Changes in the Israeli banking system

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I. Introduction

During the last decade the Israeli economy has undergone a huge structural change - the share of the advanced high sector has grown significantly at the expense of the more traditional sectors. However, this considerable structural change has not yet been matched by a similar change in the Israeli financial structure. Commercial banks continue to dominate the allocation of savings to investment.

Yet recently a financial reform bill (the Bachar reform) was passed in the Knesset which will undoubtedly affect Israel's financial structure, and which will also have profound effects on Israeli banks.

The purpose of this paper is to explore the planned effects of the Bachar reform on the local financial scene with emphasis on the reform's effects on: a) the nature of banking business, b) competition within the banking system as a whole, and c) the stability of the banking system.

The plan of the paper is as follows: Section II describes the main features of the Israeli banking system, emphasizing its dominant role in financial intermediation in Israel, its high concentration and the (at least potential) conflict of interest contained within it. Section III examines the major proposals of the Bachar Committee, whose main purpose is to deal with the joint problem of high concentration and conflicts of interest within the banking system. Section IV attempts to evaluate the role that commercial banks will play in the future, following the implementation of the Committee's proposals. Section V offers a brief conclusion.

II. The Dominant Role of Commercial Banks in the Israeli Financial System

At present the financial system in Israel is largely dominated by banks and the banking system itself is dominated by the two largest banks (Hapoalim and Leumi). The dominance of these two banks is a result of their control over other financial institutions such as provident funds, mutual funds and underwriters, credit card companies and others.

A major result of this financial structure is that at the end of 2004 more than 55% of the Israeli public's assets were controlled directly (via bank deposits) or indirectly (through accounts with provident and mutual funds) by banks (Table 1).

A similar picture emerges with respect to sources of finance. In 2004, about 76% of the sources of finance to the business sector came from bank credit or from credit extended by provident funds that are owned and controlled by banks (Table 2).

There is also a high degree of concentration within the banking system. The largest two banks control most of the deposits, credit mutual funds, provident funds and underwriting activities (Table 3).

By international standards the Israeli banking system is highly concentrated (Diagram 1), and not very competitive (Diagram 2).

The dominance of banks is also evident in secondary market trading (Diagram 3).

The high degree of concentration in itself would be an impenetrable barrier to entry were it not combined with structural conflicts of interest which, according to the Bachar Committee's report, include the following:

- Banks are both (investment) advisers and owners/managers of provident and mutual funds. They have an incentive to advise their customers to invest in financial products of the entities under their control, and have done so on many occasions.

- Banks are both underwriters and credit providers; they have an incentive to underwrite selected borrowers where the proceeds are used to repay loans.
- They also have an incentive to channel the funds of the institutions under their control to purchase issues of companies under their control.
- Banks are both providers of a wide range of commercial banking activities and owners/managers of provident and mutual funds; they have an incentive to structure their activities in this way as these institutions receive the commercial banking services from the parent bank, without considering possible better alternatives. This is a very common practice in Israel.

The above mentioned conflicts of interest are well entrenched despite the vast array of restrictions and regulations ("Chinese walls") designed to control them. In the words of the State Comptroller, "the Chinese walls set up by the Bank of Israel (BOI) and the Ministry of Finance (MOF) are not strong enough to overcome conflicts of interest and entail regulatory cost".

Some empirical evidence on the results of the pervasive conflicts of interest in the banking system is provided in a study by Bar and Kosanko (2004). They compare the yields on shares recommended by two types of analysts: independent and non-independent - those employed by banks making up a large portion of the latter group. The result presented in Diagram 4 clearly shows how independent analysts outperform the other group.

III. The Bachar Committee Proposals

- The combination of a high degree of concentration with far reaching conflicts of interest has created a vicious cycle that perpetuates the status quo. Concentration taken together with an involvement in a wide variety of activities creates structural conflicts of interest; and the exploitation of these conflicts serves to preserve the concentration.
- Because all attempts to curtail conflicts of interest through Chinese walls have failed, deliberate government intervention in the structure of ownership and the activities of financial intermediaries, including banks, is required in order to break the above mentioned vicious cycle.

  Three major principles guided the recommendations of the Bachar Committee, which comprised representatives from all of the regulatory and supervisory authorities dealing with Israel's capital market.[1]

The principles are:

- Enhancing competition in the management of the public's financial assets by developing alternative investment vehicles to those offered by banks, and by decentralizing the management of existing investment vehicles.
- Enhancing competition in credit provision by developing non-bank credit instruments.
- Enhancing competition vis-à-vis the household sector by exposing households more to non-bank assets and by adopting measures that would make it easier to switch from one bank to another.

