Chapter 3
Activity of the Banking Supervision Department

The principal function of the Banking Supervision Department is to maintain the stability and robustness of the banking system. In this respect, it aspires to strengthen the risk and capital management framework at the banks. In addition, the department is responsible for increasing the competition and efficiency in the banking system, and for ensuring that a fair network of relationships is maintained between the banks and their customers.

In 2010 the department's activity was focused on enhancing the capital adequacy in the banking system as a cushion for the absorption of unexpected losses, on applying—for the first time—the directives of Basel II at the banking corporations and at the Banking Supervision Department, on strengthening corporate governance and risk management at the banks, and on coping with the development of risks in the housing market.

This chapter comprises five sections. The first section provides an extensive review of the Banking Supervision Department's principal activities in 2010 in the area of strengthening the robustness of the banking system, and also refers to activities aimed at increasing the competitiveness and the fairness of bank-customer relations in the system. The second section describes the organizational structure of the Banking Supervision Department with all its various divisions and units. The third section presents a table of supervisory events in 2010 by chronological order. The last two sections review data in the area of bank-customer relations at the banking corporations—a review that is based on the information obtained from the Banking Supervision Department's processing of enquiries and complaints by the public and on main developments in the area of commission fees.

1. PRINCIPAL ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2010

a. Work processes under Basel II—the process of supervisory review and evaluation and activity for strengthening capital adequacy

The Banking Supervision Department's activity during 2010, and particularly its activity aimed at strengthening the capital adequacy in the banking system, was a direct continuation of its activity in previous years. This activity became even more important in view of the global crisis, which highlighted the necessity of capital at an amount and at a quality adequate for the purpose of absorbing unexpected losses. This year the department placed an emphasis on close scrutiny of the banking corporations in the risk management process, strengthening the adequacy of their capital and adjusting it to their risk profile.

Since December 31, 2009 the Israeli banking system has operated in accordance with the directives of Basel II, while adopting the standardized approach for the allocation of capital in respect of credit risks.

As a result of the global financial crisis, the Basel Committee and leading regulators worldwide compiled changes that were intended to increase the robustness of the world's banking systems by increasing the level and the quality of the capital held by the banks, and adapting this capital to the business cycles. These changes, which were incorporated within the framework of Basel III, are expected to go into effect gradually, until they are fully implemented in the year 2019.

In order to maintain the adequacy of the capital of the banks in Israel, even before publication of the final recommendations of Basel III, the Banking Supervision Department took a significant step to strengthen the resilience of the banking system in Israel by requiring the banking corporations to adopt by December 31, 2010 a Tier 1 capital ratio[1] of not less than 7.5 percent, and presented them with a work program for adhering to this ratio. The banking corporations were also required not to distribute a dividend if they do not adhere to the said objective or if the dividend distribution results in failure to adhere to the objective, without prior permission from the Supervisor of Banks. The banking corporations were also asked to take into account the high degree of probability that new issues of complex capital instruments would not be recognized in the future for capital adequacy purposes.

During 2010 all of the Banking Supervision Department's divisions continued with measures for assimilating the principles of risk based supervision (RBS), for expanding the banking corporations' information infrastructure, and for applying the principles of Basel II. In this respect, in 2010 the Banking Supervision Department promoted a project for upgrading supervisory information infrastructures, at the end of which the department will have at its disposal an advanced BI system for the analysis, investigation and presentation of such information in accordance with the directives of Basel II and the risk-focused supervisory method.

A supervisory review and evaluation process and activities for strengthening capital adequacy

A major measure adopted in 2010 for strengthening capital adequacy and risk management in the banking system was the introduction of the supervisory review process (SRP),

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[1] Tier 1 capital is the most stable and reliable component of a capital base due to its consisting principally of equity capital and surpluses; hence its importance for the stability of the banking corporations. The reference to Tier 1 capital reflects the Basel Committee's reference to complex capital instruments in a draft circular that was published in December 2009 as a result of the lessons learned from the financial and real crisis.

which is described in the second pillar of Basel II. This process is intended to ensure that the banking corporations allocate enough capital to support all the risks inherent in their business activities, and to encourage the banks to develop and to employ enhanced techniques for the management of risks.

The SRP process is comprised of two parallel processes. One is carried out by the banking corporations and the other by the Banking Supervision Department, and a constant dialogue is maintained between the two of them.

The first process is reflected by the requirements imposed on the banking corporations to maintain an internal capital adequacy assessment process (ICAAP). This process is intended to ensure that they maintain an appropriate level of capital, which will support all the risks inherent in their business activities, and that they develop and adopt suitable risk management measures. The process includes the determination of capital targets, capital planning[2] and examination of the capital situation in a range of stress tests.

The second process in the SRP process is the supervisory review and evaluation process (SREP). The Banking Supervision Department evaluates and reviews banking corporations' assessments of their internal capital adequacy, their strategy and ability to monitor capital ratios, and their ability to adhere to the ratios that have been determined. In this respect the Banking Supervision Department determines whether the available capital and capital targets are suitable for the banking corporation, and if necessary stipulates remedial measures, including a requirement for incremental capital.

Under these processes, the banking corporations at the head of the banking groups and the three independent banks were required to submit official ICAAP reports by June 2010, and these were examined and analyzed by the Banking Supervision Department across various sections. Among other activities, special teams were established in the different areas (such as analysis of the risks and examination of the quality of their management, method for the allocation of capital with respect to pillar 2 risks, capital planning and stress tests), and comprehensive discussions were held at the Banking Supervision Department's management for the purpose of compiling supervisory principles with respect to a broad range of issues and for examining improvements that are required regarding the reports that were received.

Subsequently and within the framework of the SREP process, the Banking Supervision Department formulated and integrated a structured and orderly method for determining the capital adequacy and capital targets suited to the risk profile of each banking corporation. Here, the department examined the practice of other supervisory authorities, and was assisted by external advisors from Israel and abroad. The method that was formulated is based on an assessment of each of the material risks inherent in the banking corporation's activity, an assessment of capital management and adherence to the targets that were determined, the actual quality of capital, the results of stress tests

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2 A process that analyzes the present and future requirements of the banking corporation with respect to its strategic objectives and business plans. The planning must describe capital requirements, the level of capital available and external sources of capital

examining risks that could emerge or increase as a result of unexpected events and an assessment of the implications of the examination's results for capital targets.

Application of the method was based on the Banking Supervision Department's information infrastructure within the RBS, and information that was accrued in the department's divisions.

Within the framework of the SREP process, extensive discussions were held in various forums at the Banking Supervision Department, a current dialogue was held with the banking corporations, and at the end an overall risk profile was compiled for each of the corporations as well as remedial measures, if necessary, including strengthening of corporate governance, risk management and internal controls. The principal findings from the SREP process were sent to the banking corporations' boards of directors and boards of management. This was done *inter alia* within the framework of special meetings which the Supervisor of Banks held with them.

A supervisory review process is officially embodied in Proper Conduct of Banking Business Regulation 211, "Assessment of the Proprietary of Capital Adequacy", which was issued in June 2010. Also prescribed during 2010 were Proper Conduct of Banking Business Regulations concerning the measurement and adequacy of capital.

b. Activities for strengthening corporate governance

The Banking Supervision Department is endeavoring to integrate suitable frameworks for internal supervision and control, and is examining the efficiency of the functioning of the control and supervision bodies at the banking corporations—the board of directors, senior management, a risk management network, internal auditing and the compliance officer.

During 2010 the Banking Supervision Department continued to examine the effectiveness of the work of the boards of directors. In this respect, Proper Conduct of Banking Business Regulation No. 301 concerning the board of directors was amended. (See Box 3.1).

An additional emphasis was placed during the year on an examination of the effectiveness of the risk management function in the banking system, a function that is headed by the Chief Risk Officer (CRO).

(1) The board of directors

During recent years, concurrent with the integration of the Basel II project in Israel and while learning lessons from the financial crisis, the Banking Supervision Department provided focused supervisory guidance in order to assist the banking corporations in enhancing the effectiveness of the work of the boards of directors and changing the emphases in its activity. This was done by outlining corporate policy and via the supervision and control of the activity of management.

Audits for the purpose of evaluating the effectiveness of the work of the board of directors: In the course of the year the Banking Supervision Department continued to cover the majority of the largest banks in the system with audits that examined the effectiveness of the work of the board of directors. An emphasis was placed in these audits on the ways in which the board of directors outlines the overall strategy of the bank, determines the bank's risk appetite and supervises the management of the bank in the application of that strategy. The audits were conducted under a method that evaluates the board of directors' performance and the quality of its discussions, as well as the characteristics and practices required for the purpose of fulfilling its function. The findings of the audits have helped the banking system to improve the board of directors' work processes.

Amendment to Proper Conduct of Banking Business Regulation 301: As a result of the move to a risk-focused supervisory environment and as part of the lesson-learning process from audits evaluating the effectiveness of the boards of directors at most of the banks, a decision was made to amend Proper Conduct of Banking Business Regulation No. 301 concerning "the board of directors". The main changes in the regulation are based on three major principles: enhancing the functioning of the boards of directors (particularly in the outlining of strategy and the supervision of the bank's management) vis-à-vis the functioning of the board of management (primarily current management); enhancing the competition, proficiency and independence of the board of directors in order for it to hold effective and challenging discussions; and improvement in the board of directors' working practices and performance. (See Box 5.1 below for further details).

The Supervisor of Banks' periodic meetings with the boards of directors of the banks in the system: In the periodic meetings which the Supervisor of Banks held with the members of the boards of directors of the banking corporations, supervisory expectations with respect to the functioning of proper corporate governance were clarified to many boards of directors. In addition, within the framework of the SREP process a supervisor details to the board of directors and to members of the senior management the strong and weak points of each banking corporation, and the measures which the board of directors should take in order to deal with the weak points.

"The board of directors at a banking corporation—Challenges in the era of heightened corporate governance" seminar: As part of its activities for explaining its expectations regarding the work of the board of directors, the Banking Supervision Department held a one-day seminar for directors and senior managers in the banking system. Among the issues presented at the seminar were dilemmas in the work of the board of directors and the Banking Supervision Department's expectations of the banking corporation's board of directors, including its expectations regarding the board of directors' function in the process of determining the bank's strategy and risk appetite, supervision and control of the management and the appointment of office-holders.

Box 3.1: Update of Proper Conduct of Banking Business Regulations 301 concerning the board of directors

In December 2010 Proper Conduct of Banking Business Regulations 301 concerning the boards of directors (hereinafter: "the regulations") was amended. The amendment includes guidelines regarding the functioning, authorities and composition of the boards of directors, types of board committees and their functioning, and the practices adopted for the purpose of efficient functioning. The directives in the regulations fully conform to the recommendations of the Basel Committee, and with regulatory practices in Israel and abroad.

A basic assumption is that satisfactory and high-level functioning of the boards of directors as part of proper corporate governance is a basic element in the proper management of the banking corporation, which is essential for maintaining the public's credibility in the banking system and for protecting deposit holders. Accordingly, the Supervisor of Banks has a major interest in the existence of a quality and effective board of directors, which fulfills and clearly understands its functions while employing appropriate and independent discretion with respect to the banking corporation's affairs.

