

Karnit Flug: The credit market and its supervision in the Israeli economy

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, to the Knesset Economics Committee on the Gray Market, Tel Aviv, 15 July 2015.

* * *

Main points:

- The forces of supply and demand create the gray market (a financing system that is an alternative to the institutional system) in Israel, some parts of which are a legitimate market that provides services that are complementary to the institutional system. This market can also contribute in certain aspects of competition.
- The main problem in the gray market starts with the lack of regulation and supervision over activity in this market. The entities that are active in this market provide credit without any regulatory supervision in relation to this activity or at all. The lack of supervision has a negative impact on borrowers in the gray market, first of all from a basic consumer standpoint. In contrast to the banking market, there is no consumer protection system for borrowers in this market.
- The risks in the gray market may spill over to the financial market, both due to regulatory arbitrage (gaps in regulatory requirements) that will lead to a decline in standards in the financial system, and from a prudential standpoint, particularly if the entities in the gray market grow and become a significant part of the credit market.
- One of the reasons for the recent global financial crisis was the development of a nonbank financial system, mainly in the US, which was not sufficiently supervised. These systems grew rapidly while taking significant risks that in the end were realized in the form of a financial crisis.
- It is preferable to act in this area in two directions: First, to reduce the gray market by developing alternative institutional sources of financing, and second, to regulate the legitimate activity in the gray market through legislation and regulation and to supervise activity in this market.
- The Bank of Israel and the Banking Supervision Department are acting to ensure accessibility and competition that will improve the situation for households and small businesses. As part of this, we are acting to increase competition both within the banking system and through entities outside the system, including other legitimate noninstitutional entities.
- Supervisory regulation of the gray market will make it possible to expand the sources of financing of the entities active in it. The proposal to enable certain entities to issue bonds and to provide credit without arranging the appropriate controls may lead to serious harm to the economy.
- I am aware of the desire for everything to be here and now. But we need to deal with these issues properly, with the proper regulation, even if that takes time, since the damage of promoting unregulated financial activity will exceed the benefit, and the victim, as always, will be the public.

Good morning,

In my remarks here today, I will present a general outline of the credit market in the Israeli economy, and relate to parts of it that are supervised by various regulators such as the Bank of Israel, and to parts that are not supervised as of today, including the gray market.

I will begin with a description of the market and the various players in it, continue with a description of the gray market within the financial system and the risks that exist in the gray

market in its current structure, and finish with a presentation of my position in relation to how we must handle the main failures in this market.

So what is the gray market, and who are the players in it?

In order to understand this and to connect it to possible solutions, I would like to start with a short description of the financial intermediation framework in Israel. By this I refer to the intermediation between the supply of sources of savings and demand for investment financing and consumption, between the supply of credit and the demand for credit. This framework can be divided into three main groups: the banking system, the nonbank financial institutions system, and the alternative financing market, which we refer to as the gray market.

Traditionally, financial intermediation between savers and borrowers takes place in the banking system through the provision of loans that are financed through deposits from savers. Even now, despite the development of additional sources of credit, the banking system is the dominant system in Israel among the various financial institutions for everything to do with financial intermediation activity.

By way of explanation, as of December 2014, total household debt was about NIS 433 billion. About 94 percent of that debt is to the banking system and credit card companies.

Over time, and following the adoption of technological improvements and alternative instruments, additional entities began operating and specializing in various components of financial intermediation. These entities include the nonbank financial system, which provides credit through financial entities such as pension funds and insurance companies. Despite the fact that these entities are part of the institutional system and are subject to a regulatory and supervisory system, they still differ from the banks mainly in their access to liquid government sources.

If we can see these first two groups – the banking system and the nonbank financial system – as institutional systems, the third group, which is the focus of this meeting today, offers an alternative financing system to the institutional system.

This type of financing is referred to in Israel as the gray market. The term “gray market” has negative connotations, although it should be noted that in and of itself, credit provision activity is not necessarily contrary to the law. There are legitimate – although insufficiently supervised – actors within the gray market, and in contrast, there are also criminal elements. The way in which this market has developed in Israel is fraught with risks, including compliance risks, which I will discuss more later on.

In Israel, the alternative financing system is mainly offered by currency service providers, private and public companies providing credit services, and charitable organizations. In addition, another industry is developing, thanks to technological developments, that offers a financing model that brings borrowers and lenders into direct peer-2-peer contact.

When we look at this phenomenon globally, we look at the banking system and at the nonbank system opposite it, referred to by the term “shadow banking”. Perhaps this name is not so complimentary, but the vast majority of this system in the world is comprised of nonbank financial entities that are subject to various levels of supervision. There is a marked increase globally in shadow banking activity, which is made possible due to technological developments in the field, the high level of liquidity that currently exists in the markets, and against the background of increased regulatory restrictions imposed on the banks.