(a) Separation of Provident and Mutual Funds from Banks - both Ownership and Management

Banks should not be permitted to hold any interest at all, either directly or indirectly, in provident and mutual funds. Neither should banks manage the funds of these institutions (nor their portfolios).

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[1] The Committee included the Securities Authority, the Antitrust Authority, the BOI, including the Bank Supervision Department, the Ministry of Justice and the Capital Market, and the Insurance and Saving Division of the MOF.

Banks should separate from the ownership-management interests in provident and mutual funds according to the following timetable (Table 4).

A different timetable applies to "large" banks and to "medium-sized and small" banks, in order to improve the competitive edge of the small and medium-sized banks.[2]

(b) Limiting Large Banks' Underwriting Activities

Due to conflicts of interest in the activities of underwriters, especially between their interest in acting on behalf of related debtors and their fiduciary undertakings to the investing public, the proposal is that an underwriter should not be permitted to serve in a price setting capacity in any public offering if it has loaned large sums of money to the issuing company - i.e. if the issuing company's outstanding debt to the underwriter exceeds NIS 5 million, and comprises more than 10% of the issuing company's outstanding total financial liabilities.

Furthermore, in order to limit underwriters' ability to reward related entities with "attractive" issues, or alternatively, to limit their ability to sell unsuccessful issues to such entities, the proposal states than an underwriter should not be permitted to sell 5% or more of the value of securities offered in an issue to itself or to all the institutional entities in its group put together.

These limitations will considerably restrict the leading role of the largest two banks in underwriting activities.

(c) Steps to Limit Concentration Among Non-Bank Financial Intermediaries

In order to reduce the risk of serious concentration among non-bank financial intermediaries, the Committee proposes that no acquisition permits be granted if, after the acquisition, the purchaser and its group of affiliated companies will control more than 15% of the market share of long term pension funds and life insurance portfolios savings or more than a 20% share of the mutual fund market.

These steps are intended to prevent the migration of concentration from the banking industry to life insurance companies and other branches of the capital market; it will lead to a decentralization of decision making centers and increase the probability of attracting international financial intermediaries. It should be emphasized that the limitations on the size of market shares pertain solely to mergers and acquisitions: they will not apply to an increase in market shares emanating from growth and competition.

(d) Expanding the Range of Banks in Selling Pension Products

In order to exploit better the use of banks' consulting and distribution networks, and to afford more convenient access to financial services, the Committee has recommended expanding the range of pension and life insurance products. Until now banks were prohibited from selling these products. The provision of financial advice along with the distribution of these products at bank branches will make the products more easily accessible to large segments of the population and will provide a new source of income for the banks.

Once again, the Committee recommends different "market entry conditions" for "large" and "medium-sized and small" banks.

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[2] "Large banks" are defined as banking corporations belonging to a banking group whose equity exceeds NIS 10 billion (at the time of writing, this comprises the two largest banks).

IV. The Role of Banks in Israel's Financial Structure

It is believed that as a result of the reform, and additional complementary steps, particularly those pertaining to supervision and corporate governance, the future Israeli financial structure will be composed of three major pillars:

(a) Classical commercial banking, which will also include financial advice and the distribution of pension and life insurance products.

(b) Life insurance companies, which will be the main producers of pension and annuity products.

(c) Investment banking, which will mainly be responsible for helping businesses to raise funds in the capital market.

In addition, it is believed that the reform will contribute greatly to the already deepening secondary markets for FX, bonds, shares and derivatives (Diagram 5).

The effects of these changes on the future of the Israeli banking system are of course uncertain, but the following observations can nevertheless be made; First, the growth of non-bank sources of finance relative to bank credit is set to continue (Diagram 6).

Second, the high concentration of bank credit is likely to be reduced, affording small and medium-sized businesses greater access to such credit.

Third, it is likely that the presence of foreign financial institutions, including foreign banks, will increase. At present, there are two foreign banks in Israel, servicing mostly large corporations and offering private banking services.

Fourth, the growth in the secondary markets will increase the risk sharing capacity of the economy as a whole and that of the banking system in particular. Israeli banks are beginning to look for ways to securitize part of their loans portfolio.

Fifth, as the business sector is likely to raise more funds through the capital market, banks will turn greater attention to the household sector.

Sixth, banks' role in consulting on and distributing pension and life insurance products is likely to grow considerably. This will require them to develop new skills and greater internal supervision. It should be noted that the law in Israel requires licensing for both financial and pension advisers.

