

## **Karnit Flug: Reforms in Israel's banking system**

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, at the launch of Prof. Meir Heth's book "Reforms in Israel's Banking System", Tel Aviv, 18 February 2016.

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This event marks the publication of Meir Heth's book, which provides a broad view of the trends and turmoil that have characterized the banking system for almost the last 50 years. His viewpoint is particularly interesting in view of the variety of positions he has held over the years: researcher in the Research Department of the Bank of Israel, the Supervisor of Banks, the chairman of one of the large banks and a professor in academia who is studying the system. One may assess that the processes and trends that the banking system will experience in coming years will be no less interesting and challenging. I will be relating to some of them.

I will present the position of the Bank of Israel with regard to the reforms that in our opinion should be promoted in order to increase competition in the credit market and in the financial system and also those which in the name of "competition" are liable to adversely impact consumers and the public in general.

Before we begin discussing the reforms, it is important to start with an examination of the data and the facts and only on that basis to define the problems and the ways to solve them. What are the trends in the various credit aggregates over time? How does the Israeli system compare to those in other countries? And so on. I will say already at this point and will soon expand on this point – the credit market has changed dramatically in recent years and the proposed reforms should be based on current trends and not on the approaches of the past.

Using the data, we will try to get a full picture of competition, which has served as the basis for the Bank of Israel's position on this issue. I will say already at this point, and I will illustrate later on, that the Bank of Israel is promoting competition in the financial system and its actions in recent years have proven that.

I will also briefly touch on the public interest in maintaining the stability of the banking system, which is often taken for granted. The volatility that affected the global banking system, primarily in Europe, during the last two weeks, provide a reminder of the importance of maintaining the stability of the financial system.

As of now, more than half of the business credit in Israel is provided from outside of the banking system, and this of course has major implications for the level of competition in this sector. From the point of view of business customers, and primarily large ones, there is an alternative to the banking system. Of course, the development of the nonbank credit market also has implications for stability. I would mention that the corporate bond market, which was less supervised than the bank credit market, was the only market in Israel that was significantly affected by the global crisis.

The development of the consumer credit market and the reforms carried out to reduce concentration have also affected banks' credit activity. The freed-up sources of capital were increasingly channeled to consumer credit, both housing and non-housing, which was provided for the most part by the banks and has been characterized by a high rate of growth in recent years. The growth in consumer credit and the fact that it was divided among all of the banks is evidence of the increasing competition between the banks in this market. As is known, the mortgage market is a particularly competitive market and the growth in the volume of mortgages began a number of years before the growth in consumer credit. It is possible, therefore, that we are in midst of a process of increasing competition in the consumer credit market. Who hasn't recently received a text message or email with an offer of credit? Within a few years, we have arrived at a situation in which the quantity of consumer credit is equal to almost half of the quantity of housing credit and therefore we are starting to see an increase in the level of competition in the non-housing consumer credit market as well, against the

background of steps taken by the Bank of Israel in recent years, even prior to the planned reforms in this sector.

In view of the rapid growth in consumer credit (which is intended for current consumption, such as non-housing credit, student loans, and the like) in recent years, it is worthwhile to examine these developments relative to other countries. As a result of the rapid expansion in recent years, we have arrived at a situation in which the ratio of consumer credit to GDP in Israel is relatively high – similar to its level in the US and higher than in countries such as the UK, France, the Netherlands and Sweden.

One of the sectors generally considered problematic, from the viewpoint of both prices and access to sources of financing, is the small business sector. This problem is not unique to Israel and the volume of credit to the small business sector in Israel is not low relative to other countries. The government is working to help small businesses through loan funds and it must do more in that area. The interest rate spreads are relatively high in this sector. It is reasonable to assume that part of the difference is the result of high operating costs (such as underwriting costs) of credit to small businesses relative to other sectors. In any case, there is undoubtedly a need to increase competition and access to credit and to reduce the prices in the small business sector. I expect that the transition to digital services will also lead to reduced prices in this sector.