A number of prominent guiding principles are expressed in the updated regulations:

- Definition of the board of directors' areas of responsibility and its principal functions with respect to the activities of the banking corporation. Emphasized in the regulations for this purpose is a definition of the boards of directors' function, which is principally to outline the banking corporation's policy and to supervise its business activity, as distinct from the functioning of the management, which is current management. As an example, with respect to the approval of credit extensions, the regulations stipulate that the board of directors must approve a detailed credit policy and define clear and detailed restrictions in the matter. The board of directors' activity with respect to credit authorizations is expected to be limited, and to focus mainly on the authorization of extraordinary transactions relative to policy that has been determined.
- With respect to its function of outlining risk management policy, the board of directors must approve a detailed risked-appetite policy, examine the appropriate capital allocation for supporting the risk profile, examine the organizational structure and ensure that suitable resources exist for the management of activity, and to approve the work programs and to determine the budget for realizing the programs.
- After the board of directors has formulated the required policy, it must review and supervise the implementation of policy. In this respect, it

must prescribe effective restrictions for the management of risk, and request and examine current reports and exceptional reports. The board of directors must use the assistance of the control functions available (such as the internal auditor and the chief risk manager), and must assure the proficiency and the independence of these functions. In order for these tools to be effective, the board of directors must deal with the findings arising from the control functions' activities and back up their activity.

- The regulations detail additional functions that are the board of directors' responsibility. These include: appointment of the CEO and definition of his authorities, evaluation of his performance and approval of his remuneration; approval of the appointment of senior office-holders in key positions, including control functions; remuneration policy; an ethical code; and compliance to regulation.
- Modes of operation of the board of directors and its performance as a collective: The regulation details matters that are expected of the board of directors (such as understanding of the function, employment of appropriate discretion and the challenges facing the management), and also details the tools that will assist the board of directors in fulfilling its function effectively (professional assistance, instructional programs and a self-assessment process). Also clarified in the directive are expectations regarding performance at the board of directors' meetings (presence, presentation of background material, manner of documentation and decision-making), and guidelines were determined for regulating the network of relationships with the banking corporation's management outside the framework of the meetings. It was determined in this respect that dialog with the management concerning business activities should usually be held at the meetings themselves. In the event of matters arising outside of the meetings, rules governing the provision of information, coordination and transparency were determined.

This principle also relates to the issue of delegating the board of directors' authority to the board of directors' committees. The regulation clarifies the expectations regarding the manner in which discussions are to be held at the committees and determines rules for the composition of the committees, in order to facilitate in-depth and effective discussions on matters of importance in a limited forum, with directors specializing in the matters relevant to the discussion. In addition, a decision was made to strengthen the independence and functioning of the audit committee, in order for it to be able to collate all audit and control matters at the corporation. A decision was also made to mandate the establishment of a risk management committee, and a salary and remuneration committee.

- Enhancing the proficiencies, composition and independence of the board of directors: The regulation prescribes a process for the approval of certain office-holders, which is stipulated in Paragraph 11a of the Banking Order of 1941. The regulation states that approval must be given before the appointment is made (on the basis of the information existing regarding the appointment) and during the period of tenure (taking into account the performance of the director as well). The Supervisor of Banks' regulations emphasize the need for banking corporations' boards of directors to be independent and to have the appropriate proficiency, in line with the concept that the composition of the boards of directors and the proficiency of the directors are the key for their success in drafting strategy and supervising the banking corporation's affairs. The regulation added a number of matters arising from supervisory experience with respect to the directors. These include: professional proficiency, enhancing the independence and proficiency of the external directors and increasing their share in the composition of the board of directors, tightening up the conditions for preventing conflicts of interest, and reinforcing the composition of the board of directors with those experienced in banking and with financial accounting specialization.

(2) Proficiency and fitness of those wishing to manage the public's money

The Banking Supervision Department at the Bank of Israel, the Capital Market, Insurance and Savings Division at the Ministry of Finance and the Securities Authority engage, each one in the area subject to its supervision, in regulating the activity of entities operating in the money and capital markets which *inter alia* manage the money of other parties. As part of this regulatory activity, the supervisors determine the proficiency and fitness of those wishing to engage in the area of activity that is regulated and supervised by them.

The structure and size of the capital market in Israel and the fact that a number of supervisors operate in it requires a degree of harmonization and uniformity in the examination of fitness and proficiency by the different supervisors, especially when it is considered that many of the supervised entities are supervised by two or more supervisors, albeit in different frames of reference. Accordingly, the three supervisors, in coordination with the Senior Economic and Fiscal Assistant to the Attorney-General, compiled a list of criteria regarding the non-fitness of those holding means of control and office-holders in the supervised entities. The list, which was published in December 2010, is comprised of twelve criteria, including conviction of an offence, submission of an indictment, a criminal investigation, serious negative findings that arose in the course of legal proceedings and audit proceedings, and numerous material complaints that were found to be justified.[3]

[3] For the full list: http://boisite/press/heb/101208/101208m.pdf

The list is not a closed list, and is not to be taken as preventing any supervisor from employing independent discretion, including the possibility of deviating from the list.

(3) A bank without a core shareholders group

In cooperation with other regulatory entities, in 2010 the Supervisor of Banks initiated a bill for the amendment to the banking laws—the Banking Law (Licensing) and the Banking Order—which was submitted to the Knesset at the beginning of 2011 and is currently under discussion at the Finance Committee, after having been passed in a first reading by the Knesset plenum.

The main objective of the bill is to adapt the legislation relating to a bank without a core shareholders group, over and above the legislative amendments that were already made in this respect in 2004, as detailed below.

As the result of a failed attempt in 2001 to sell Bank Leumi to a strategic foreign investor (as recommended by the Gal Committee in 2000), the Finance Minister and the Governor of the Bank of Israel decided to privatize the bank via the capital market. This decision marked a major change in the basic assumption guiding the Supervisor of Banks' activity, and made it necessary to adjust the regulatory, supervisory and control environment of the banks and of those controlling them.

For this purpose, in February 2002 a committee was established for examining the aspects relating to the sale of Bank Leumi via the capital market (the Marani Committee). As a result of this committee's recommendations, amendments were made to the Banking Law (Licensing) (Amendment 13) and the Banking Order ("the Marani Amendment"). Since then, a bank has been able in principle to exist with a diversified holding, without a core shareholders group. Each of these structures has its advantages and disadvantages.

The purposes of the currently proposed amendment to the Banking Laws are:

- Creation of a balance at a bank without a core shareholders group between the need to prevent actual control of a bank without receipt of a permit from the Governor of the Bank of Israel, and the right of those holding means of control to propose candidates for service as directors and to ensure their election.
- Increasing the ability to supervise a bank without a core shareholders group.
- Ensuring that a board of directors with a suitable number of directors exists, and increasing the transparency and "market discipline" in the process of electing directors, at banks without and with a core shareholders group.

(4) The risk management function

In December 2009 the Supervisor of Banks required the banking corporations to establish a risk management function to be headed by the Chief Risk Manager. The Supervisor's intention was to create an independent, effective and formal risk function at the corporation, which will be able to enhance the understanding of the risks inherent in the banking corporation's activity and to ensure that the entire range of risks are managed cautiously, properly and completely.

In order to assure the effective integration of the CRO function, the Supervisor of Banks conducts audits for the purpose of examining the integration of the CRO function in the bank's work processes. The supervisor intends to continue placing an emphasis on this function, in accordance with the recommendations of leading international organizations on the matter, and to clarify his expectations regarding the manner of the function's integration.

(5) Remuneration policy at a banking corporation

One of the principles of proper corporate governance is to determine suitable remuneration policy for the banking corporations. As part of the lessons learned from the global crisis of 2008, in order to reduce the risks deriving from unsuitable incentive structures and in line with the Supervisor of Banks' adoption of the FSF recommendations, the banks were required to adopt a suitable remuneration policy to be determined by the boards of directors no later than December 31 2009. This remuneration policy is required to adhere to the following principles: adaptation to overall-organizational profitability and the long-term objectives of the banking corporation; the avoidance of incentives that encourage risks exceeding the banking corporation's risk appetite; basing remuneration on risk-adjusted return and the cost of capital; inclusion of a component that will reflect adherence to the banking corporation's general objectives in the areas of risk management and compliance to laws, supervisory directives and the banking corporation's procedures. In addition, the banking corporations are required to employ strict supervisory and control processes over remuneration policy, and the agreements governing severance payments to members of the senior management must take into account their actual performance over time and the reason for their retirement. As a result of these requirements, a number of banks expanded and updated their remuneration policy in order to adapt it to the said principles.

c. The processing of risks

(1) Credit risk

During 2010 the Supervisor of Banks continued to examine and assess the credit risks inherent in the banking corporations' activity, and to take action for the purpose of enhancing the quality of risk management and the operation of suitable controls. In this respect, the Supervisor of Banks continued to conduct audits on credit risk related matters at the level of the entire banking system and at the level of the single bank, examining credit policy and the manner in which it is assimilated, and the processes for authorizing and managing credit. In addition, the Supervisor examined the processes for detecting and classifying problem debts, dealt with potential risk centers in the bank credit portfolio and specific problems that were identified, especially with respect to borrower concentration, the largest borrowers in the system and the quality of debts.

Subsequently, the Supervisor of Banks provided close support for the banking corporations in their preparations for applying a directive for reporting to the public concerning the measurements and disclosure of efficient debt, credit risks and the provision for loan losses, a directive that went into effect on January 1, 2011.[4]

In examining the risks in the banking system and the management of macroprudential policy, in 2010 the Supervisor of Banks continued to deal with the risks inherent in developments relating to housing loans:

- In view of the rapid expansion in the activity of purchase groups, the Supervisor of Banks examined the risks in this activity. This examination showed that alongside the advantages compared with the purchase of an apartment from a contractor, credit taken within the framework of purchase groups involves additional risks both for the members of the group and for the banking corporation financing their activity. Concern over the development of these risks became even more important due to the characteristics of such activity—principally the involvement of organizers whose business proficiency has yet to be proved and the lack of adequate experience regarding material failures during a period of falling housing prices. Due to concern over potentially serious damage to the banks' credit portfolio and reputation, the Supervisor of Banks determined that until an apartment is actually handed over to the purchasers, this credit will be classified as a corporation's indebtedness in the real-estate industry (and not as a housing loan) and will be weighted at 100 percent in the calculation of capital adequacy.
- Developments in the housing market during the year resulting from the low interest rate environment and the supply of apartments that was inadequate for fulfilling the growing demand led to a substantial increase in prices. These developments had the effect of increasing demand for housing loans. The Supervisor of Banks took action to moderate these developments. The objective was that the combination of an upturn in the Bank of Israel interest rate, the Banking Supervision Department's adoption of focused action and the promotion of resolute government measures aimed at influencing the supply of apartments would halt the rapid upturn in prices and benefit apartment buyers.

