a resource-intensive supervisory approach. Pressures on staff are rising, with no relief in sight.

C. Operational Independence

10. **It is of paramount importance that the BSD continues to enjoy its traditional degree of *de jure* and *de facto* independence.** The BoI has a clear mandate for the safety and soundness of the Israeli banking system, administers a comprehensive set of banking laws and regulations, and carries considerable authority and public standing. The objectives and priorities for the BSD are determined by the Supervisor of Banks subject to the approval of the Governor, and the Supervisor of Banks is accountable only to the Governor for the performance of BSD under an annual working plan. Against this background, changes in the relationship with the government are now threatening to undermine the operational independence and authority of the BSD in the discharge of its prudential mandate.

11. **The 2012 FSAP Update expressed concerns about the influence of the MoF on the salary scale of BoI employees**. Salary scales for new hires have been brought into line with those of Government employees, constraining the ability of the BSD to compete with the private

sector and other parts of the public sector for the right skill sets to fulfill its supervisory functions.[7] This influence was a major factor in the "Largely Compliant" rating on independence in the 2012 BCP assessment.

12. **Two more recent developments are cause for additional concern**. The first is the increasing attempts of the MoF to intrude into the prudential policy and supervisory decisions of the BSD, especially in the context of banking reform proposals. Coordination with the MoF is to be expected while the details of comprehensive reforms are being finalized, but the BSD must operate independently from the MoF and needs to be able to perform its functions, and make decisions within its remit, without challenge from the Ministry. The second development is the increasing desire on the part of individual members of the Knesset to engage directly with BSD staff. Such engagement has to be handled courteously and professionally, of course, but it is a distraction from the BSD's priorities, adds to work pressures, and leaves the BSD at risk of perceptions of "undue influence."

13. **A new Central Services and Financial Education Unit has been established in the BSD with the objective, *inter alia*, of communicating with and disseminating information to the members of the Knesset about the roles and responsibilities of the BSD**. The mission supports this initiative and would encourage the Unit to develop protocols that would respond effectively to day-to-day enquiries from politicians while limiting demands on already stretched supervisory staff.

III. STABILITY AND COMPETITION OBJECTIVES

A. The Relationship between Stability and Competition

14. **Stability and competition are two essential characteristics of a dynamic and well-functioning banking system.** Effective competition characterized by contestability increases bank efficiency and, thereby, drives down the cost of production of banking services, improves the range and quality of banking products, and encourages innovation in the banking industry. Effective competition can also open up greater access to financing. Stability in the banking system, underpinned by robust bank risk management and a prudent regulatory and supervisory regime, promotes sustainable competition that will not be disrupted by losses in consumer or investor confidence associated with bank distress. It also ensures confidence necessary for banks to reliably access funding from depositors and investors at a cost that enables credit provision at a reasonable price. For these reasons, competition and stability need not be competing characteristics but should be seen as mutually reinforcing.

15. **That said, the relationship between stability and competition in the banking system is complex and subject to tension.** High barriers to entry and over-regulation of banks can impede competition, constrain sensible risk-taking, and stifle innovation, eventually lowering the quality of bank services and increasing their price. On the other hand, as the global financial

[7] In addition, the BSD's ability to recruit mid-level or specialist staff is precluded by union restrictions.

crisis highlighted, reckless competition fostered by excessive bank risk-taking within a weak regulatory regime can generate substantial threats to financial stability, with high fiscal and social costs. Achieving the right balance between the two objectives is an ongoing challenge for policymakers.

B. The Current Policy Debate

16. **The balance between stability and competition in the Israeli banking system is currently a major focus of policy debate**. The banking system is highly concentrated and has not been subject to competitive threat in some lending markets for a long period. In principle, a market can be concentrated but competitive if it is open and contestable, with the threat of entry limiting the pricing power of incumbents. Greater contestability in commercial lending through the direct participation of institutional investors has made that lending highly competitive in Israel, with low margins. In the retail credit market, however, the concentrated market structure is associated with perceptions of limited access and high cost of credit for the SME sector and for unsecured credit to households, although that same structure is also associated with strong competition in mortgage lending.