The interest rates on credit cards in Israel are relatively low in comparison to other countries and the interest rates on overdrafts and revolving credit in Israel are similar to those in other countries. (It should be noted that a report ordered by the Ministry of Finance from the McKinsey company shows that the prices of credit in Israel and the level of fees are lower than in the countries chosen as reference in that report.)

Prices are also ultimately reflected in the banks' return on assets, which is not out of line relative to the average in other countries. This situation is influenced by the fact that the banking system in Israel is characterized by a low level of efficiency relative to the global average, which apparently affects profitability; yet at the same time, the system in Israel is characterized by a lower level of risk than banking systems in other countries. In some countries, the profitability of the banking system has been very adversely affected by the realization of risks that were the result of imprudent conduct.

Cautious conduct and close supervision of the banking system in Israel are also reflected in the fact that Israel did not have to rescue a single bank from failure during the global financial crisis. Such rescues in other countries were costly to their taxpayers. The fact that in Israel we did not have to rescue any of the banks contributed to Israel's rapid exit from the global crisis with minimal effect on growth, employment and standard of living. The experience of other advanced economies illustrates the damage that we avoided thanks to the maintenance of stability in our banking system and also the extent of damage that may occur if as policy makers we will not do so in the future.

Even though we in Israel did not experience the global financial crisis in the banking system, we have learned from the experience of other countries and we have aligned ourselves with global regulation. In recent years, the Banking Supervision Department at the Bank of Israel has taken numerous measures in order to strengthen the stability of the system. For example, in accordance with international standards, the capital requirements of the banks have been raised markedly, more stringent liquidity requirements have been introduced, etc. These measures, together with additional regulation that is meant to improve the management of risk in the banks and along with regulatory measures to reduce concentration in the banking system, have helped achieve a stable banking system that can deal with future crises. This is not something to be taken for granted, especially now.

What can be learned from what I have so far presented with respect to competition in the financial system?

- There is no doubt that the credit market for large businesses is characterized by a high level of competition.
- The mortgage market is also characterized by a high level of competition, as well as wise consumption by the customers themselves who compare the options available before signing, and this is reflected in the level of prices. It is important to remember that there is a high level of competition in mortgages even under the current structure of the banking system!
- The segments in which there is room to continue to increase competition, as pointed out in past Bank of Israel reports and by the committee that was headed by the former Supervisor of Banks, are the small business sector and the household sector (aside from housing credit).

Even in these segments, there are processes that are leading to increased competition. Some of these originated in the banks themselves, that have identified the retail sector as a strategic objective and have been increasing their scope of activity in this sector. This can be seen, for example, in the notable increase in consumer credit. Some of these processes are external to the banking system, such as the development of non-bank entities, which has partly been made possible by technological advances. A considerable part of these processes is the result of policies promoted by the Bank of Israel to increase competition, and I will relate to them in a moment. It is important to remember in this context that numerous measures have been implemented in the last two years and their effects have not yet been fully felt. Thus, for example, the banking ID card which will be distributed shortly to all of the banks' customers is the result of work started more than two years ago and whose full effect will only be felt in a few months. Changes in the financial system are not accomplished by declarations and headlines but rather by wise, thorough and well-thought-out long-term policies, policies that require a measure of perseverance.

How then do we promote competition in the financial system in general and in the banking system in particular? How do we expand the competition in the business sector and the mortgage market to also include households and small businesses?

In view of the statements made recently, I would like to stress, as unambiguously as possible, that the Bank of Israel has been working **towards ensuring the interests of the public**, including the promotion of competition!

Competition is critical for the existence of an advanced financial sector. Without competition, our banking system will not develop, the quality of service provided to customers will be adversely impacted, the consumer will lose confidence in the system and eventually there may also be consequences for stability. Therefore, we are in favor of encouraging competition. Competition does not contradict stability. Let me repeat that in order to make sure that the message gets across – **we are promoting competition in the banking system. We have done so in the past and we will do so in the future.**

How has the Bank of Israel worked to encourage competition?