Seventh, mark to market accounting practices are likely to become more prevalent, which will increase the discipline imposed on banks by the financial markets.

V. Conclusion

Following the adoption of the Bachar reform, the financial scenery in Israel is going to change considerably. The dominance of banks in the financial system will be reduced. Banks will not own or manage mutual funds or provident funds. The two largest banks are going to be more restricted in their underwriting activities.

On the other hand, banks will be able to engage in activities from which they are presently barred. This includes distributing pension and life insurance products.

The proposed reform will also help to further develop both the primary and the secondary capital market. This will enhance securitization activities, which banks can exploit to better allocate and share risk. This, in turn, will improve the functioning of the economy and also be of benefit to the banks themselves.

Table 1

Assets Managed by Banks

	2000	2001	2002	2003	2004
	NIS billion				
Deposits in banks	418.8	445.5	463.5	461.7	460.9
Total assets of provident funds managed by banks	147	152.5	146.5	165	179.5
Total assets of mutual funds managed by banks	39.0	56.4	40.6	74.8	86.6
Total assets of the public managed by banks	604.8	654.4	650.6	701.5	727.0
Total assets of the private sector	973.6	1,071.3	1,160.2	1,227.7	1,308.8
Share of assets managed by banks in the total assets of the private sector (%)	62.1	61.1	56.1	57.1	55.5

Table 2

Banks' Share in Financial Activity, 2000 to 2004

%

	2000	2001	2002	2003	2004
Share of banks and of provident funds managed by banks (%) in					
Total assets of the financial sector (gross)	78	78	77	75	74
Total credit	62	61	61	59	57
Total credit to the private sector	88	88	86	85	84
Total credit to the business sector	83	83	81	80	76

Table 3

Banking Sector Concentration

Banking		**Mutual funds**	**Provident funds**	**Underwriting**
Deposits	**Credits**	**Assets managed**	**Assets managed**	**Number of issues**
Poalim - 30%	Poalim - 33%	Poalim - 36%	Poalim - 41%	Poalim - 27%
Leumi - 30%	Leumi - 30%	Leumi - 31%	Leumi - 19%	Leumi -24%
IDB - 18%	IDB - 13%	IDB - 13%	IDB - 13%	Clal - 14%
78%	**76%**	**80%**	**73%**	**65%**

Table 4

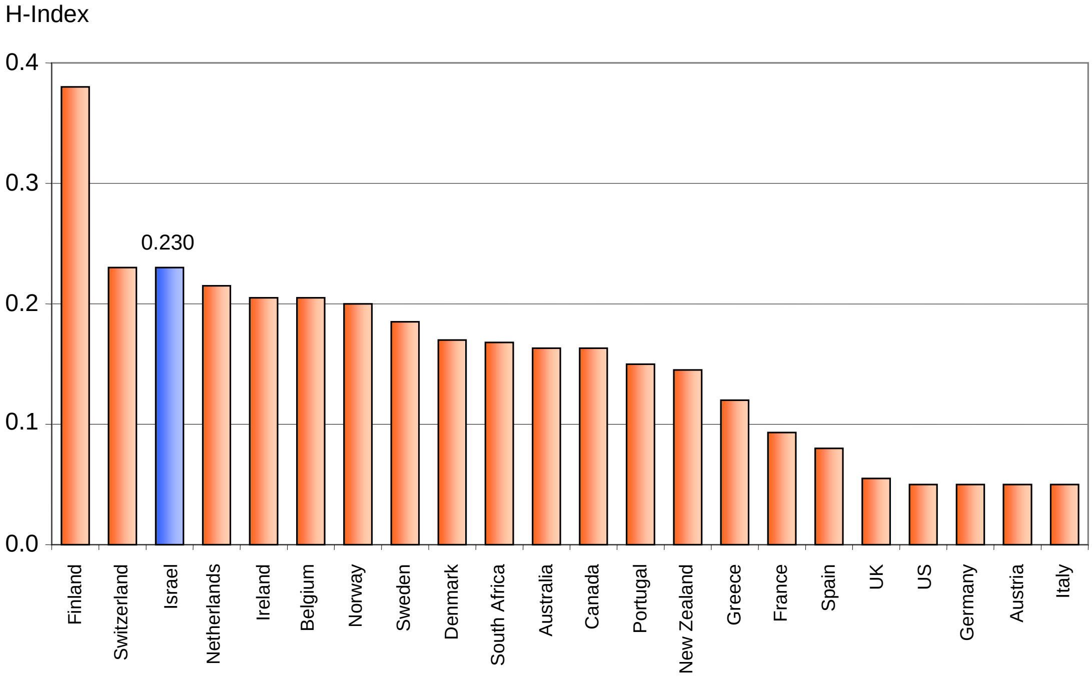
Indicators of Quality of Bank Loans

Percentages

	2000	2001	2002	2003	2004
Problematic loans/total loans	7.0	9.0	10.1	10.6	10.9
Non-performing loans/total loans	1.5	1.7	2.5	2.6	2.6
Provision loss rates	0.50	0.85	1.31	1.12	0.92