17. **Competition in the Israeli banking system has been the subject of a number of official inquiries and important policy initiatives have flowed from these inquiries in recent years.** These have involved behavioral rather than structural reforms. The emphasis has been on empowering bank customers by easing the burden of switching bank accounts, and narrowing information gaps through a bank "identification card" (now finalized) and the establishment of a Credit Data Register (in progress). These reforms, and others that preceded the inquiries, have been driven by the BoI. They are welcome and significant reforms in their own right, although it is too early to judge how much use bank customers will make of greater account mobility.

18. **Notwithstanding, the Strum Committee has concluded that behavioral measures will not be sufficient and that a "decisive structural step" is needed to promote competition in retail banking.** The Committee believes that excessive market power in the hands of the largest Israeli banks is constraining competition in the provision of retail banking services to SMEs and households (excluding mortgages). In its Interim Report, it has proposed a comprehensive and complex set of reforms designed to increase the number of players in the retail credit market. The reforms include the separation of two credit card companies from the ownership of the two largest banks, protection of these separated companies from competition from their previous owners for a period, changes in the ownership of the clearing and settlement infrastructure, the entry of new non-institutional entities into the credit market that would fund themselves through bond issues, and the introduction of a bank deposit insurance scheme. The need to separate the remaining credit card company from the ownership of two mid-sized banks would be evaluated within four years. The final shape of these proposed reforms is still under discussion.

19. **It is critical that a reform exercise on this scale be based on rigorous analysis of the competition problem in Israel, incorporating the most recent data**. It also requires a careful evaluation of the costs and benefits of alternative responses from the viewpoint of target

customers, credit provision, supervisory arrangements and the stability of the banking system. There is little international precedent to guide some of these proposed reforms and, in important respects, the reforms appear at variance with policy initiatives elsewhere that draw on the lessons of the financial crisis:

- The reforms involve a form of "ring-fencing" of banking activities in the largest and (if implemented) mid-sized banks, but on competition rather than stability grounds and likely to have adverse consumer impacts in the short term;
- Separation of the third credit card company from the two mid-sized banks—for which credit card activities are a significant profit source—will, if implemented, constrain their ability to compete against the two largest banks, also undermining stability; and
- The reforms explicitly encourage the growth of the "shadow banking" industry, under new and largely untested supervisory arrangements.

C. The Mission's Evaluation

20. **The mission is not in a position to evaluate the evidence put before the Strum Committee nor does it wish to intrude in the Committee's deliberations**. Nonetheless, the mission notes that more recent data, as summarized in the BoI's *2015 Annual Report*, are providing a clearer and somewhat different picture of competition in the retail credit market in Israel than that presented in the Interim Report. For example, there has been a substantial growth in bank lending to the SME sector and to households (excluding mortgages) over the past three years; overdraft and credit card interest rates in Israel are low relative to other OECD countries and the ratio of consumer credit to GDP is relatively high; margins on SME lending have fallen, both in absolute terms and relative to lending to large corporates; and the share of credit to SMEs in Israel (out of total business credit) is in line with the OECD average. These data suggest that access to retail credit in Israel may not be as constrained as had been thought previously, although margins on SME lending may be judged as having further to fall. Accordingly, the competition problems to which the Strum Committee's comprehensive reforms are addressed are less apparent based on more timely data.[8]

21. **In preparing its advice to the BoI, the mission has focused its attention on the potential impact of the proposed reforms on financial stability**. The centerpiece of these reforms is the separation of the two credit card companies from the ownership of the two largest banks within a three-year timetable, and the possible separation of the third credit card company at a later time. Stand-alone credit card companies are seen by the Strum Committee as the only

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[8] Problems in funding the SME sector are not, of course, unique to Israel. SMEs generally have access to fewer sources of financing than large businesses because information asymmetries make it more difficult and costly for SMEs to directly access capital markets or attract new lenders; this is particularly the case for start-up SMEs without a proven credit history, secure cash flows or collateral to offer. In its latest publication, *Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard*, the OECD has noted an easing in credit conditions for many SMEs across the countries surveyed but concluded "SME access to finance will remain a concern for many years to come" (pp. 27).

guaranteed way of bringing new and battle-ready competitors into retail banking in Israel. The potential impact of this reform on competition and pricing will depend on a number of factors, including the extent of protection provided to the new card companies, the funding models of the card companies, and the behavior of Israeli consumers, who appear more conservative than counterparts elsewhere in preferring to use credit cards as a payment instrument ("transactors") rather than as a source of credit ("revolvers").