One of the barriers to competition is the difficulty in switching between banks and the entities that compete with them. The Bank of Israel is working to remove these barriers and will continue to do so.

The Zaken Committee did not wait for the entry of new players and drew up a list of measures that strengthened the position of households and small businesses and increased the level of competition. The vast majority of those measures have already been implemented by the Bank of Israel. These include, among others, making it easier to switch banks and providing the possibility of implementing more bank activities on the Internet, such as opening and closing of accounts. The Banking Supervision Department recently issued an innovative directive that expands the activities that can be implemented by electronic communication, which has a huge potential for increasing competition between the banks. In general, the Bank of Israel views

technology as a challenge for the banking system and also as a powerful lever for improving service to customers and lowering its price.

The activity of the Bank of Israel to increase competition for the benefit of the consumer goes beyond making it easier to switch banks. Another barrier to switching banks is the fact that a customer's current bank knows the customer better than the bank he would like to move to and as a result the customer may be apprehensive that he will not be able to obtain loans at a good interest rate from a bank that doesn't know him as well. We have started to deal with this problem as well through the Zaken Committee and we have required that the banks issue a banking ID card to customers, which as I mentioned will be sent to bank customers in the coming days. In addition, we are promoting the creation of a central credit register at the Bank of Israel which will complement the work we have started with the banking ID card.

By means of directives issued by the Banking Supervision Department, we have worked to reduce bank fees and the cost of banking services, in cases where we have found that a market failure exists. And again, it must be emphasized that the effect of some of these changes is not felt immediately. The recommendations of the Zaken Committee were implemented over the last few years and it is reasonable to assume that when their full effects are felt, we will see an increase in the level of competition.

The Bank of Israel believes that these measures to increase competition between existing entities are not sufficient and therefore we have created a less stringent supervisory environment for nonbank entities, such as the separated credit card companies or companies that will provide large-scale credit against the issue of bonds. This new category will encourage the activity of these entities, in the recognition that regulation in this case can be less stringent since their activity is not financed by deposits. In other words, the supervision will be risk-adjusted. This policy will facilitate the entry of new competitors into the area of credit and acquiring.

Finally, as is known, the Minister of Finance and I established the Strum Committee and the Bank of Israel is taking a leading role in the work of the committee and in formulating its recommendations (and many important ones have not generated any controversy or public discussion). One of the main recommendations of the committee is the separation of two of the credit card companies from the large banks. However, it is important to understand that the credit card companies have systemic importance for the economy and therefore must continue to be supervised by the Bank of Israel, on a risk-adjusted basis. The transfer of supervision over these companies from the Bank of Israel to a regulator with a different focus and different expertise raises a real concern that the damage from separating the credit card companies will be greater than the benefit.

All of the many steps to improve competition have been carried out responsibly and after a professional and comprehensive examination of the potential benefits and risks involved. It is possible to promote competition without harming stability.

We have seen what happens when financial entities are allowed or even encouraged to seek profits by taking on excessive risk and at the same time imposing high risks on the general public. This occurs when regulators are unable to monitor these risks or, even worse, ignore them.

Our responsibility to the public is a long-term one and requires us to prevent such a situation. We will not agree to measures that in the name of competition will enable financial entities to operate without there being a supervisory body with an overall perspective of stability and consumer welfare, which in the first stage will harm the consumer and in the second stage the general public. Many countries and millions of unemployed people all over the world are still paying the price of irresponsible financial activity.

How does the Bank of Israel view the maintenance of stability? We have seen that the banking system in Israel is indeed stable and weathered the worst global crisis since the 1930s

relatively unscathed. We at the Bank of Israel want to make sure that the system will also endure the next crisis, if it occurs.

How are we doing so?

First and foremost, it is important to understand – and this is something that is not sufficiently emphasized in public discourse – that ***maintaining the stability of the banking system is not meant to serve the interests of the banks or their managers and employees, but rather to serve, first and foremost, the interests of the banks' customers, the economy as a whole – the public.*** Maintaining stability means that when we deposit our salaries with the bank, we can sleep at night and can feel sure that we will be able to use that money when we need to; that when we save for our children, we can be confident that those savings will be available to them when they grow up; and when a businessman or factory receives a commitment, that commitment will be honored.