Diagram 1

Concentration (H- Index) of Selected Banking Systems, 2003[a]

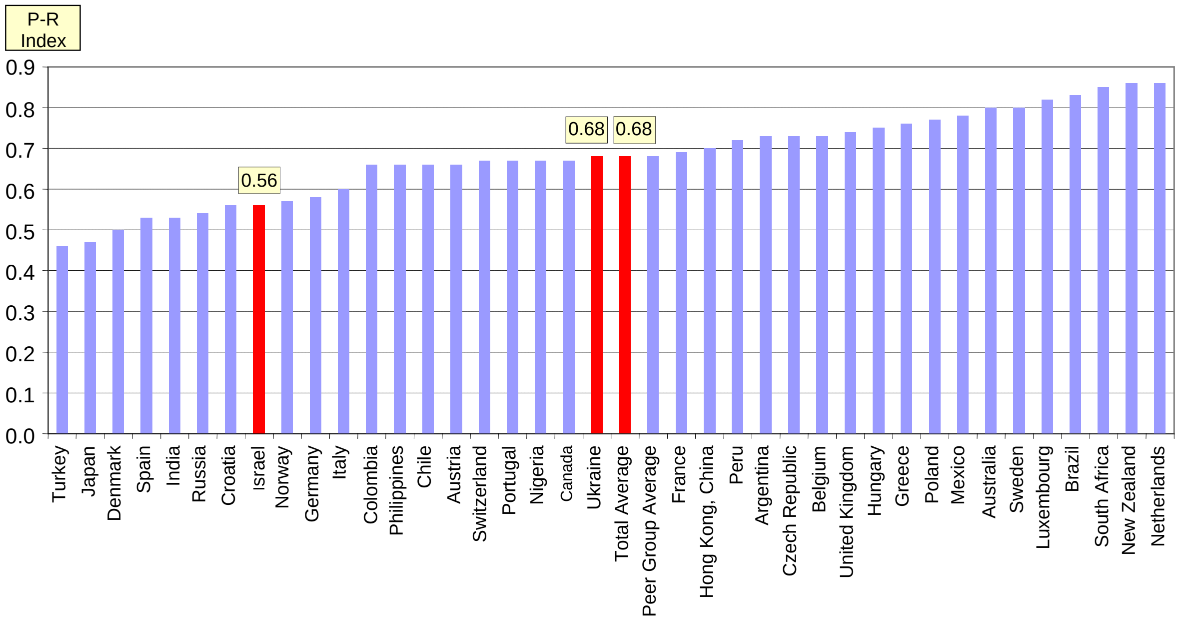


[a] For Italy, Germany, the US, France, Canada, Australia, South Africa, Norway and Ireland the H-Index is calculated from data relating to 2002. [b] For Israel the H-Index is calculated from data relating to 2004.

Source: Banking supervision authorities of the relevant countries.

