Recent developments in Israeli banking and financial markets

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Israel is a small country, with a population of eight million residents, renowned for its human capital and for being fertile ground for technology companies, both of which have earned it the name "Start-up Nation". While the global economy is undergoing trying times, the Israeli economy is weathering the storm, compared to the international markets. One of the key players in maintaining stability in Israel's economy has been the Bank of Israel – Israel's central bank, as supervisor of the banks and the financial markets more generally.

As part of this ongoing effort, the Bank of Israel and the Banking Supervision Department (which is the body within the Bank of Israel charged with preserving the stability and strength of the banking system) have been and still are taking action to support and maintain financial stability in Israel. These activities include:

- adopting a monetary policy of lowering the Bank of Israel's interest rate (which as of September 2014 is at an all-time low of only 0.25%) along with dollar purchases intended to lower the Israeli Shekel's exchange rate, whose increasing strength has made it more difficult to export from Israel, all the more so against the backdrop of the slump in global trade;
- strengthening the capital adequacy of Israeli banks by implementing the Basel III framework in all matters concerning capital adequacy as of January 2014 and gradually introducing the Basel III recommendations regarding Liquidity Cover Ratio (LCR), starting on April 2015;
- in response to increasing housing prices, taking steps to reduce the risk for both lenders and borrowers, such as limitations on housing loans that banks are allowed to offer (including limitations on the Loan to Value ratio (LTV), on the portion of the loan that can be given with a floating interest rate, on the proportion of the repayment from the borrower's income and limiting the term of the loan); and
- implementing processes aimed at increasing the competition within the Israeli banking sector, as shall be further discussed later in this article.

THE ISRAELI BANKING SYSTEM

There are only a handful of banks that form the Israeli banking system. There are about 15 local banks, as well as branches of foreign banks whose activity in the local market is confined mainly to private banking, investment consulting and investment banking. Regulation of the local and foreign banks and related guidance is issued by the Bank of Israel and is influenced by the state of the world economy and by international regulatory processes (such as the various Basel Accords) together with local processes, all this resulting in Israeli banks, their controlling shareholders and other institutional market participants having to deal with ever-increasing regulation.

Acknowledging the burden created by increasing regulation, in January 2014 a law was passed having the objective of easing existing regulation and stimulating activity in the financial market.

STIMULATING COMPETITION

A great deal of attention has been devoted in recent years to matters concerning the level of competition in the Israeli economy, most notably in the context of the cost of living and housing. The Israeli public has been voicing deep dissatisfaction on this matter, both through the media as well as by demonstrations and protests; so much so that several committees have been set up to look into the situation and find ways of resolving it. This has influenced the Israeli banking and finance industries considerably.

A committee has recently convened to examine the level of competition and to reduce the centralisation in the Israeli economy. This committee was set up mainly as a result of the public outcry that erupted from the high cost of living. The committee, whose recommendations became law in December 2013, recommended, among other things, that a person who holds a significant holding in a substantial financial institution will not be permitted to hold significant holdings in substantial "real" entities, meaning entities which are neither banks nor insurance companies. The expected implications of the new law are that in coming years, stakes in a number of key corporations are expected to be divested, since a number of individuals with a controlling interest in both substantial financial and "real" entities will be compelled to let go of either the financial or the real arm of their portfolios.

The Bank of Israel has placed the promotion of competition high on its agenda. To that end, the Governor of the Bank of Israel and the Minister of Finance commissioned the "Evaluation Task Force on Increasing Competition in the Banking Industry". The task force published its recommendations in March 2013 which included, for example, increasing the number of retail credit providers within the banking system and adjusting the regulations to enable the establishment of a cooperative bank and the first Internet bank in Israel. Other recommendations include setting up a credit bureau and creating a "banking ID card" detailing customers' total assets and liabilities at the bank, which the bank will be required to provide at the request of the customer, reducing service charges for small businesses and reducing commissions for trading securities and increasing the use of the internet for banking transactions (e.g. opening of bank accounts). These last steps are intended to increase the competition among the existing credit providers. Some of the recommendations have become binding directives in 2014, and others are still within the legislative process.

Other regulatory bodies have joined the effort to increase competition, e.g. the Israel Securities Authority which has promoted legislation making it easier to open accounts at investment houses.

NON-BANK FINANCIAL INSTITUTIONS – BECOMING MAJOR PLAYERS IN THE CORPORATE/ SYNDICATED LOAN MARKET

Over the last decade, institutional investors, primarily insurance companies, provident and pension funds have doubled their share in the corporate credit market and more recently have emerged as major competitors of the banks in the corporate loan market. Consistent with this trend, one can identify a decrease in the volume of large-scale syndicated loans being arranged by the large banks alongside an increasing number of arranging mandates being given to non-bank financial institutions. This is a major shift in the market given that until recently, these financial institutions would typically join syndicates arranged by the large banks.