In this respect and in view of the development of the risks in housing loan activity, in July 2010 the Supervisor of Banks instructed the banking corporations to reexamine the existing credit portfolio and credit policy in the area of mortgages, and required the banks to hold a supplementary provision at a rate of at least 0.75 percent in respect of new housing loans with an LTV exceeding 60 percent. The Banking Supervision Department also required the banking corporations to conduct stress tests at differing levels of seriousness, in order to examine the impact of the scenarios, including those with a low probability of materialization, on customers' finance rates and repayment

[4] The directive adopts structured and more detailed standards for the measurement and disclosure of credit risks in the banks' financial statements, in order to: (a) to improve the banking corporations' ability to monitor and manage credit risks, *inter alia* due to the increased uniformity and consistency in the measurement of loan losses that are expected; (b) to enhance the forward-looking approach in the calculation of loan-loss provisions; (c) to increase the ability to make comparisons among banking corporations in Israel and between those corporations and banks abroad.

ability. The Department examined the details of the tests carried out by the banking corporations.

In October 2010, due to the rapid growth in floating-rate leveraged housing loans, the Supervisor of Banks increased the capital allocation required in respect of these loans to 100 percent (instead of 35 percent or 75 percent). The Banking Supervision Department will continue to examine the management of credit risks in the area of housing loans.

(2) Market risk and liquidity risk

In view of the trends in foreign-currency trading in the local markets, during the year the Supervisor of Banks monitored developments in the banking corporations' activity on behalf of their customers and on their own behalf in complex financial instruments and in instruments that include an element of shekel/foreign currency trading, especially in shekel/foreign currency type derivative instruments.

The increased volume of activity in shekel/foreign currency type derivative instruments observed at the beginning of 2011 prompted the Supervisor of Banks to order the banks to expand their monthly reporting on derivative instruments (Banking Supervision Department Reporting Regulation No. 814), in order for the reporting to contain more extensive details on the characteristics of activity in instruments of this type, including details of the volumes of transactions by types of counter parties and by period of the transactions.

The requirement to report in the expanded format was initially applied to March 31, 2011 data.

As a result of the crisis in global financial markets, the importance of cautious management of liquidity risk and financial investments increased during recent years, and the Banking Supervision Department tightened the stringency of the supervisory processes over these matters.

In 2010 the Banking Supervision Department examined liquidity risk and the exposure to financial investments at the banks by regularly monitoring the development of liquidity and the exposure to financial investments at the banks, by conducting audits, and by adapting the supervisory directives and reports on these matters. These measures are intended to assess the quality of the management of liquidity risk at the banks and the level of this risk.

The qualitative appraisal of risk management is focused on an examination of a variety of matters, including: the existence of suitable strategy and policy; suitable detection and measurement systems; models matching the size and complexity of the banking corporations; current reporting and warning systems; suitable control systems and control processes; an up-to-date and valid liquidity model matching the bank's risk profile; the propriety of the internal restrictions prescribed for liquidity risk management; the effectiveness of the liquidity model's assumptions; the propriety of stress tests; management and monitoring of liquidity by control entities at the bank; and the existence of a plan for business continuity in stress tests.

Assessment of the level of liquidity risk is based on a wide range of liquidity indices that were developed in at Banking Supervision Department, and which are intended to measure various aspects of liquidity risk such as the concentration and stability of the bank's sources, the bank's access to liquidity, liquidity ratios and the existence of liquidity cushions.

(3) Operational risks and compliance risks

IT risks: In 2010 the Banking Supervision Department conducted audits on matters relating to the management of the banks' IT networks and the use which the banks make of IT in their technological systems, in processing unusual events, and in their range of IT related ventures and activities.

In 2010 the Banking Supervision Department began a comprehensive review of the area of IT in the banking system. This process included the preparation of a document on the subject of "social networks", in which the banking corporations were presented with examples of potential risks in the matter, and their attention was drawn to the need for proper management of the use of social networks.

Embezzlement and fraud risks: In 2010 the Banking Supervision Department began to examine the banks' deployment for the management of operational risks. The department circulated a letter clarifying its position on the subject, and developed audit tools for covering the matter of the management of controls within the banking corporations.

Prohibition of money laundering and the financing of terrorism: In 2010 the Banking Supervision Department conducted audits at the banks and the credit card companies in the area of the prohibition of the financing of terrorism, in addition to the current audit on AML matters. An emphasis was placed on the system of controls and infrastructures for applying legislative and regulatory directives. Audits were conducted at the banking corporations in the area of AML, and a focus was placed on examining the application of changes concerning the credit card companies, which had been included in the Money Laundering Prohibition Order.

Concurrent with the adoption of measures for remedying deficiencies that had been identified in AML and terrorism financing prohibition related matters, audit findings concerning violations of legislative requirements on this subject were sent to the Sanctions Committee in the Matter of Money Laundering Prohibition. As a result of the findings of the audit reports, the committee imposed monetary sanctions totaling NIS 7.75 million on the banking corporations in 2010:

- Fines amounting to NIS 6.9 million were imposed on Bank Hapoalim: In connection with the findings of the Banking Supervision Department audit that was conducted at the Global Private Banking Center ("Hayarkon Branch") in 2004, a fine of NIS 5.4 million was imposed, and in connection with the findings of the audit conducted at the bank during 2007–2008, a fine of NIS 1.5 million was imposed.
- A fine of NIS 850 thousand was imposed on Arab Israel Bank in connection with violations of the provisions of the Money Laundering Prohibition Law, which were detected in the Banking Supervision Department's audit report of 2007.

(4) Contingency plans for emergencies

In its capacity of banking financial authority, in 2010 the Banking Supervision Department continued to promote measures aimed at increasing the banking system's preparedness for a state of emergency. This activity is based on the Business Continuity Management method, whose main principles are:

- Business impact analysis—a dynamic process for identifying critical operations and services.
- Definition of recovery strategy for critical processes and service objectives.
- Detailed business continuity planning programs—definitions of functions, responsibility and guidelines for activity.

In this respect, in the first quarter of 2010 the Supervisor of Banks held a meeting with senior officials in the banking system, and instructed them to place the issue of preparations for a state of emergency on the agenda of the banking corporation's boards of directors and boards of management, to update the relevant scenarios and to allocate a suitable budget for the matter.

In addition, the Supervisor of Banks established a consultation forum with the banking system. This forum met on a monthly/bi-monthly basis during 2010, and held 8 meetings.

The directives issued by the Supervisor of Banks to the banking system during 2010 included: a requirement to open a minimum number of branches during a state of emergency (core branches); preparation of infrastructure for the operation of mobile branches, preparation for a shortening of the business day at short notice; policy principles for service objectives; and relaxations for the population in a state of emergency. As regards the Proper Conduct of Banking Business Regulations, the Governor's general permit for the opening and moving of branches during a state of emergency was amended.

The Banking Supervision Department participated in the *Turning Point 4* national emergency drill that was held at the end of May 2010 and that emulated a state of war. The drill examined work processes and infrastructures in a state of emergency.

Box 3.2: Macroprudential policy[1]

Macroprudential policy: definition and objectives

Macroprudential policy is intended to strengthen the financial system's resilience in the face of shocks, and to moderate the impact of the materialization of financial risk on the real economy. The policy is therefore largely preventative in nature.

Macroprudential policy focuses on the relationships between financial institutions, markets, infrastructures and the economy as a whole[2], for the purpose

[1] See the box on this subject in the Bank of Israel report for 2010.

[2] "Macroprudential Instruments and Frameworks: A Stocktaking of Issues and Experiences", May 2010, Committee on the Global Financial System, BIS.

of reducing systemic financial risk, the materialization of which involves heavy macroeconomic costs. The policy includes a range of tools that are adapted for this purpose. Systemic risk[3] is defined as a disruption in the supply of financial services caused by deficiencies in part or in the whole of the financial system, and can have substantial negative results for real activity. According to Borio (2009)[4], the disruption may derive from imbalance in the financial system which develops over time (the time dimension), or from contagion channels between financial institutions, including failure of a large institution (the cross-section dimension).

The processes considered as macroprudential policy have changed over the years. Today, macroprudential policy is perceived as policy supplementary to microprudential policy— policy for supervision over single financial institutions, the financial markets and financial instruments. Examples of the use of this policy during the recent past, in view of the implications of the global crisis, are regulatory developments relating to the cyclicality of the financial system, the regulation of the infrastructures on which derivatives trading is based, and the failure of financial institutions of systemic importance.

The main way of dealing with threats to financial stability in the time dimension is to identify processes that are not sustainable over time and/or that have a domino effect (such as pro-cyclical credit or an asset bubble), and to react to developments in good time. The main way of dealing with threats to financial stability in the cross-section dimension however is to examine the resilience of the financial system in the face of internal and external shocks, take measures to increase its resilience, increase the preparedness for a failure event, and ensure that it possible to react to events in real time.

The objectives of macroprudential policy are therefore to create an awareness of potential threats to financial stability in both dimensions (the time dimension and the cross-section dimension), to detect these threats in a timely manner and to adopt measures for reducing the risk.

Macroprudential policy instruments

Macroprudential policy includes micro policy instruments (such capital ratios, provisions, restrictions on credit, LTV restrictions, liquidity reserves and restrictions on concentration), fiscal policy tools (such as taxes and financial activities), monetary policy instruments (such the interest rate and liquidity instruments) and other instruments (such as restrictions on capital flows). No agreed list of macroprudential instruments currently exists; and the emphasis is placed on the

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[3] The above-mentioned document (CGFS, 2010) proposed this definition, which was developed in a study conducted by the IMF, the FSB and the BIS for the G20.

[4] "Implementing a Macroprudential Framework: Blending Boldness and Realism", Claudio Borio, BIS, July 2010.

supervisory and regulatory instruments that are employed with respect to banking institutions, although the subject is under constant development.

Macroprudential policy at the Bank of Israel

One of the three objectives of the Bank of Israel under the law is to support the stability of the financial system and its regular activity. The law also enables the Bank of Israel to provide credit to non-banking financial institutions in circumstances where real concern exists over the stability of the financial system or its regular activity. The onset of the global recession highlighted the need for strengthening the central banks' function as responsible for the stability of the financial system, in order to reduce systemic risk by means of macroprudential instruments.

A major example of the Bank of Israel's use of macroprudential policy in the recent past is the action taken by the Supervisor of Banks to moderate undesirable developments in the real estate market and in the financial system: a persistent growth in demand for housing, which pushed up prices in the housing market to a greater extent than the rise in the standard of living and households' income, and led to large increase in demand for hosing loans. In this respect, the Supervisor of Banks issued a number of directives to the banking corporations:

July 2010—a requirement for a supplementary loan-loss provision at a rate of 0.75 percent in respect of loans with an LTV exceeding 60 percent.

October 2010—a requirement to allocate capital at a rate of 100 percent (instead of 35 percent or 75 percent) in respect of loans with an LTV exceeding 60 percent, in which the floating-rate proportion of the loan exceeds 25 percent and in respect of loans at an amount exceeding NIS 800 thousand.

May 2011—a prohibition on granting loans in which the floating-rate component exceeds 33 percent. This measure is intended to reflect the concern over an increase in the risk in the bank credit portfolio and at the same time, together with the resolute measures adopted by the Bank of Israel and other authorities, to reduce the gap between demand and supply and to moderate price increases in the housing market.

d. Strengthening international relations

The Banking Supervision Department maintains relations with supervisors abroad in order to exchange supervisory information, as required under the international standards prescribed by the Basel Committee. In this respect, a delegation from the Bank of Israel's Banking Supervision Department met with the banking supervision authority in the USA, and held working meetings with the principal supervisors in Washington and New York. Subsequently, a delegation from the supervisory authority in the UK (the FSA) visited Israel to exchange supervisory information. In October, a delegation from the Banking Supervision Department visited the supervisory authorities in Switzerland,

and an IMF delegation was hosted in Israel in accordance with Article IV.[5] The Banking Supervision Department also hosted delegations from the central banks of Croatia and Georgia.