22. **The potential impact on stability will depend on the form of competition between the card companies, and between the card companies and the banks**. Competition can be expected to take two forms:

- *Price competition*, including interest rates and fees and charges. From a prudential perspective, competition in this form is transparent and its impacts on profitability can be readily monitored by boards and by supervisors. Boards of the card companies will need to be satisfied that credit card interest rates include an appropriate premium for risk; and
- *Non-price competition*, which may be through loyalty programs and changes in lending standards, reflected in risk appetite, screening procedures for new cardholders and the size of credit card and overdraft limits. Competition through relaxing lending standards can be more difficult for boards and supervisors to monitor, and the impacts of declining credit quality on profitability can be delayed in the absence of forward-looking provisioning.

23. **Lending standards in credit cards is one important area in which competition and stability issues may interact under the Strum Committee's proposals.** There is recent precedent. In 2003, Korea suffered a painful credit card crisis after a boom in credit card lending burst, with severe financial and real effects. The lending boom was attributed to government incentives to stimulate credit card spending, a weak regulatory and supervisory regime, and a relaxation of lending standards. Factors contributing to that relaxation included the entry of new players, a limited infrastructure for credit reporting, and distortions in the incentives to screen and monitor borrowers.

24. **To achieve the objectives of the proposed reforms, the card companies must be capable of providing a source of effective and sustainable competition in their own right.** Hence, it is essential that they be subject to a rigorous licensing process and are established with:

- A shareholder base that has been subject to due diligence and is free of substantial conflicts of interest; ideally, shareholders should be committed over the long term and able to contribute additional capital if required;
- Adequate capital resources against credit, liquidity and operational risks, and able to absorb any initial set-up losses;
- Robust governance, risk management and internal control systems for monitoring and limiting risk exposures;

- In particular, a rigorous framework for identifying, monitoring and reporting on credit risk, including procedures for customer screening and detailed databases for credit scoring and assessing seasoning in credit card lending;
- Appropriate liquidity and funding arrangements, with risks associated with the use of wholesale funding clearly identified. (Reliance on wholesale funding through the issue of credit card receivables-backed securities was seem as a contributing factor in the relaxation of lending standards by Korean credit card companies before the 2003 crisis); and
- A stable IT infrastructure with proven resilience and well-tested back-up arrangements.

D. Supervisory Authority for Credit Institutions

25. **It is also essential that the credit card companies be subject to an ongoing regulatory and supervisory regime**, which could be tailored to the narrower range of activities these companies will undertake. The Strum Committee has acknowledged this. It has recommended that the BSD be allocated this role, although the recommendation has been contentious.

26. **The mission strongly supports the recommendation that the BSD remains the supervisor of any new credit card companies.** First, it would mean that all significant participants in the retail credit market in Israel would be subject to the same regime, ensuring competitive neutrality and minimizing the risk of regulatory arbitrage. Like risks would be supervised in a like manner. Pushing credit card lending into the shadow banking area, under a new regulatory regime with untested skills and perhaps different objectives, would negate one of the major lessons of the financial crisis and would appear inconsistent with the EU framework for the supervision of "credit institutions." Secondly, the BSD is already supervising the lending activities of the card companies as part of bank supervision, and has the skills and capabilities to evaluate the card companies on authorization and on a stand-alone basis. This would help to smooth the subsequent conversion of a card company into a retail bank, if it so wished. Thirdly, the continued involvement of the BSD would help to ensure that the card companies continue to enjoy the "reputation and public recognition" acknowledged by the Strum Committee, underpinning consumer and investor confidence in the Israeli banking system in the transition to the new structure. Finally, and very importantly, the credit card companies will be significant participants in the clearing and settlement system in Israel and, on system stability grounds, should be subject to the same standard of prudential supervision as other significant participants.

27. **Competitive neutrality and regulatory arbitrage concerns also argue for retaining the BoI's current role in licensing financial companies.** Under current legislation, financial companies that issue bonds above a certain size and extend credit from those funds must be licensed by the BoI. The Strum Committee has recommended that these size limits be removed and that the new Capital Markets, Insurance and Savings Authority supervise financial companies. The mission understands that such companies have yet to reach the size limits set out in current legislation; if they were do so, however, their activities would have systemic significance and it would be appropriate that they be brought within the BoI's supervisory purview.