Regarding the gray market, there are no complete data on the volume of its operations or on its customers, which is one of the problems it presents.

A survey conducted for the Small and Medium Business Agency in the Ministry of the Economy in 2010 shows that many small businesses have difficulty financing their operations, but that only 0.4 percent gave a positive answer to the question of whether they use the gray market. It seems that this number is downward biased, since there is no

complete information on credit provision or check clearance by currency service providers or charitable organizations. Current estimates talk about a credit market of about NIS 10–20 billion. In relation to the existing numbers in the banking system, the rates are very low.

Up to now, I have outlined the financial environment in which the gray market operates in Israel. Now I will try to answer the question of who the customers are in this market.

There is apparently a wide variety of customers that use the financial services of the gray market. These are mainly households and small businesses, to whom the banking system or the nonbank institutional system are inaccessible from the outset, or those that have used up their banking credit facilities. Examples of those who use the services of the gray market include restricted customers, those in bankruptcy, customers without sufficient collateral, borrowers in need of rapid and liquid money, and borrowers wishing to take out a loan under complete discretion for reasons both legitimate and illegitimate.

The situation thus far is something that we recognize well from Economics 101. There are forces of supply and demand that create the gray market, and some of that market may be a legitimate market that provides services complementary to the institutional system that cannot or does not want to be part of this market. There are also advantages, including increased public access to credit. In addition, the fact that the gray market exists and is developing shows to a certain extent that it is necessary.

However, there are also problems and failures in how this market has developed in Israel.

The main problem in the gray market begins with the lack of regulation and supervision over activity in this market. The entities active in this market provide credit without regulatory supervision in relation to this activity or in general. The lack of supervision has a negative impact on borrowers in the gray market, first of all from a basic consumer standpoint. In contrast to the banking market, there is no consumer protection system for borrowers in this market. For instance, the banks have due disclosure obligations in relation to the terms of credit. For the most part, they are cautious in the provision of credit beyond customers' needs and repayment abilities, and there are fixed and regulated dispute settlement mechanisms. The Banking Supervision Department also enforces consumer directives, and serves as the decider of disputes in many cases where customers have claims of improper activity on the part of the banks. Just this week, we published the activity report of the Banking Supervision Department's Public Enquiries Unit. The Unit worked to clarify thousands of enquiries, brought about the repayment of more than NIS 3 million to customers, and was able to provide systemic handling of a number of complaints where it turned out that the complaints did not only concern those customers who enquired about them.

None of this exists in the gray market. Advertisements about the terms for providing credit in the gray market often lack basic information the borrower requires, and sometimes contain misleading information. For instance, a simple search on the Internet regarding the possibility of taking out a loan results in the following information: "Immediate loans, within half an hour, for any purpose, at low interest, without guarantors."

Another aspect of the lack of regulation and supervision is the fact that there are no entry barriers to the gray market, and criminal elements working through illegitimate means – from exaggerated interest that is prohibited by the Nonbank Loan Regulation Law, to means of debt collection – are entering it. Of course the existence of criminal elements leads to additional damage in terms of the war against money laundering, the personal security of the borrowers, and the social strength of the public as a whole.

In addition, since many entities in the gray market work with and within the institutional financial system, the problems and risks may also spill over into the financial system. This may be reflected in regulatory arbitrage (the gap in regulatory requirements) that may in the end lead to a decline in standards in the financial system. Should these entities grow and

become a significant part of the credit market, any failure that may occur could develop into a prudential problem.

One of the reasons for the recent global financial crisis was the development of a nonbank financial system, mainly in the US, which was not sufficiently supervised. These systems grew rapidly while taking significant risks that in the end were realized in the form of a financial crisis. Therefore, the International Monetary Fund in its most recent financial stability report warned of the existing risks in nonbank credit. The Federal Reserve also shone a light on these risks as part of a department that was established after the crisis and is responsible for identifying and analyzing risks in the various financial systems – not necessarily the banking systems – with a systemic, rather than individual, view.

In this context, it is important to note an additional point. As I have already mentioned, there is insufficient data and information on the gray market. It is therefore difficult to estimate the prudential risks in this market. Regulation of this market will ensure proper information and data on the size and development of the market, the level of risk in the activity of the various entities in the market, and their effect on the overall financial system. For example, in view of the high growth of consumer credit in recent years, and the understand that the risks that may derive from this growth must be monitored, the Banking Supervision Department released a new reporting directive on consumer credit risk just a few days ago.