Progress was made in the course of the year in the signing of a memorandum of understanding (MoU) with the supervisory authorities in the USA and Turkey.

In 2010 the Banking Supervision Department participated in the work of the OECD Financial Markets Committee in the matter of supervisory policy and regulatory changes, and in discussions at the organization's offices in Paris. Working meetings were also held with representatives of the large international rating companies.

e. Activity for increasing the competition and fairness in the banking system

(1) Legislation and regulation in 2010 for the protection of bank customers

In 2010 the Banking Supervision Department made amendments to directives in the area of proper conduct of banking business and promoted legislation related to bank–customer relations to increase fairness, encourage competition, and strengthen the position of the customer vis-à-vis the bank. Thus it issued circulars and letters to all the banks on these matters. A summary of regulations in the field of banking consumerism is set out below.

(a) House Sale Regulations (Securing Investment of House Purchasers) Bank Guarantees, 5770–2010

The Banking Supervision Department participated in the formulation of the above regulations, which were published by the Ministry of Housing and Construction on November 21, 2010, and which went into effect ninety days later.

The regulations specify a uniform obligatory formulation of the bank guarantee, which is the most common security of the various alternatives under the Sale (Apartments) (Assurance of Investments of Persons Acquiring Apartments) Law, 5734–1974 (herein "the Sale Law"). As stated in circular 2238–09 published by the Supervisor of Banks in February 2011, when the regulations go into effect Directive 456 of the Proper Conduct of Banking Business—which until the publication of the regulations specified the uniform formulation of the guarantees under the Sale Law—will be cancelled.

(b) Directive 432—transferring activity and closing a customer's account

As part of the activity of the Banking Supervision Department to strengthen competition in the banking system an amendment to Directive 432 was introduced which dealt with the closure of an account or transfer of activity from one bank to another by a customer;

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[5] The clause in the IMF articles of association requiring member countries to adhere to the fund's objectives. In this respect, member countries cooperate with the IMF in promoting financial stability, and the fund is obligated to supervise the international monetary system in order to assure its proper functioning and to ensure that member countries comply to the fund's policy.

the amendment became effective on December 1, 2010. It is aimed at further easing the process of transferring accounts from one bank to another, and in this case dealt with customers' transferring their debit card activities.

When switching from bank to bank customers were in most cases required to replace debit cards in their possession with new cards issued by the bank to which they were transferring. Hence the importance of simplicity and ease of transferring current activity via the card, including authorities for direct debits granted by customers to suppliers.

The amendment requires the issuer of the new card to provide the details of the new card to the issuer of the old card, and the latter will deal with the suppliers regarding the transfer of ongoing transactions to the new card. Thus the burden of transferring transactions via debt cards has been passed from the customer to the issuer of the old card. After dealing with the suppliers regarding the transfer of ongoing transactions via the debit card, the issuer of the old card must inform the customer if there are any suppliers that did not act in accordance with the instructions and continue to make debits from the old card, and if so, must provide details of those suppliers.

(c) Circular 2254–06 re disclosure of cost of a service when providing a service relating to securities or foreign exchange

In accordance with section 26A(a) of the Banking (Service to the Customer) (Proper Disclosure and Provision of Documents) Rules, 5752–1992, (henceforth Rules of Proper Disclosure) the banking corporation, when providing the service, must inform the customer of the cost of the service.

In January 2010 the Banking Supervision Department published a circular absolving banking corporations from disclosure of the cost of the service when providing a service relating to securities or foreign exchange. The circular gave a complete list of services related to securities, the cost of which services the banking corporation is not obliged to disclose to the customer at the time of providing the service, on condition that the customer has given his explicit consent in writing. The list includes among other things buying and selling securities traded on the Tel Aviv Stock Exchange, and buying, selling and redeeming mutual funds.

In addition, with regard to customers who are nonresidents and customers who deal directly vis-à-vis the bank's trading room, the circular listed services relating to foreign exchange for which the banking corporation would also be absolved from the disclosure of cost requirement. These services include among others changing currency, transferring foreign currency to or from abroad, and futures transactions.

d. Letter from the Supervisor of Banks about amending bank contracts in accordance with the ruling of the Standard Contracts Court and of the Supreme Court.

In December 2010 the Supervisor of Banks sent a letter about the implementation of the rulings of the Standard Contracts Court and the Supreme Court on the Bank Leumi contract "Rules for Managing Accounts/Deposits (henceforth the Current Account

Contract),[6] and the First International Bank Housing Loan Contract.[7]

In that letter the Supervisor of Banks directed all banking corporations to implement the above court rulings and to amend the contracts they used accordingly. He also directed them to amend the contracts signed by new customers, to publicize the court rulings on their websites, and to make them accessible to their customers. The Supervisor of Banks also set a preparatory period during which all banking corporations were required to examine the effects these court rulings would have on their other contracts that contain similar clauses to those referred to in the rulings, and to amend them accordingly.

The Supervisor also emphasized that although the banking corporations were granted a period of several months to amend their contracts, they had to act in accordance with the court rulings from the day they became effective.

(2) Activity of the Banking Supervision Department in 2010 in the area of information and explanatory material

In 2010 the Banking Supervision Department expanded its activities in the provision of consumer information to the banks' customers, with the aim of reducing the knowledge gap between banks and their customers, and to provide the latter with information and useful tools in the banking area. A review of activities undertaken follows.

a. Publication of a file on bank–customer relations, legislation and directives

In February 2010 the Bank–Customer Division of the Banking Supervision Department published a file collating the main banking legislation, the directives on the Proper Conduct of Banking Business, and circulars on bank–customer relations, classified by the most common services provided. This was done as a public service, to increase the public's awareness of directives in the area of banking consumerism, and also to create an aid for all engaged in banking, either within or outside the banking system. The file deals with subjects such as bank accounts, means of payment, loans and debts, guarantees and guarantees for house buyers, interest rates, and bank fees.

In addition to the printed version, which can be bought from the Bank of Israel Publications Unit, the file is available in electronic form on the Bank's website, and the Banking Supervision Department updates it in accordance with changes in the directives on the Proper Conduct of Banking Business, circulars from the Department, and amendments to legislation.

(b) Program to increase public awareness

In December 2010 the Banking Supervision Department ran a campaign (on the radio, internet, and printed media) on switching banks. The purpose was to increase competition in the banking system by increasing bank customers' awareness of their

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[6] Miscellaneous Appeal 195/97 Attorney General v Bank Leumi, Civil Appeal 6916/04 and Civil Appeal 7680/04, Bank Leumi Ltd v the Attorney General and Counter Appeal.

[7] Standard Contract 8002/02 The Supervisor of Banks, Bank of Israel v the First International Mortgage Bank Ltd.

rights, and to strengthen their position vis-à-vis the banks. The campaign provided the public with consumer information, tools, calculators and comparative tables which can help customers check their banking activity, identify the bank most suited to their needs, and provide information on the process of switching banks, including the ways to simplify and shorten the process. The campaign was also intended to increase public awareness of the wealth of information on banking consumerism available on the Bank of Israel's website.

(c) Distribution of pamphlets to the public

As part of its public relation activities, the Banking Supervision Department published two pamphlets, one on Checks Without Cover, and the other on the Public Enquiries Unit in the Bank of Israel. The purpose was to increase the public's awareness of these subjects and to inform them of their rights in these matters.

Pamphlet on the Checks Without Cover Law: This pamphlet contains information on the various restrictions imposed on drawers of checks without cover, and describes their direct and indirect implications for the management of an account and for the account holder. The pamphlet also describes the tools available on the Bank of Israel website to find restricted accounts or customers restricted in aggravated circumstances, and how to communicate with the Drawers of Checks Without Cover Section in the Banking Supervision Department.

Pamphlet on the Public Enquiries Unit: The purpose of this pamphlet was to increase the public's awareness of the service provided by this Unit in the Banking Supervision Department and of the possibility of turning to the Unit for clarification or to lodge a complaint on banking matters. The pamphlet details the tools available to the Unit and its powers, the issues on which complaints may be lodged or enquiries made, and how to communicate with the Public Enquiries Unit.

(3) Processing of enquiries and complaints from the public

The Bank-Customer Division in the Banking Supervision Department endeavors to maintain the fairness of the relations between the banking corporations—banks and credit card companies—and their customers, while protecting the rights of the banking consumer. One of the division's core activities is clarification of customers' enquiries and customers' complaints against the banking corporations, and the learning of lessons from the information obtained from the processing of complaints.

This activity is centered in the Public Enquiries and Commission Fees Unit, and includes deciding on complaints while providing suitable relief if necessary, supplying information to the banks' customers in order to reduce the information gaps between them and the banking corporations, and the detection and processing of systemic deficiencies.

The Public Enquiries Unit operates under Paragraph 16 of the Banking Law (Service to the Customer), 5741–1981, which confers the Supervisor of Banks with the authority to clarify the public's complaints regarding their activities with the banking corporations. The unit is comprised of economists, lawyers and accountants, and serves as an objective-external body for deciding on disputes between the banks and their customers in accordance with legal principles and in view of the value of fairness in bank-customer relations.

In 2010 the Banking Supervision Department processed 7,165[8] written enquiries and complaints from customers of the banks and credit card companies (not including complaints to the call center, which are estimated at 20,000 a year), of which 2,757 were complaints and the rest were enquiries and requests. A position was determined with respect to 2,028 complaints—justified or unjustified—while no position was determined regarding the remaining complaints, due to the inability to make a decision with respect to conflicting verbal claims or concurrent legal proceedings, or because the bank had in any case agreed to accede to the customer's request.

Eighty five percent of the complaints that were submitted to the Banking Supervision Department in 2010 were processed within six months. Replies are given to enquiries from the public concerning questions and requests for information shortly after they are received. The period of time spent in processing complaints includes the time spend on clarification with the banks and the credit card companies. A number of clarifications are sometimes necessary in order to make a decision on a complaint, depending on its scale and complexity.

Set out below is the distribution of the ratio of enquiries and complaints whose processing was completed, together with the length of time spent in processing them at the Public Enquiries Unit:

Twenty five percent of the complaints against banks and credit card companies in respect of which a position was determined were found to be justified in 2010, compared with 26.6 percent in 2009. As can be seen from Figure 1.5 and Table 1.5, following a decrease in the rate of justified complaints in the first half of the decade, stability in the number of complaints was recorded in the second half.

As a result of the Banking Supervision Department's intervention (in individual complaints and in systemic processing), the banking corporations paid their customers a total amount of NIS 6.2 million in 2010.