28. **Implementation of the Strum Committee's proposals will make considerable demands on the resources of the BSD and will distract from its ongoing prudential responsibilities.** The BSD's resources are already stretched but are now having to take on the preparations for this complex set of reforms without supplementary resources. Hence, it will be important that, whatever final form they take, the reforms are sensibly staged and their implementation is closely monitored. It will also be critical that the timing of the reforms take full account of the macroeconomic environment in Israel and major systemic risks; pressures to extend credit in an economy already at full employment will not be helpful to economic management or financial stability.

IV. Evaluation of the Supervisory Approach

29. **Banking supervision in Israel follows a very rigorous and comprehensive approach.** As noted above, this reflects a BSD engagement model that is predicated on a low tolerance to bank failure. The supervisory approach tends to be cautious and resource-intensive, in sharp contrast to the "light touch" approach that had been followed by supervisors in some advanced countries seriously hit by the global financial crisis. The BSD's approach has a number of strengths. At the same time, the mission sees scope for streamlining the current engagement model to sharpen its risk focus and reduce regulatory burdens, while still preserving its strong prudential bias. The rest of this section discusses the engagement model of the BSD and its approach to supervision. It also provides a number of recommendations to steer banking supervision towards a more forward-looking and efficient model, without losing the rigor and effectiveness demonstrated during the global financial crisis and subsequently.

A. Engagement Model and Approach to Banking Supervision

30. **The BSD's intensive engagement model has encouraged a conservative and very "hands-on" approach to supervision.** In the absence of an enhanced recovery and resolution regime and an explicit deposit insurance scheme, the BSD mindset is firmly focused on minimizing the risk of bank failure. Accordingly, supervisory oversight in some areas can be quite intrusive, both *ex ante* (regulatory approvals) and *ex post* (day-to-day supervision), and this puts pressure on supervisory efforts and resources. Strains on resources are compounded by the increasing size and complexity of the Israeli banking system.[9] The BSD's hands-on approach has proven effective in achieving its safety and soundness objectives through informal supervisory actions; formal enforcement powers are rarely used.

31. **The current engagement model involves considerable interaction with bank boards and senior management**. The Governor, the Supervisor of Banks, and senior BSD staff meet on a regular schedule with relevant members of bank boards and senior management, ensuring that supervisory concerns are directly communicated. This strengthens the BSD's ability to respond to emerging stresses where risks need to be contained decisively. Outside those situations, the

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[9] In the absence of an internal system to account for, or to approximate, the cost of standard supervisory activities, it is difficult for the mission to be precise in quantifying these costs.

engagement model has involved a range of prior approval processes that are time consuming and could unduly delay banks' business decisions and deter innovation.

32. **The mission welcomes the BSD's intention to introduce more flexibility into a number of key approvals in order to lower regulatory burdens and encourage increased efficiency.** The BSD has a number of prior approval requirements that in scope go beyond those of other supervisory agencies also pursuing risk-based approaches. This has been the case in the area of technology and innovation particularly, where prior approvals have been required for initiatives such as connection to the Internet or the use of "cloud computing"; some of these approvals have apparently taken considerable time. As part of its new strategic direction (see paragraph 39), the BSD is updating its policy and regulations to support technological change, especially digital activity and online banking.

33. **The structure of the BSD is well adapted to fulfill its broad responsibilities**. The BSD deploys 160 staff members (about 19 percent of total BoI staff) in five divisions and three support units in charge of the key supervisory functions. The divisions are Policy and Regulation, Bank-Customer Relationships, Off-site Examination, On-site Evaluation and a division recently created to oversee Innovation and Technology. Each division is organized into smaller units, and there are separate units dealing with Licensing, International Relations, and Central Services and Financial Education. When needed, formal remedial action is effected by the Supervisor of Banks in terms of existing legislation.

34. **The BSD's engagement model incorporates a resource-intensive "four eyes" approach.** Besides the concomitant work of other divisions in the BSD, this approach is based on close coordination of activities performed by the Off-site and On-site divisions. The Off-site Evaluation Division is organized in five internal units according to the banks being supervised. This Division leads and "owns" the risk rating of each entity or banking group. The On-site Examination Division is organized by risk type, with its staff specialists distributed in six units. This Division conducts targeted risk examinations and its assessments are factored by the Off-site Evaluation Division into its risk ratings.