How can we handle the problems created by the gray market in Israel?

I think it is worthwhile acting in two directions in this area: first, to try to reduce the gray market by developing alternative institutional sources of financing, and second, to regulate the legitimate activity in the gray market through legislation and regulation to the point where it no longer justifies the term "gray market", and to supervise activity in this market.

When we talk about increasing the legitimate sources of financing for households and small businesses, first of all there is the institutional system.

The banks: In recent years, bank credit to households and small business has constantly been increasing, and the banks have identified the advantages, from their standpoint, in operations vis-à-vis these customers. By the way, I note that the growth in this activity is not coming at the expense of proper risk management, and it is good that there is a regulator supervising this.

The second group that could be a major factor both in terms of availability of and access to credit and in terms of price through competition with the banking system, is institutional investors.

The Bank of Israel and the Banking Supervision Department are acting to ensure accessibility and competition that will improve the situation for households and small businesses. I would like to mention here the recommendations of the Interministerial Team to Examine How to Increase Competitiveness in the Banking System, led by the Supervisor of Banks, a large part of which are already in advanced stages of implementation. The recommendations related to increasing competitiveness within the banking system itself, and to increasing competitiveness through entities outside the system. Among other things, the Team saw many advantages in providing credit to households and to small businesses by nonbank financial institutions. These institutions provide a tangible potential for increasing competitiveness in the households and small businesses segments. They lead to a greater variety of credit instruments offered to the public, to an increased supply of credit to these segments, and to lower costs of such credit. Another advantage is from the standpoint of managing long-term savings, since credit to households and small businesses has characteristics that are appropriate for the public's pension savings portfolio. It is an investment that is characterized by significant diversification and by a suitable return. The Team's work reviewed the obstructions preventing the expansion of such activity or delaying the entry of these entities into the retail credit market, mainly the ability and cost inherent in establishing an underwriting, management and collection array for retail credit. The Team

presented initial directions for removing these obstructions, and I hope that we will succeed through joint effort with the Ministry of Finance to help the entry of institutional investors into this field take form.

Another measure for increasing households and small businesses' access to credit is in line with the Team's recommendation to increase the number of players in the banking system itself, by creating a regulatory framework for the establishment of Internet banks and credit unions.

In addition, other legitimate noninstitutional entities should be able to take part in various parts of financial intermediation, such as mass financing platforms, state guaranteed credit funds for small businesses, the securitization of bank loans to these segments and their sale to institutional investors, and more. Many of these measures are already on the table, and their expansion should be considered. Some of the issues are also being discussed today by the Team to Increase Competitiveness that was recently established by myself and the Minister of Finance.

To sum up this point, increasing the supply of credit by the banking and institutional systems, and increasing the availability of credit on other supervised tracks will make it less worthwhile for households and small businesses to turn to the gray market.

One necessary complementary measure is the regulation of legitimate entities within the market that is currently called the gray market, and removing illegitimate entities from this market. Such entities should be put under a regulatory framework with all that that entails – in other words, a regulatory, a system of laws and directives, supervisory and enforcement authorities, and so forth. When this market is under regulatory supervision, it will be possible to talk about the sources of financing of the entities operating in it, including the proposal to enable certain entities to issue bonds and to provide credit. Expansion of such activity without the proper controls may lead to serious damage to the economy. As such, we are opposed to it. We must not be tempted by quick solutions that offer the unsupervised development of additional financial systems. We need a long-term vision in order to know how to deal with the risks that exist in the activities of the various actors in this market. A report by the Ministry of Justice has already recommended regulating the activity of these entities, and there is now a discussion on how to implement those recommendations.

Beyond that, enforcement authorities must obviously deal with contraventions of the law and of public order, should any take place, and they must be given the proper tools for this both through the required legislative changes – for example, there is a proposed Fair Credit Law that sets out criminal penalties for collecting interest beyond a rate set by the law – and by making resources available.

In summation, the gray market in Israel is an existing fact. There is place for a credit market beyond the banking system, mainly concerning increased access to credit. The market can also contribute in terms of competition. It is important to establish a regulatory framework to regulate, supervise and enforce the law and regulations for activity of the noninstitutional market.

There are currently many processes in various committees relating to some of the problems. There is a committee in the Ministry of Finance to establish a dedicated regulator, there is a committee to increase competitiveness in the financial services, and the government is leading various efforts to assist small businesses.

I am aware of the desire for everything to be here and now. But we need to deal with these issues properly, with the proper regulation, even if it takes time, since the damage of promoting unregulated financial activity will exceed the benefit, and the victim, as always, will be the public.