These changes are the product of several factors: changes in the regulatory regime applicable to investments by institutional investors over the last decade, which now afford a larger array of permitted investments; a significant reform in the Israeli capital markets in 2005 (known as the Bachar Reform), under which banks were forced to divest provident and mutual funds under their management, so as to enable the buyers of those funds to compete with the banks in providing credit; and the compulsory pension reform, which came into effect in 2008 and compelled all salaried workers in Israel to save for retirement, which resulted in an increased amount of money deposited with the institutional money managers.

As a result of these reforms, and catalysed by the 2008 global financial crisis, the necessity of best practice rules for the institutional investors investing in corporate bonds and loans became all the more acute. In order to regulate investment by institutional investors in corporate bonds, the Commissioner of Capital Markets, Insurance and Savings in the Ministry of Finance (the regulator in charge of supervising the institutional investors) set up a committee (known as the Hodak Committee) which submitted its recommendations in 2010, which were later generally implemented in the local legislation. These included a requirement for institutional investors to thoroughly review the terms and conditions of bonds and refrain from investing in bonds that do not meet certain minimal financial criteria or do not include other contractual terms and covenants.

Furthermore, most of the regulation in recent years applied to credit in general, without focusing on loans, and in particular on loans being granted within a syndication or a consortium, an asset class which has grown considerably in recent years. For this, the Commissioner of Capital Markets set up a committee (known as the Goldschmidt Committee), which submitted its recommendations in April 2014 regarding the types of investments by non-bank financial institutions, their amount, their approval process, the contractual stipulations and the financial criteria which they must meet and the means of their collection and repayment.

The committee added a series of recommendations regarding aspects of corporate governance which were intended to ensure the existence of adequate human resource infrastructure within financial institutions granting credit and regulating the way the board of directors evaluates credit transactions (including the exposure limits), dealing with conflicts of interest, setting up internal credit committees, existence of process controls and *post facto* assessment of credit risks. In addition, the recommendations refer to the appropriate corporate governance within credit institutions, obligations of disclosure in the institution's financial reports, etc. The committee's recommendations have not yet been statutorily implemented.

TO BE OR NOT TO BE – BANKS WITH OR WITHOUT A CONTROLLING CORE

For many years, Israeli banks, most of which are traded on the Tel Aviv Stock Exchange, were held by controlling shareholders. The only exception was Bank Leumi (one of the two largest banks in Israel), which, until a few years ago, remained under the Israeli Government's ownership since it was nationalised in the eighties.

In recent years there has been a new trend towards decentralisation of controlling cores of banks in Israel (i.e., dispersing the controlling core through the stock exchange among multiple entities as opposed to selling a controlling stake to a single buyer or buyers acting in concert). There are several drivers for this trend: whereas in the past it seemed that the Bank of Israel believed that the stability of the banking system was better preserved when the banks were owned by controlling shareholders, in recent years the Bank of Israel has been signalling that the question of ownership of a bank (controlling core or no core), is irrelevant to its stability.

This approach was also expressed by the Bank of Israel in July 2013, in its tightening of the criteria for acquiring a controlling interest in Israeli banks (for example, increasing the minimum size of the holdings required for a core interest, a new requirement for a personal commitment by the owners of the controlling interest to inject capital into the bank in times of crisis, etc.). In addition, for the first time the Bank of Israel published criteria (in July 2013) for the process of decentralisation of banks' controlling core, criteria which are intended to ensure that during the interim period between the start of the sale of parts of the control interest until all parts of the control interest have been sold, the former controlling owners of the bank will not continue to effectively control the bank, even if they still own a substantial portion of its shares. This trend of the Bank of Israel has resulted in the owners of controlling interests in banks in Israel considering, more than ever, the possibility of divesting their stake to dispersed buyers as an alternative to selling the control interest to a different controlling group. And so, in addition to Bank Leumi, which is the first bank to operate without a control core for the last several years, the opportunity was seized by the foreign control holders of the Israel Discount Bank, who in December 2013 announced the beginning of a process of divesting their controlling interest, which was completed via a sale to the public through the capital markets in September 2014. This trend is expected to continue.

COLLABORATION ON FATCA AND THE WAR AGAINST MONEY LAUNDERING

In July 2014, the Government of Israel signed a cooperation agreement with the Government of the US on sharing tax information on citizens of both countries. This took place against the backdrop of the coming into effect of the FATCA rules.

In addition, in an effort to increase the income sources of the Government of Israel and broaden its collection potential and tax base, the Israeli Prime Minister appointed a committee to review the use of cash and cheques. One of the recommendations of the interim report (May 2014) was to limit the use of cash and cheques (in terms of the allowable transaction amounts), and to increase the use of electronic payment methods as a substitute for cash – e.g. debit cards and personalised prepaid cards, while reducing the fees involved in their use, as well as promoting other aspects of a virtual wallet.

SUMMARY – WHERE WE ARE HEADED TO

The Israeli economy and the banking and financial systems within it continue to face the global realities and events in the world markets on the one hand and to deal with the local requirements and needs, on the other hand. The way these challenges are balanced, in smooth sailing and when the going gets tough, will determine the direction of the banking system in the coming years.

The information included in this article is correct at the time of writing.

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