35. **This "four eyes" approach fits well into the design of the BSD's Supervisory Review and Evaluation Process (SREP).** The BSD's SREP appears robust and well designed. All divisions actively collaborate during the SREP, with the interaction between the Off-site and On-site divisions pivotal and strongly supported; the working relationship between these two divisions is one of the BSD's particular strengths. In addition to generating formal written requirements and recommendations, the SREP concludes in a risk matrix calibrated to produce a Pillar 2 Tier 1 capital add-on based on the risk profile assessed for each particular bank or banking group. The latter risk profiles are re-assessed in full each year by the Off-site division

using a mix of combined on-site examinations, off-site work and review of banks' internal information,[10] including analysis and monitoring of financial reports.

36. **The On-site Examination Division conducts deep-dive targeted examinations combining reviews of safety and soundness, compliance and conduct.** Besides reserving about a quarter of its time for unanticipated demands, this division performs an average of about 33 targeted risk examinations per year (36 planned for 2016). The standard duration of a targeted examination is close to six months for a dedicated team of two specialist examiners. This period includes the full examination process, from initial planning to follow-up and verification of compliance with requirements and recommendations. In addition to examinations, the division participates in systemic risk reviews, the SREP evaluation, and other tasks such as the development of regulations. It follows a minimum coverage cycle of three years implemented through annual plans. In credit risk reviews, risk-based samples of credit files are taken with varying coverage depending on the portfolios targeted for review. A new examination report has recently been adopted to streamline the reporting process.

37. **The Off-site Evaluation Division is the central contact point with the banks and monitors their risks on an ongoing basis.** The division reassesses in full every year the risk profile of each bank following a methodology consistent with sound international practice, and integrates the results of all the assessments performed in the BSD. The risk assessment incorporates an end-of-year risk map reporting nascent risks from the operating environment, and takes into account the viability of banks' business models. The risk assessment is fully embedded within the SREP, which is the full responsibility of this division, along with other responsibilities including key reporting functions. In the mission's view, the frequency of the risk reassessment should take into account the ratings assigned in previous periods. The division uses nineteen risk cards to assess significant inherent risks and their controls, including governance, as well as capital quality and its management. Most of the risks cards include stressed indicators. A number of thematic horizontal business line reviews provide an outlook on evolving risks in the banking system.

38. **The staff of the BSD is very dedicated and of high professional standing, yet, as noted above, resources are under stress**. Remuneration levels are capped under public sector limits required by the MoF. Moreover, recruitment of new mid-career professionals is precluded by union restrictions. The proportion of staff with less than three years of experience (about a quarter of total staff) is growing and is subject to high turnover, in part because of the difficulty in offering attractive remuneration packages.

39. **The BSD has recently adopted a new strategic direction aimed at maintaining stability whilst promoting competition, fairness and increased public confidence**. The objectives of this strategy are to support technological change; to take an active leadership role in

[10] In addition to the target reviews by the On-site Examination Division, the Off-site Evaluation Division reads in detail banks' business policy and strategy documents and the minutes of the Board and its key committees, and follows up on the programs and reports of the compliance, risk management and internal audit functions.

improving the efficiency of the system; and streamlining and simplifying regulation and reporting requirements to facilitate the entry of new, lower-risk participants. This new strategic direction has been translated into a plan of actions, some already implemented or in the process of implementation, including fourteen risk mitigation actions. The mission believes that the objectives of the strategy and the plan of actions are reasonable, and need not compromise safety and soundness objectives.

40. **Plans to upgrade the resolution regime and introduce bank deposit insurance are being considered.** Following the recommendations of the 2012 FSAP Update and recent IMF staff visits, the BoI has reached agreement in principle with the MoF to develop draft legislation to enhance the recovery and resolution regime as well as to introduce a bank deposit insurance scheme, which is a recommendation of the Strum Committee. A number of relevant policy themes are being evaluated including, *inter alia*, the scope of banks covered by deposit insurance, the need to have separate funding for resolution, whether such funding should be on an *ex ante* or *ex post* basis, and the location of the future resolution authority. Given the systemic importance of the largest banks, the mission believes that the authority should be located within the BoI, as a separate unit from the BSD.