Diagram 2

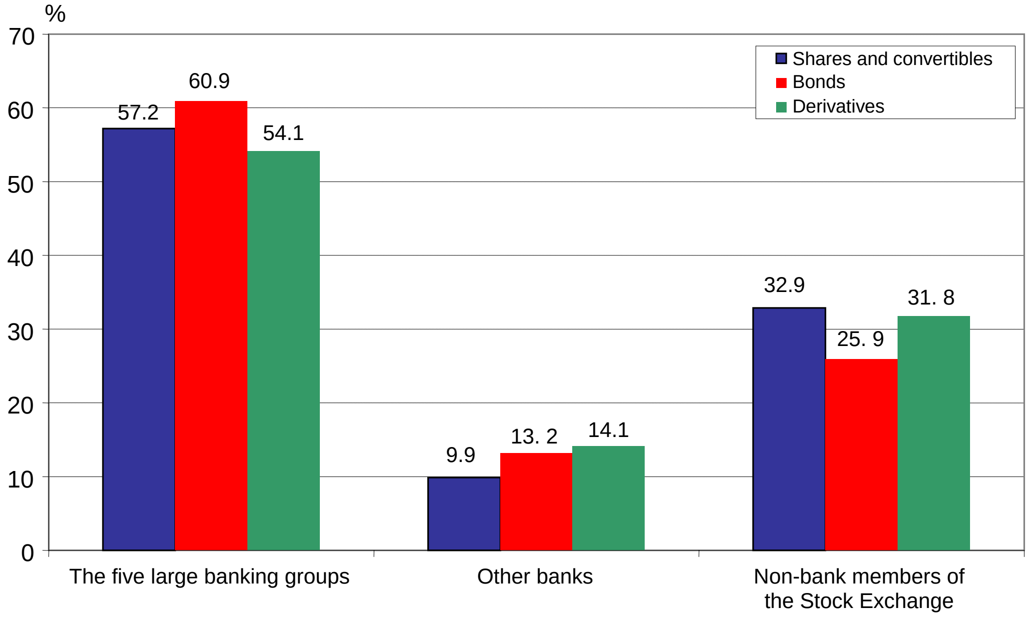
Panzar & Rosse[1] Index for measuring contestability of selected banking systems - intenational comparison



The data source: (1) Claessens & Laeven, "What Drives Bank Competition?: Some International Evidence" (2003). (2) The data of the countries are annual averages for the period 1994-2001. (3) Israel's peer group consists of eight countries that have similar characteristics - size of the economy, size & concentration of the banking systems - Denmark, Greece, Norway, Portugal, Ireland, Finland, South Africa. (4) The data for Israel is annual averages for the period 1997-2003.

Diagram 3

Composition of Turnover: The Five Large Banking Groups, Other Banks, and Non-bank Members of the Stock Exchange, 2004



Source: Data of the Tel Aviv Stock Exchange.

Diagram 4

Analysts with Equity Stakes vs. Independent Analysts: Accrued excess return for half a year following the recommendation