The overall rebate and compensation to customers resulting from the processing of individual enquiries and complaints in 2010 totaled NIS 2.4 million. Of this amount, NIS 750 thousand were paid by the banking corporations even though the

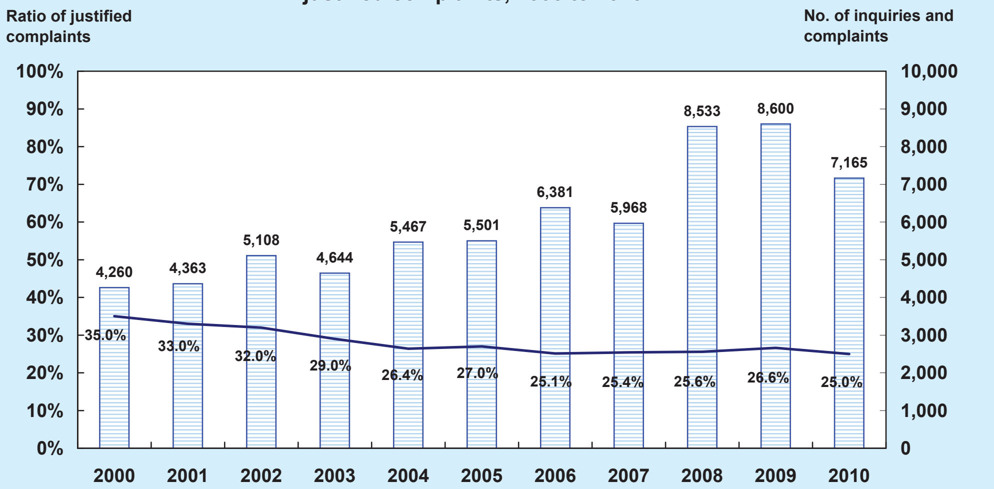
Table 3.1
Distribution of processing time of inquiries and complaints the processing of which was completed in 2010
(Percent)

Up to 3 months	3 to 6 months	6 to 9 months	9 to 12 months	Over 12 months
74	11	7	5	3

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

[8] This figure includes complaints concerning the collapse of the Heftziba company. All the other statistical findings presented here do not include complaints on that matter which were processed, and that will be detailed separately.

Figure 3.1
Number of complaints and inquiries whose processing was completed and ratio of justified complaints, 2000 to 2010



SOURCE: Public Enquiries Unit at the Banking Supervision Department.

complaints or enquiries were not classified as justified. This figure is indicative of the banking corporations' willingness to examine each case on its merits, and in suitable cases to act to the customer's benefit even if his complaint was not found to be justified.

Complaints and enquiries are also used in detecting and remedying systemic deficiencies in the banking system. In 2010, 30 systemic deficiencies were processed, in respect of which the banking corporations were required to adopt such measures as defining or amending working procedures, improving processes and improving service, and refunding money to groups of customers Rebates to groups of customers resulting from the lessons learned from complaints totaled NIS 3.8 million in 2010. The Banking Supervision Department is monitoring the implementation of the measures that were required.

(4) Processing of systemic matters

As stated, complaints and enquiries are used for detecting and remedying systemic deficiencies in the banking system. In addition, the information gained from enquiries and complaints is used to identify matters that need to be regulated by means of Proper Conduct of Banking Business Regulations from the Supervisor of Banks, or to identify matters that need to be explained to the general public.

In 2010, 30 systemic deficiencies were processed, in respect of which the banking corporations were required to adopt such measures as defining or amending working procedures, and improving processes or service. The Banking Supervision Department is monitoring the implementation of these measures.

Remedying of systemic deficiencies which led to a cash rebate to groups of customers
The measures which the banking corporations are required to adopt are likely to include a cash rebate to customers who were harmed by the same deficiency. Rebates to groups of customers resulting from the lessons learned from complaints totaled NIS 3.8 million in 2010, and these are detailed in Table 3.2.

Table 3.2

Total cash rebates to customer groups by relevant deficiency

Systemic subject	Banking corporation	Amount of rebate (NIS thousand)
Value days fee	Discount	651
Settlement fee	Mizrahi-Tefahot	580
Cancellation of authorization fee	Mizrahi-Tefahot	746
Card fee commission	ICC	15
Conversion fee	ICC	45
Rollover card[a]	ICC	59
Non-granting of disocunt on early repayment of supplementary loan[b]	Mizrahi-Tefahot	1,773
Total		**3,869**

[a] Included in the previous survey. Part of the rebate was made in 2010.

[b] Part of the rebate was made in 2009 and part in 2009.

SOURCE: The Public Enquiries Unit at the Banking Supervision Department.

Charging of value days commission fee as a ratio of the transaction amount
Clarification of an inquiry shows that when a foreign-currency check was deposited or withdrawn, Israel Discount Bank charged a fee of 0.7 percent in respect of "value days", in addition to the fee for the transaction itself. According to the scale of commission fees, "value days" is not a fee that is determined as a percentage of the transaction amount, but the number of days which it takes the bank to carry out the transfer or deposit for the customer and the fee-scale therefore contains a reference to a "value days" appendix. In accordance with the Banking Supervision Department's position, the bank stopped charging the fee, and repaid a total of NIS 651 thousand to customers from whom it had illegitimately charged the fee.

Determination of a new fee for the settlement of mutual funds
Bank Mizrahi-Tefahot wished to charge its customers with a new fee, and thereby recoup its expenses in respect of the settlement of mutual funds, at a rate of 0.003 percent. The Banking Supervision Department objected to the addition of the fee because those expenses are included in another fee that is charged for such activity. Under the law, the approval of the Banking Supervision Department is required in order to set a new commission fee. In accordance with the Banking Supervision Department's position, the bank stopped charging the fee and repaid a total of NIS 580 thousand to its customers.

Charging of an authorization cancellation fee

When the commission fee reform went into effect, the fee for the cancellation of an account debiting authorization was abolished, and it was stipulated that only in the case of the cancellation of an account debiting authorization before at least 6 debits were presented, will be a bank be entitled to charge a minimum fee at the level of 6 transactions via a direct banking channel. Clarification of the inquiry showed that Bank Mizrahi-Tefahot charged cancellation fees despite this. As a result of the intervention of the Banking Supervision Department, the bank stopped charging the fee and repaid a total of NIS 746 thousand to its customers.

Charging of a card holding fee despite an exemption

Because of a malfunction, an exemption from a card holding fee was not reported to one of the customers clubs in respect of July 2008. The Banking Supervision Department's intervention resulting from an inquiry by a customer led to a rebate of NIS 15,000 to customers by the Israel Credit Cards (ICC) company.

Non-disclosure of the charging of a conversion fee

Clarification of an inquiry received at the Banking Supervision Department showed that in a specific month, because of a malfunction in the itemization page, full disclosure was not given of a conversion fee that was charged for shekel transactions that are conducted abroad. (The reference is to transaction payments on the internet via Paypal). As a result, ICC repaid a total of NIS 45,000 to its customers.

Revolving credit card

Clarification of an inquiry received at the Public Enquiries Unit at the Bank of Israel revealed that customers who had used a revolving credit card only discovered on the charge date the particularly high interest rate at which their card was charged in respect of the balance of the revolving debt for the next month. The clarification showed that the customers did not understand the nature of the service provided with a card of this type and the manner of using the card, and did not examine its suitability for their purposes. ICC was required to reduce retroactively the interest rate for all the customers who canceled the card or who stopped taking new credit by means of the card, during a period of 6 months from the execution of the first transaction with the card. The credit card company credited its customers with a total amount of NIS 59,141.

Non-granting of a discount on early repayment of a "supplementary loan"

Clarification of a complaint showed that a customer was charged with an early repayment fee in respect of the repayment of a "supplementary loan" without obtaining the discount that is determined in the Banking Order (Early Repayment Fees), 5762–2002. An investigation found that due to an error in Bank Mizrahi-Tefahot's systems, loans that were granted at certain times were not defined as "supplementary loans". The bank rectified the malfunction and credited customers who had made early repayments in the years 2009–2010 with a total amount of NIS 1.7 million.

Examples of the rectification of systemic deficiencies

As a result of the clarification of enquiries, deficiencies are sometimes discovered in the performance of the banking corporations. The corporations are required to remedy the deficiencies, including in this respect the amendment of working procedures and improvement of the service to the customer. The Public Enquiries Unit monitors rectification of the deficiencies.

"Approval in principle" for housing loans

During the clarification of an inquiry received at the Public Enquiries Unit, at one of the banks a number of deficiencies were discovered in the issue of "approval in principle" for a housing loan. The bank was required to remedy the deficiencies and to operate in accordance with the Proper Conduct of Banking Business Regulation concerning housing loans.

Repayment of a housing loan

During the clarification of an inquiry received at the Public Enquiries Unit, at one of the banks deficiencies were discovered in the loan repayment process. The bank was required to remedy the deficiencies and to improve the service.

Revolving credit card

A credit card company is required to provide due disclosure on the nature of the card and the interest rate at which the customer will be charged as soon as the customer joins the service and at the very latest, at the stage when the card is sent to the customer.

(5) Banking fees

The Banking Supervision Department continued to apply its authorities in accordance with the law during 2010, and also continued to promote transparency in the prices of banking services, mainly by:

- Gathering data on the actual charging of commission fees in respect of common banking services for households, analyzing the data and publishing principal trends by reporting to the Knesset and by issuing press releases.
- Examination of 250 requests from banking corporations to update commission fees and determine new fees, and providing a response to these requests.
- Developing comparative tools on the web site—an online comparison of all services to households and small businesses.
- Enforcing provisions of the law in the matter of commission fees, including the issue of repayment instructions for repaying money to groups of customers in cases where fees were charged in contravention of the fee scale.

(6) Cases of checks without cover handled in 2010

In the course of 2010 the Checks Without Cover Section dealt with written communications from about 2,900 customers who were restricted under the provisions of the Checks Without Cover Law, 5741–1981. Some asked for information on the restriction, its implications, and some asked that it be removed or asked for an examination of whether the restriction had been imposed properly. The Section also answered telephone queries and gave advice by phone to callers on these matters.

During the year the number of restricted customers and restricted accounts in Israel increased sharply: the total number of restricted customers increased by 61 percent from the number in 2009. As a result the number of restricted accounts increased by 78 percent. Nonetheless, the number of customers restricted due to checks returned because of insufficient cover declined (regular restrictions and restrictions under aggravated circumstances).

The increase in the number of restricted customers derived from the large number of restrictions imposed by the Execution (Bailiffs) Office following the legal change in the debt collection processes (Amendment 29 to the Execution Office Law) which went into effect in 2009. Among other things the amendment specifies that the Registrar of the Execution Office is empowered, under certain conditions, to impose a special restriction on a debtor defined as solvent who does not pay his debts, this being one of the sanctions available to the Registrar. As a result, the number of debtors on whom restrictions could be imposed increased significantly, and with it, so did the number of actual restrictions.