B. Findings and Recommendations

41. **Notwithstanding the robustness of the prudential framework and the BSD's supervisory approach, the mission sees opportunities to streamline the current engagement model**. Without losing the high quality and rigor already achieved in supervision, there are a number of possible actions that may assist the BSD to enhance its risk-based approach to supervision, making it more forward-looking and resource-efficient at the same time. The paragraphs below discuss the findings and recommendations of the mission to achieve these goals.

Development of a risk appetite statement

42. **The BSD could give greater operational content to its supervisory stance and tolerance for failure by developing a *Risk Appetite Statement*.** Other supervisory agencies have been moving in this direction. Developing such a statement would help the BSD to clarify internally the principles on which it prioritizes risk issues and the allocation of resources; would provide a framework in which to review prior approval processes, routine supervisory interventions, and *ad hoc* data requests; and would provide guidance to BSD staff in making judgments about the benefits and costs of specific supervisory actions. A clear and detailed *Risk Appetite Statement* would confirm and enhance the BSD's focus on critical risks to a safe and sound banking system, while ensuring its supervisory responses are carefully targeted and make the most effective use of its stretched resources. The *Risk Appetite Statement* would be part of the BoI's corporate governance and there should be no expectation that it needs to be publicly available.

Comprehensiveness of the risk coverage

43. **Nascent risks and challenges from the operating environment can be explicitly captured in the risk assessment process without increasing the number of risk cards**.[11] The SREP should include a specific step to factor in macroeconomic and operating environment risks. This analysis should translate into two sets of actions. First, to ensure a dynamic change in the emphasis of the risk assessment based on the latest available risk scoring. And second, to explicitly add an additional column to the risk cards to capture an "outlook dimension" in the assessment to give priority to such risk assessment. This step would fully support the aim of the BSD to enhance its forward-looking approach.

44. **New explicit themes or control points could be considered in the risk cards.** These additional control points would be addressed to nascent risks and issues. For example:

- Risks from the business model should be made explicit and added both in a new control point dedicated to earnings (as part of capital) as well as part of the strategic risk card assessment.
- If there were significant risks associated with group structures (upward and downward) these could be explicitly captured in the capital and the strategic risk cards.
- Once implemented, the exposure to new technologies should be explicitly referred to in the strategic and operational risk cards.

45. **Rather than adding new risk cards, most emerging risks can be accommodated within the current framework**. This should be done keeping in mind the associated incremental workload and the need to substitute priority areas across the supervisory cycle. In addition, control points that already exist can be postponed or de-activated depending on the outlook and most recent risk scoring. Possible modifications and additions in the SREP process to accommodate nascent risks and control points should not necessarily be assessed every year but only when this is determined relevant, for example, as part of a new SREP step and based on judgment about risks and costs. The availability of an efficient IT system to capture and manage the risk assessment, as discussed below, will facilitate the task.

Enhancements to the forward-looking approach of the SREP

46. **The BSD can enhance its forward-looking approach by complementing its evaluation of capital and its buffers in the final stage of SREP with a dynamic perspective on the viability of banks' business models.** This could be achieved by fine-tuning the risk assessment in three ways. First, as discussed above, by adding to the relevant risk cards an outlook dimension as a new column. This could drive a modification of the score since there is never precision in risk scoring. Second, by enhancing the attention paid to earnings (by focusing

[11] At present, these risks and challenges are captured in a separate "map of main industry risks" from the operating environment, prepared for the first time during 4Q2015.

on pre-provision profits). And, third, by fine-tuning the KRIs and proxy control points utilized in the risk cards.

47. **This enhanced evaluation will support the BSD's new strategic focus on the viability of banks' business models as a major contributor to stability.**[12] To this end, earnings should be considered as the key driver of capital assessments. The trend and outlook of pre-provision profits, their stability and quality, and their recurrence, are the first line of defense to absorb losses. Earnings are closely watched by the market, in addition to providing key incentives for management performance and remuneration. The mission recommends emphasizing the importance of earnings as part of the assessment of capital with two possible actions:

- Complement the averages of return on assets (ROA) and return on equity (ROE) with measures of the outlook, trend, and level of pre-provision profits, including projected capacity to absorb losses and to source capital, both in base cases and stress states.
- Further differentiate the three sets of control points in capital management to address: (1) the quality and coverage of regulatory and Pillar 2 requirements; (2) the consistency and stability of earnings; and (3) access to capital. Capital management and the Internal Capital Adequacy and Evaluation Process (ICAAP) could be made more granular.