The lessons from the global crisis in 2008 taught us that instability in the financial system has long-term consequences on employment, growth and welfare in general. The fact that Israel weathered the crisis in 2008 relatively well emphasizes the need for professional and efficient supervision and illustrates the possible implications of not having such supervision.

The responsibility for maintaining a stable financial system rests with the Bank of Israel and we will fulfill that responsibility; but it also rests with the government and other regulators. The Financial Stability Committee is an appropriate framework for coordinating activity and for the monitoring of risks and will make it easier to deal with those risks at an early stage.

As we have come to realize following the series of financial crises during the last decade in many advanced economies, credit providers, which are financed through deposits or bonds issued to the public, and entities that settle most of the payments in the economy have systemic importance for financial stability and therefore we will insist that they continue to be supervised by the Bank of Israel. This is also the trend we are beginning to see worldwide, such that more and more central banks are being given responsibility for financial stability, together with the tightening of regulation of banks and nonbank entities.

The Bank of Israel, like other central banks worldwide, has the necessary knowledge and expertise and is the entity most capable of supervising systemically important financial institutions. Reducing the supervisory powers of the Bank of Israel in order to ease prudential supervision will create trends that are liable to pose a risk to the stability of the economy. It is interesting that although many countries have learned the hard way how much damage a lack of stability can cause depositors and taxpayers, there is no lobby for stability. There is no public cry to “promote stability”. Therefore, it is also important that an apolitical entity, which is not measured according to its day-to-day popularity, will have responsibility for maintaining stability.

We will continue to work according to these principles in the future, with determination and with the sense of purpose and responsibility that is required for this important task. Therefore, we will oppose any change in the regulatory structure that will reduce the Bank of Israel's ability to fulfill its role in preserving stability.

Our position with respect to competition and stability is also based on our position with respect to the recommendations of the Strum Committee. ***We are in favor of measures to strengthen competition but are opposed to measures that will negatively impact the consumer.*** For example:

The Strum Committee recommendation to prohibit the issuing of credit cards by the banks: This will create essentially a monopoly of three companies that will be issuing credit cards as opposed to 10 today. It is easy to see that this will lead to an increase in the price of credit. For example, when the mobile telephone market was opened to competition, the existing companies were not prevented from selling devices, maintaining their customers and recruiting new ones.

The Bank of Israel is opposed to separating Cal-Cardisey Ashrai LeYisrael (Israel Credit Cards) from the banks that own it. Leaving Cal-Cardisey Ashrai LeYisrael (Israel Credit Cards) in the hands of Discount Bank and First International Bank will strengthen their ability to compete with the larger banks.

Encouragement of consumer credit: We have seen that the quantity of consumer credit in Israel is not low relative to that in other countries and encouraging the growth of consumer credit against pension savings may lead to a reduction in the level of pension security. In this case, the short-term perspective is clear – of course all of us are happy to increase our consumption by taking a loan, but in the long term loans have to be repaid and if they are not, it is the borrower who suffers the most, followed by the possible systemic threat to the economy and consumers in general.

To sum up:

Competition can be increased in the financial intermediation market without harming the stability of the financial system.

The Bank of Israel will insist on maintaining its ability to continue supervising the credit providers and acquirers that have systemic importance.

The Bank of Israel's supervision will be adjusted to the supervised entity's level of risk.

Within the framework of the reforms, the consumers' protection must be ensured, according to standards similar to those for the whole system.

The Bank of Israel will adamantly oppose measures that might set the stage for the next crisis or that might adversely impact customers.

The continued implementation of measures initiated by the Bank of Israel, the creation of a central credit register and the promotion of measures for which a consensus has been achieved and which reflect the long-term welfare of consumers and the economy, will achieve significant improvements in the level of competition in the financial system without endangering stability or harming the consumer.