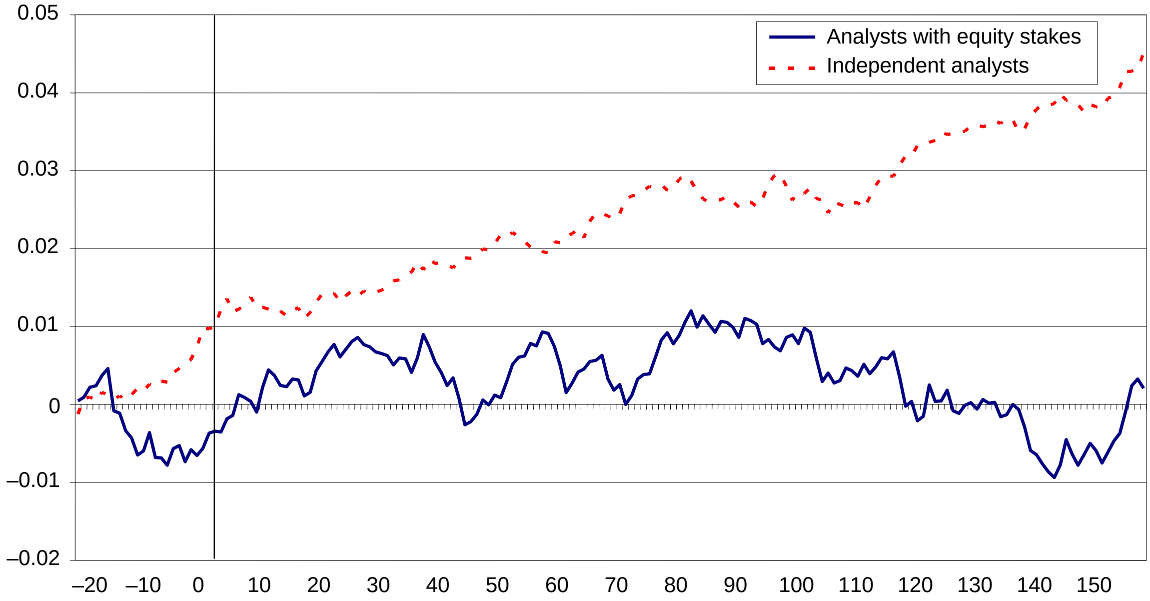


Diagram 5

Average Daily Turnover in Israel's Financial Markets, 2000-2005

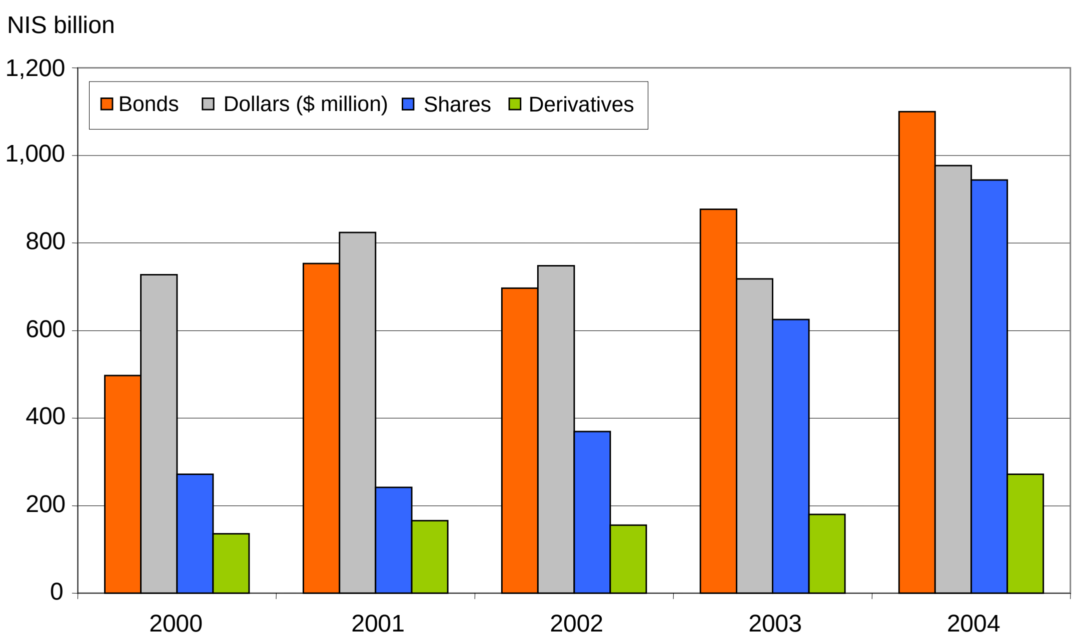
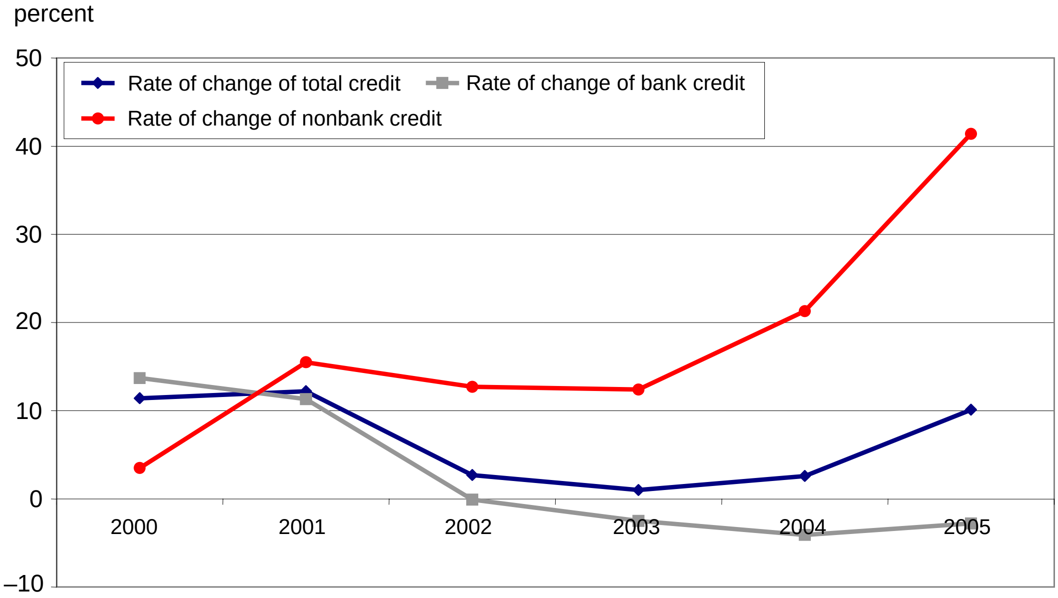


Diagram 6

Annual Changes in Credit to the Business Sector, Bank Credit vis-à-vis Credit from other Sources, 2000-2005[a]



[a] Cumulative changes in credit till June 2005. Rates of changes in credit are in annual terms.