48. **Further actions are recommended to support forward-looking assessments under SREP.** To be forward looking, all risks should have, if possible, an indicator under stress, whether quantitative (a stressed KRI) or qualitative (proxy of plausible threats). If the aggregation process does not do this already, the worse risk scores could be weighted more than the less adverse scores. This could be achieved by calibrating the benchmarks used as cut-off points (or using an exponential algorithm). For non-quantifiable risks, a proxy could be adopted to reflect changing risk.[13] For example, there are proxies for forward-looking risks that the BSD may add to the risk matrix, or consider as part of the new column suggested to explicitly capture an outlook dimension.

49. **The BSD can further enhance its forward-looking approach by communicating its expectations to bank boards and senior management.** A forward-looking approach aims at promoting behavioral changes and eliciting prudent risk management from boards and senior management, beyond simply responding to supervisory directives. Supervisory concerns should always generate a plan of action that boards and senior management commit to take to satisfy the BSD's expectations, with appropriate benchmarks to monitor progress. The BSD should intervene primarily when there is a need to ensure that a board delivers on its strategic objectives, to challenge its risk management policies and framework, and to assess its forward-looking risk appetite according to various scenarios. Other than that, the BSD should step back and act only when adverse circumstances arise that jeopardize prudent decision-

[12] The strategic plan aims in 2016 at assessing the risks that the low interest rate environment creates in pressuring banks to expand their sources of revenues.

[13] For example, in assessing a central control function, it seems clear that lower headcount and budget dedicated to the function would be detrimental ex ante to its effectiveness and reliability.

making. BSD staff should refrain from influencing unduly or "second guessing" decisions that are the prerogatives of bank boards and senior management, particularly in the technology area.

Adequacy of human resources

50. **Few supervisory agencies publicly estimate the workload associated with their engagement model, taking into account activities performed and their duration.** The BSD is no different in this sense. Anecdotal evidence, including discussions with bankers, indicates that the BSD's engagement model is very resource-intensive, including detailed reviews of minutes, policies, and the reports of key control functions. The suite of activities undertaken indicates further need for specialized skills (cyber-IT, scoring and credit rating models, market and interest rate risk models). Given its central role and heavy responsibilities, the Off-site Evaluation Division would seem significantly overloaded.

51. **Depending on how the BSD chooses to enhance its risk-based approach, a cadre of essential specialists might be needed with some urgency.** This will be the case for the evaluation of cyber risks, standard IT tasks related to the validation of management information and electronic data processing systems, and data extraction. Another area is the development of modeling skills, for example to validate scoring and risk pricing systems. Based on an inventory of BoI staff's current skills and interests, the BSD could supplement its resources, for example in its market risk unit, including by drawing on staff from the Research Department of the BoI. The addition of specialists should, of course, be consistent with the BSD's new strategic objectives (paragraph 39 above) and the proposed *Risk Appetite Statement* (paragraph 42 above).

52. **Access to mid-career professionals may be needed to obtain specialized know-how.** The mission would suggest that the BSD explore two alternatives used by other supervisory agencies. The first is to contract short-term consultants from the industry, say audit or specialized consulting companies, with reentry guaranteed to their original entities. The second is to enter into exchange programs with other supervisory agencies of interest, including medium-term (say six months) placements into specialized functions targeted by the BSD.

Update of the management information system

53. **All the actions planned and executed to update and prioritize regulation are important avenues to improving supervisory efficiency**. This should result in reduced requirements for prior approvals and mitigate over time the costs of regulatory compliance, without compromising the safety and soundness of banks' operations.

54. **The BSD is encouraged to explore other avenues to enhance efficiency, given the resource demands on banks and the BSD of the current engagement model**. For example, to achieve further operational synergies, the mission recommends the adoption or development of an automated project management tool to support the key stages of the SREP from planning and risk assessing to the final rating and remediation. Improvements in management information

systems will enhance supervisory efficiency without compromising the BSD's supervisory approach and methodology.[14]

[14] The Examiner Documentation tool used by the US Fed, or the "IMAS" recently launched by the ECB as the management information system of the Single Supervisory Mechanism, are possible examples.