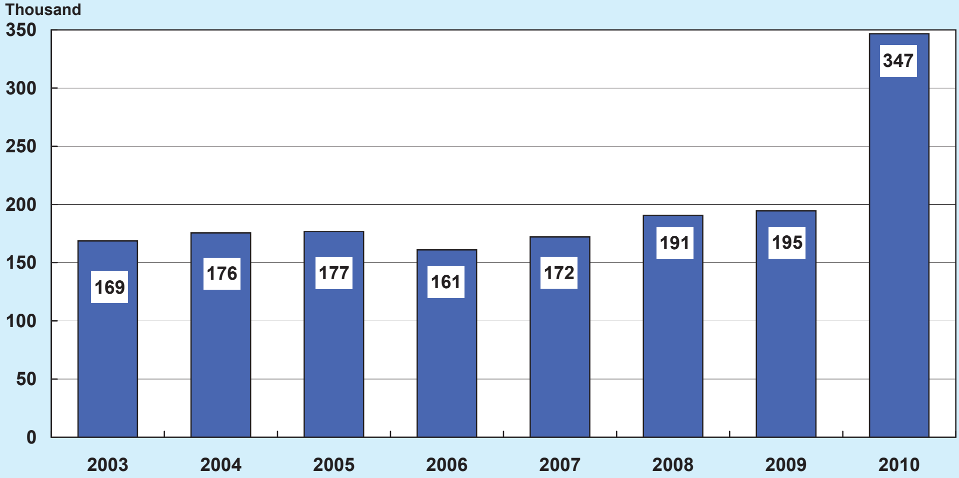
The number of restricted customers and restricted accounts in the system

At the end of 2010 there were about 181,000 restricted customers in the system, compared with 110,000 a year earlier. Of the total, about 29,500 were "restricted under normal circumstances," 25,000 "under aggravated circumstances," and 127,000 "under special circumstances," compared with 44,000 "under special circumstances" at the end of 2009.

Figure 3.2
Total restricted customers and their distribution by type of restriction

SOURCE: Drawers of Checks Without Coverage Section at the Banking Supervision Department.

Figure 3.3
Number of restricted accounts



SOURCE: Drawers of Checks Without Coverage Section at the Banking Supervision Department.

There were 346,000 restricted accounts at the end of 2010, compared with 194,500 at the end of 2009 (Table 3.3).

Appeals

The Section constantly monitors the banking corporations' implementation of court rulings related to appeals submitted to the court by customers restricted by virtue of the law. In this context the Section is responsible for the proper adherence to the appeal procedure followed by the banking corporations in the courts.

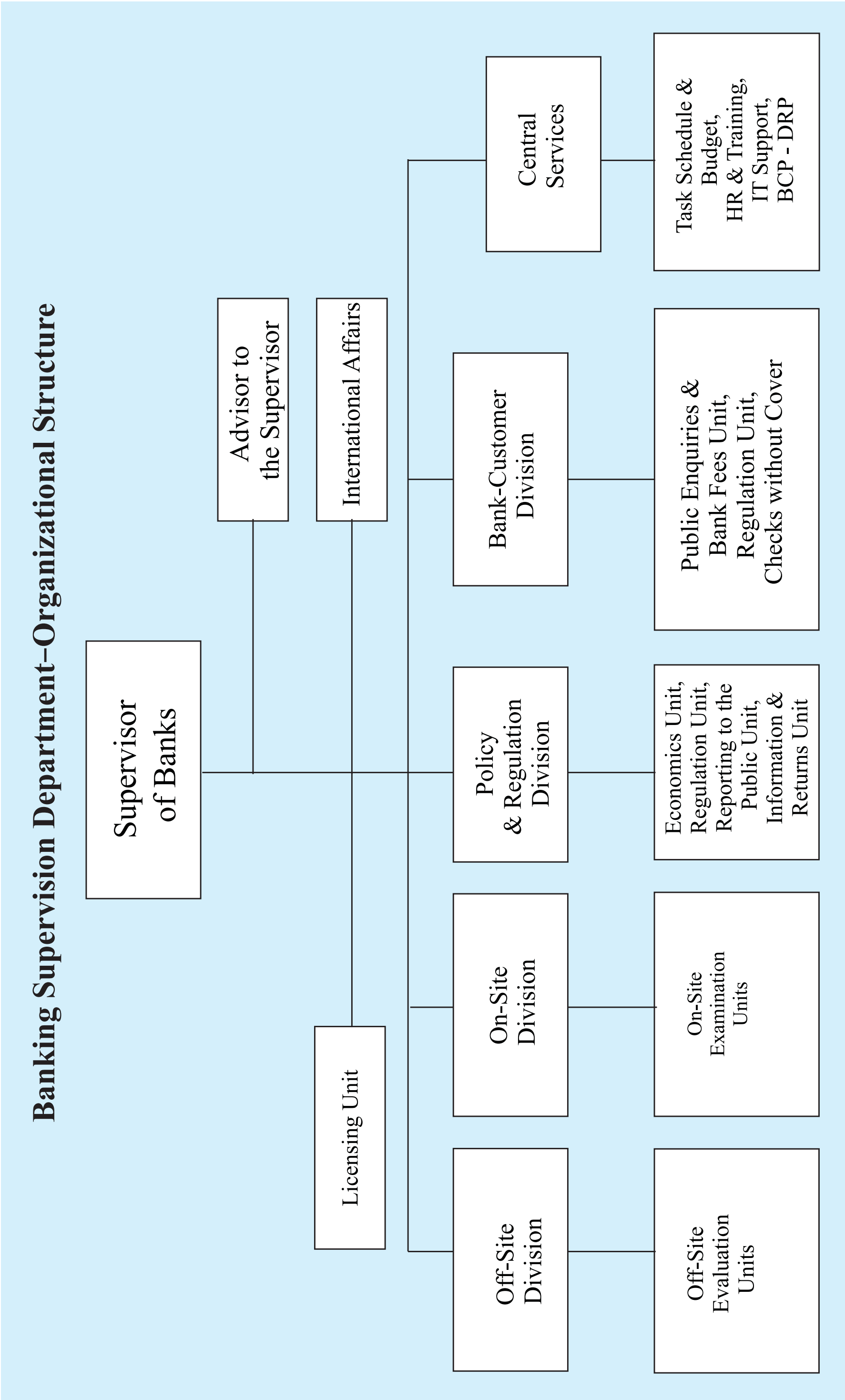
In 2010, 688 appeals were lodged and 780 files closed following discussion of the appeals (some of which were opened in earlier years, and some opened in the courts in 2010). About a third of the appeals submitted to the court were accepted, and in these cases the restrictions on the customers were removed.

2. STRUCTURE OF THE BANKING SUPERVISION DEPARTMENT

The Banking Supervision Department's operations are carried out by four main divisions: the Off-Site Examination Division, the On-Site Examination Division, the Policy and Regulation Division and the Bank-Customer Division. In addition, there are three other units: the International Affairs Unit, the Licensing Unit, and Central Services.

a. The Off-Site Evaluation Division

The division collates and compiles the Banking Supervision Department's periodic appraisal of the stability, robustness and management of the banking corporations,


Banking Supervision Department–Organizational Structure
Supervisor of Banks
Advisor to the Supervisor
International Affairs
Licensing Unit
Off-Site Division
On-Site Division
Policy & Regulation Division
Bank-Customer Division
Central Services
Off-Site Evaluation Units
On-Site Examination Units
Economics Unit, Regulation Unit, Reporting to the Public Unit, Information & Returns Unit
Public Enquiries & Bank Fees Unit, Regulation Unit, Checks without Cover
Task Schedule & Budget, HR & Training, IT Support, BCP - DRP

including auxiliary corporations, banking subsidiaries and overseas branches of the Israeli banks.

The evaluation units

The institutional evaluation units' responsibilities are divided up by banking groups. The units are charged with monitoring the banking groups, assessing the risks of each bank and collating the SREP process, which ensures that each bank maintains the necessary level of capital adequacy relative to its risk profile. The units are also responsible for the current processing of enquiries from the banking corporations, and for monitoring implementation of the Supervisor of Banks' directives. The risk assessment process makes it possible to determine operational arrangements for assisting in the early detection of negative and unusual developments in the activity and risk exposure of the banks. This process is carried out under the risk-focused supervision method: The overall evaluation of the banking corporation is based on an appraisal of corporate governance, the quality of risk management, and the level of the bank's risk exposure and the capital which it holds for the purpose of supporting the overall risk profile. Evaluation processes include an analysis of the bank's exposure to risk, and an assessment of the characteristics and performance of the management and control functions.

b. The On-Site Division

The division carries out in-depth and comprehensive on-site examination processes at the banking corporations and the credit card companies.

The purpose of this audit activity is to identify and assess the banking risks inherent in the entire range of the banking corporations' activities and to examine the propriety of the bank's risk management and the processing of matters that are audited, with an emphasis on conformance to laws and to the Supervisor of Banks' directives and guidelines. Audit reports that warn of deficiencies and malfunctions present requirements and timetables for their rectification. Audit findings and audit policy are used in compiling an assessment of the banking corporations' stability, and in promoting regulatory arrangements for the banking system.

Auditing activity is carried out via five auditing units that specialize in the following areas: credit risks; market risks and liquidity risks; operational risks; compliance risks; and corporate governance risks.

(1) The Credit Risk Audit Unit

The unit's principal function is to identify and assess the risks inherent in the extension of credit at the level of the single transaction and the level of banking corporations' overall credit risk management. The unit examines credit policy and the manner in which this policy is assimilated, credit approval and credit operation processes, control over these processes, processing of the detection and classification of problem loans, and conformance to the Supervisor of Banks' directives.

(2) The Market Risk and Liquidity Risk Audit Unit

The unit's principal function is to identify and assess market and liquidity risks. The unit's audits are centered on risk management policy, and its assimilation and implementation in the management of the banking corporation's assets and liabilities. An emphasis is placed on the management of market risks (interest-rate risks, indexation-base risks and inflation risks), liquidity risks, risks deriving from dealing rooms' activity, and risks deriving from the activities of the banking corporation's customers in the capital markets.

(3)The Operational Risk Audit Unit

The unit's principal function is to examine the banking corporation's management of operational risks and to assess these risks. An emphasis is placed on IT risks, including information security risks, risks deriving from material processes and changes in the area of information technology, potential risks deriving from the link-up of the banks' systems to external networks, and outsourcing risks. The unit also examines the propriety of the controls which the banks operate over each of these forms of activity.

(4) The Compliance Risk Audit Unit

The unit's principal function is to examine the banking corporation's compliance to directives concerning the prevention of money laundering and financing of terrorism—matters that are likely to expose them to regulatory and legal risks and to reputation risk—and the observance of Proper Conduct of Banking Business Regulations in the consumer area. In the course of the unit's audits, examinations are made of the propriety of policy, the assimilation of policy and the operation of efficient control mechanisms.

(5) The Corporate Governance Risks Audit Unit

The unit's principal functions are to identify weak points in the bodies managing the banking corporations, including internal auditing. In the course of the unit's audits, examinations are made of the efficiency of the functioning of the board of directors, the senior management, the risk management network, the internal auditing department and the compliance officer.

c.The Policy and Regulation Division

The division is responsible for determining supervisory policy, regulatory arrangement of banking activity, measurement principles, disclosure and reporting, while examining and analyzing developments in risks and banking activity. This activity is carried out via four units: The Regulation Unit, the Reporting to the Public Unit, the Information and Returns Unit, and the Economics Unit.

(1) The Regulation Unit

The unit is responsible for the regulatory arrangement of banking activity, principally via Proper Conduct of Banking Business Regulations and circulars from the Supervisor of Banks, and also by means of legislation. The purpose of these activities is to assure proper and cautious management of the banking corporations, to provide regulatory coverage for the activity of the bank's board of directors and management, and to strengthen internal risk management and control systems.

(2) The Reporting to the Public Unit

The unit is responsible for determining principles for the measurement of the banking corporations and their disclosure and reporting to the public. In addition, the unit conducts audits for the purpose of examining the banking corporations' adherence to the measurement and disclosure principles that have been determined.

(3) The Information and Returns Unit

The unit is responsible for the receipt of the banks' reports to the Banking Supervision Department, processing and characterizing these reports, and turning them into readily available information for serving the department's purposes. The unit also publishes data on the banking system on the Bank of Israel's web site.

(4) The Economics Unit

The unit is responsible for analyzing and examining the risks and threats to the stability of the banking system, which are inherent in the activity of the banks and in the development of credit risks. In addition, it is responsible for constructing tools for analyzing the state of the banking system and the risks within it (stress tests and other tests), and also compiles and publishes period reviews as well as the annual survey of the banking system.

d. The Bank-Customer Division

The unit is charged with maintaining fairness in the relations between the banking corporations and their customers while protecting the rights of the banking consumer; applying and enforcing bank-customer related legislation and directives; encouraging competition in the banking system; and increasing the public's awareness of their consumer rights in the area of banking. In order to achieve these objectives, the division operates via two units and a section: the Public Enquiries and Commission Fees Unit, the Regulation (Bank-Customer) Unit and the Checks without Cover Section.

(1) Public Enquiries and Bank Fees Unit

The unit examines customers' complaints against the banking corporations (banks and credit card companies), and makes decisions regarding disputes that are presented to it. The unit also supplies information and answers the public's questions on banking and consumer matters. The information accrued from complaints is used as a means for detecting and remedying deficiencies at the banking corporations. In addition, the unit applies and enforces provisions of the law concerning commission fees, including measures for increasing the transparency of the prices of banking services and the ability to compare between them.

(2) The Regulation (Bank-Customer) Unit

The unit provides regulatory coverage in the area of banking consumer related legislation and Proper Conduct of Banking Business Regulations. The unit monitors the observance of the Supervisor of Banks' directives and the provisions of the law in the bank-customer area, and tests compliance to consumer directives. In addition, the unit engages in consumer-related explanatory activity to customers in order to increase their awareness of their rights and to reduce information gaps on banking matters.

(3) The Checks without Cover Section

The Checks without Cover Section is charged with the management of the drawers of checks without coverage system. The department collates all the information contained from the banks on the matter of restricted customers and restricted bank accounts, as well as information on special restrictions imposed by the executioner's office, rabbinical courts and bankruptcy courts. The section deals with clarifications concerning restricted accounts and customers, and customer enquiries on these matters.

Apart from four supervisory divisions, three independent units operate in the Banking Supervision Department. These are:

e. The International Affairs Unit

The unit manages current contact with supervisory authorities worldwide. This contact is necessitated by globalization, the Israel banks' increased international activity, the interest shown by foreign investors in the Israeli banking system, and by the recommendations of the Basel Committee, which emphasize the need for cooperation and information exchange between worldwide supervisory authorities.

f. Banking Supervision Department Staff

The Banking Supervision Department Staff engages in the systemic planning of the work of the Banking Supervision Department and in the promotion of cross-organizational projects. The staff's areas of responsibility include the development of information infrastructures, the compilation of work programs, budgetary planning, procurement activity and the cultivation of human resources, including the construction and application of instructional programs. The staff is also responsible for deployment for business continuity in a state of emergency: In its capacity as the banking financial authority, it is responsible for preparations in a state of emergency and the emergency operation of the commercial banks, the credit card companies, the Sheba automatic banking services company and the Masav Banking Settlement Center—bodies whose routine and other activities are supervised by the Bank of Israel.

g. The Licensing Unit

The unit processes applications that under the law require licensing from the Governor of the Bank of Israel or from the Supervisor of Banks. The unit's activity includes examination of candidates for the control or holding of means of control in banking corporations, a fit and proper test for senior office-holders at the banking corporations, licensing for branches and the activity of foreign banks in Israel.

3. TABLE OF EVENTS IN 2010

January 5, 2010—Disclosure of the cost of the service when providing securities and foreign-currency services

With respect to part of the securities services provided by the banking corporations, the Supervisor of Banks decided to exempt the corporations from disclosure of the cost of the service at the time of provision of the service, as stated in sub-paragraphs (1) to (3) of Paragraph 26a of the Banking Regulations (Service to the Customer) (Due Disclosure and Provision of Documents), 5752-1992, in the case of customers who gave their prior written agreement to this. For customers who are nonresidents and customers who work directly with the banking corporations' dealing rooms, the said exemption was expanded and applied to certain foreign-currency, futures and options transactions as well.

January 17—Publication of information on the internet

In order to provide regulatory coverage for the publication of information on the internet and to permit greater accessibility to information for those using financial reports, banking corporations and credit card companies were required to include on their web sites their published annual and quarterly financial reports, as well as the data from the annual and quarterly reports which are contained in the file that is sent to the Information and Reporting Unit in the Banking Supervision Department at the time when these reports are published.

January 24—Amendment to the directive concerning "prevention of money laundering and the financing of terrorism and identification of customers"

As part of the adoption of the extended criteria determined by the Financial Action Task Force (FATF) for the examination of international cooperation in the fight against money laundering and the financing of terrorism, Proper Conduct of Banking Business Regulation No. 411 "prevention of money laundering and the financing of terrorism and identification of customers" was amended. The amendment places an emphasis on the supervision of banking corporations' overseas offices and on enhancing the status of the organization's official responsible for ensuring adherence to the requirements of the Money Laundering Prohibition Law, 5760-2000 (hereinafter: "Money Laundering Prohibition Law") and for maintaining contact with the internal auditing department.

February 18—postponement of application of the directives concerning measurement and disclosure of deficient debts and credit risk

The application of the directives for reporting to the public concerning the measurement and disclosure of deficient debts, credit risk and loan-loss provisions was postponed until January 1, 2011. The new directives explain how the requirements relating to the calculation of the group loan-loss provision are to be applied.

February 24—publication of bank-customer relations file: legislation and directives

A legislative file was published containing the principles of the laws, orders, Proper Conduct of Banking Business Regulations and circulars in the area of bank-customer relations with respect to commonly used services. This is intended as a device for assisting all those engaged in the area, inside and outside of the banking system. As a service to the public, the file is also published on the Bank of Israel web site, and is updated regularly.

March 17—amendment to the directive concerning transfer of activity and closure of a customer's account

In order to facilitate customers' move between the banks and to promote greater competition in the banking system, Proper Conduct of Banking Business Regulation No. 432 "transfer of activity and closure of a customer's account" was amended. The amendment is intended to create the most effective possible mechanism for transferring debits on the basis of the currently existing infrastructures in the interface between the credit card companies and suppliers and between the credit card companies themselves. The burden of transferring activity in ongoing credit card transactions has been shifted from the customers to the transferring issuer, which will be responsible for transferring activity with suppliers by using the infrastructures in question. In order to apply the arrangement for the transfer of activity to the credit card companies, Proper Conduct of Banking Business Regulation No. 470 concerning the transfer of ongoing credit card transactions was amended as well.

March 25—purchase groups

Due to the special nature of independent constructions projects that are carried out by purchase groups, clarifications were published regarding classification in the matter of indebtedness restriction, industry-specific classification and capital adequacy. The banks were required to define procedures for dealing with credit for purchase groups' projects. In this respect, parameters were determined for the examination of credit risk with reference to a single borrower's repayment ability and to the risks involved in the project. Apart from the usual parameters for examining the repayment ability of borrowers taking a housing loan, the special or typical parameters of loans for purchase groups will be taken into account.

June 6—policy for opening core branches in a state of emergency
Policy guidelines were determined for opening core branches of the banks in a state of emergency. (Branches that are prepared in time for all aspects of a state of emergency, and in respect of which a decision was made in advance to keep them open in this situation).

June 20—integration into the Proper Conduct of Banking Business Regulations of the temporary provision in Basel II concerning "working framework for the measurement and adequacy of capital"

Proper Conduct of Banking Business Regulations were determined concerning the measurement and adequacy of capital. These regulations integrate the temporary provision in Basel II concerning "working framework for the measurement and adequacy of capital", which is based on the Basel Committee's recommendations regarding international convergence for the measurement of capital and capital standards, which were published in June 2006.

June 20—supervisory review process
A framework document concerning the supervisory review process was published. Together with Proper Conduct of Banking Business Regulation No. 211, "assessment of the propriety of capital adequacy", this complements the adoption of Basel II. The document details the measures which the Supervisor of Banks is likely to adopt in the supervisory review process. The process is intended to ensure that the banks allocate adequate capital for supporting all the risks inherent in their business activities, and to encourage them to develop and adopt enhanced techniques for the monitoring and management of risks.

June 30—capital policy for the interim period
As a result of the global financial crisis, the Basel Committee and leading regulators worldwide compiled changes for the purpose of increasing the level and quality of the capital in the global banking system. Accordingly and until publication of final recommendations on the subject, the banking corporations were required as follows:

- To adopt by December 31, 2010, a Tier 1 capital ratio in accordance with Proper Conduct of Banking Business Regulation No. 202 "measurement and adequacy of capital—capital components", at a rate of not less than 7.5 percent.
- To send to the Banking Supervision Department a work program for adherence to this target.
- In the absence of prior approval from the Supervisor of Banks, a banking corporation that does not adhere to the said target, or whose dividend distribution will result in failure to meet the target, must not distribute a dividend.

July 11—development of risks in respect of housing loans
Because of increased demand, prices in the housing market in many parts of Israel have risen. As a result, the banking corporations have been required to re-examine their mortgage loan portfolio policy, and to ensure that this policy does not increase the bank's exposure to risks in excess of the risk appetite which it has defined as a business strategy. It was also stipulated that a banking corporation must hold a supplementary provision of at least 0.75 percent in respect of housing loans that were granted after July 1, 2010, and in which the LTV exceeds 60 percent at the time when the loan was extended.

July 13—postponement of application of amendment concerning transfer of a customer's activity and closure of his account

The application of the amendment to Regulation 432, concerning closure of an account and the move from bank to bank, and the amendment to Regulation 470 concerning credit cards, was postponed to December 1, 2010.

July 25—operation of mobile bank branches during a state of emergency
In accordance with the Governor's General permit of July 11, 2010, for the opening and transfer of branches in a state of emergency, guidelines were determined for the banking corporation's preparations for operating mobile branches during a state of emergency.

July 26—international financial reporting standards
The directives for reporting to the public were adapted to international financial reporting standards (IFRS) with respect to matters that are not core banking business.

July 28—the social networks
The growing use of social networks on the internet involves potential risks for a banking corporation and its customers, including operational, legal and regulatory risks and reputation risks. Accordingly, measures have been determined which a banking corporation must adopt in order to reduce the risks deriving from the use of social networks.

October 17—guideline concerning the validification of models
Due to the banking corporations' growing use of models for the purposes of risk assessment, pricing and estimation of fair value, a guideline was determined concerning the validification of the models. It was stipulated that by March 3, 2011, the banking corporations must complete the formulation of policy on the matter and the approval of this policy by the board of directors.

October 28—leveraged housing loans at floating-rate interest
It was stipulated that the risk weight (as defined in Proper Conduct of Banking Business Regulation No. 203) of the floating-rate component of a housing loan extended at an LTV exceeding 60 percent and accounting for 25 percent or more of the loan, will amount to 100 percent (instead of 35 percent or 75 percent depending on the characteristics of the loan). This directive will not apply to a housing loan in which the amount of the loan approved for the borrower, including amounts that have yet to be withdrawn, is less than NIS 800 thousand, and to housing loans that were granted to borrowers conforming to Ministry of Construction and Housing criteria for the receipt of state housing assistance.

November 1—business continuity: policy principles for service targets in a state of emergency
Policy principles were determined for the banking system's minimum service targets in order to guarantee the supply of essential financial services to the economy and the public during a state of emergency. Since each service target is based on the assumption that the supply of the service in question could be disrupted, a tolerable period of time in which its supply actually might be disrupted must be defined. The target for the renewed supply of the other services will be to return to routine as soon as possible with the help of existing resources. Target terms for the resumption of services were determined:
- Within a few hours from the beginning of the state of emergency.
- Within a maximum of 24 hours from the beginning of the state of emergency.
- Within a few days at the very most from the beginning of the state of emergency.

November 17—relaxations for the population in a state of emergency
As part of the preparations for a state of emergency and in order to make it easier for the population to obtain banking services at times of emergency, temporary relaxations in the Proper Conduct of Banking Business Regulations were determined:
- Regulation No. 325 (management of credit lines in current accounts);
- Regulation No. 357 (management of information technology—Section 7—online banking services);
- Regulation No. 358 (management of business activities outside of the banking corporation's offices);
- Regulation No. 435 (telephone instructions):
- Regulation No. 439 (debits by authorization).

December 5—amendment of banking contracts in accordance with the ruling of the Standard Contracts Tribunal and the Supreme Court
Following the Supreme Court ruling that rejected the appeal against the decision of the Standard Contracts Tribunal concerning the revocation or change in discriminatory terms in a contract for the management of accounts and deposits of Bank Leumi le-Israel B.M. (current account contract), the Supervisor of Banks issued directives to all the banking corporations. These directives specify a period of preparation of several

months for completing the amendment of the contracts used by the banking corporations, in accordance with the said court ruling. A similar directive was issued to the banking corporations concerning the application of the Standard Contracts Tribunal's decision on the request to revoke or change discriminatory terms in a housing loan contract of the First International Bank Ltd. regarding paragraphs in respect of which an appeal was not submitted. In addition, the Supervisor of Banks instructed the banking corporations to publish on their web sites an announcement of the said court rulings and a link to them.

December 27—amendment to Proper Conduct of Banking Business Regulation concerning processing of problem debts

Due to the development of risks in the housing loan industry, the applicability of the method for calculating provisions in respect of housing loans by extent of arrears in Proper Conduct of Banking Business Regulation No. 314 was extended.

December 27—amendment of Proper Conduct of Banking Business Regulation concerning "measurement and adequacy of capital—standardized approach—credit risk"

Proper Conduct of Banking Business Regulation No. 203 concerning "measurement and adequacy of capital— standardized approach—credit risk" stipulates that "foreign-currency denominated positions which the State can discharge in shekels if it has difficulty in raising foreign currency" will be regarded as local currency denominated positions, and a risk weighting of 0 percent can be applied to them. This is providing that "the conversion rate to shekels will be a current rate (which enables the banking corporation to convert the shekel amount which it received to foreign currency at an amount which the State was to have repaid)".

December 29—amendment of Proper Conduct of Banking Business Regulation concerning the board of directors

Proper Conduct of Banking Business Regulation No. 301 concerning "the board of directors" was amended, adapting it to the working framework of the Basel Committee and of other supervisory authorities abroad, to existing practice and to local regulation. The main elements of the amendment to the regulation relate to the following matters:

- Board of directors functions and authorities—new directives were determined concerning conflicts of interest, audit and control functions, monitoring of the CEO's performance and a requirement to hold meetings without the presence of the management.
- Composition of the board of directors—directives were added concerning the definition of the proportion of directors with banking experience and directors with financial specialization in a composition that includes a process for the re-approval of a director.
- Board of directors committees—new matters were added: effective director, instruction programs and independent appraisal of the efficiency of the work of the board of directors.

4. REVIEW OF DATA ON THE BANKING CORPORATIONS BASED ON THE INFORMATION OBTAINED FROM THE PROCESSING OF THE PUBLIC'S ENQUIRIES AND COMPLAINTS.

The rating of the banking corporations contained in this survey is based solely on the information obtained at the Banking Supervision Department following the processing of customers' enquiries and complaints, and is provided as a service to the public. This rating is not an overall score for the banking corporation concerning its entire range of activities, and is not to be regarded as a proposal or recommendation.

In 2010 the manner in which the five banking groups and the five largest banks deal with their customers was appraised, as reflected by the public enquiries and complaints processed at the Banking Supervision Department. The appraisal was based on four criteria:

a. The ratio of justified complaints to the total number of complaints in respect of which a position was taken;
b. The ratio of the bank's share of total justified complaints to its share in the system;
c. The ratio of enquiries and complaints that were properly processed by a banking corporation to the total number of enquiries and complaints referred to the bank;
d. The proportion of enquiries and complaints in respect of which the bank ruled in the customer's favor even though they were not classified as justified.

During previous years, the banking corporations were appraised solely according to the ratio of justified complaints (criterion a above). Following a re-examination, the Banking Supervision Department decided to extend the base data for appraisal and to include in them additional relevant information obtained from the processing of the public's complaints.

Based on the said criteria, the banking corporations were rated in accordance with the values detailed below, a rating that is similar to the grading usually employed for the appraisal of management and control at the banking corporations:

1. Particularly good
2. Good
3. Satisfactory.
4. Requiring improvement
5. Requiring considerable improvement
6. Deficient

See the appendix for details of the different criteria and their weightings.

a. General rating tables

(1) The rating table that includes the five banking groups (based on a weighting of the four above-mentioned criteria):

(2) Set out below is the rating table that includes the five largest banks (based on a weighting of the said four criteria):

b. Details of each of the criteria that were calculated as above for a banking corporation:

(1) Ratio of justified complaints to the total number of complaints in respect of which a position was determined.

As can be seen from Table 3.5, among the five largest banks, the lowest ratio of justified complaints (15.7 percent) was recorded at Bank Leumi. This bank has presented the lowest ratio of justified complaints for several years now.

A decrease in the proportion of justified complaints was recorded at all of the five largest banks. The Banking Supervision Department attributes this decrease inter alia to the action which it has taken to detect and remedy systemic deficiencies, its comprehensive measures for providing regulatory coverage for matters concerning bank-customer relations, and to the efforts which the banks are investing in improving the service to their customers, including the processing of complaints.

Among the medium and small-sized banks, the lowest ratio of justified complaints (17.5 percent) was recorded at Bank Yahav.

The number of complaints against the credit card companies is relatively low due to the comprehensive legal arrangement in the Credit Cards Law, 5746-1986, and to the credit card companies' general observance of the provisions of the law.

Table 3.3
Overall rating of the five banking groups

Group	Rating
Leumi	Good
Hapoalim	Good
Discount	Correct
Mizrahi-Tefahot	Requires improvement
First International	Requires considerable improvement

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

(2) The ratio between each bank's share of justified complaints to its share in the system

Bank Leumi's share of justified complaints is considerably lower than its share in the system. The Banking Supervision Department regards this low ratio as a sign of the banking corporation's proper processing of customer's complaints at the branches and at the department that deals specifically with customers complaints.

Table 3.4
Overall rating of the five largest banks

Bank	Rating
Leumi	Good
Hapoalim	Correct
Discount	Correct
Mizrahi-Tefahot	Requires improvement
First International	Requires improvement

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.5
Number of complaints and rate of justified complaints in the banking system, 2010

Banking corporation	Complaints where a position was taken	Justified complaints	Ratio of justified complaints to total complaints where a position was taken
Hapoalim	470	121	25.7
Mizrahi-Tefahot	348	99	28.4
Leumi	268	42	15.7
Discount	264	58	22.0
First International	159	50	31.4
Otsar Hahayal	78	28	35.9
Yahav	63	11	17.5
Leumi Mortgage	44	10	22.7
Discount Mortgage	64	19	29.7
Mercantile Discount	42	17	40.5
Unino	43	12	27.9
ICC	40	8	
Isracard	29	7	
Leumicard	27	5	
Massad	26	8	
Poalei Agudat Israel	25	3	
Jerusalem	25	6	
Arab Israel	6	3	
Diners Club	7	0	
Total	2,028	507	
Rate of justified complaints in 2010			**25.0**
Rate of justified complaints in 2009			**26.6**

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.6
Ratio of the banking corporation's share of justified complaints to its share in the system, by criterion of its relative size in the system

Banking corporation	Share of justified complaints (%)	Share in system (%)	Ratio between share of justified complaints and share in system
Hapoalim	23.9	30.3	0.8
Mizrahi-Tefahot	19.5	14.9	1.3
Leumi	8.3	31.7	0.3
Discount	11.4	14.2	0.8
First International	9.9	8.9	1.1

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.7
Rate of inquiries and complaints properly processed by the banking corporations

Banking corporation	Inquiries and complaints referred to the bank	Properly processed inquiries and complaints	Particularly well processed inquiries and complaints	Improperly processed inquiries and complaints	Percentage of inquiries and complaints for which processing classified as "correct" and "particularly well"
Hapoalim	682	554	81	47	93.1
Mizrahi-Tefahot	529	428	44	57	89.2
Leumi	418	370	39	9	97.8
Discount	387	330	32	25	93.5
FIrst International	223	177	13	33	85.2
Otsar Hahayal	118	92	13	13	89.0
Yahav	94	85	5	4	95.7
Leumi Mortgage	94	76	14	4	95.7
Discount Mortgage	90	72	6	12	86.7
Union	76	64	7	5	93.4
Mercantile Discount	73	62	8	3	95.9
Isracard	57	50	2	5	91.2
ICC	56	55	0	1	98.2
Leumicard	52	40	2	10	80.8
Massad	40	31	3	6	85.0
Agudat Poalei Israel	34	24	1	9	
Jerusalem	32	27	1	4	
Diners Club	11	10	0	1	
Arab Israel	11	8	1	2	
Overall rate of inquiries and complaints that were properly clarified in the banking system, 2010	**3,077**	**2,555**	**272**	**250**	**91.9**
Overall rate of inquiries and complaints that were properly clarified in the banking system, 2009					**86.0**

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.8
Rate of complaints and inquiries not classified as justified but where the bank favored the complainant

Banking corporation	Inquiries and complaints referred to bank and not classified as justified	Inquiries and complaints not classified as justified but where the bank favored the complainant	Ratio of inquiries and complaints to total complaints not classified as justified
Hapoalim	562	104	18.5
Mizrahi-Tefahot	430	87	20.2
Leumi	376	52	13.8
Discount	329	70	21.3
First International	173	19	11.0
Otsar Hahayal	90	11	12.2
Yahav	83	14	16.9
Leumi Mortgage	84	12	14.3
Discount Mortgage	71	11	15.5
Mercantile Discount	56	19	33.9
Union	64	14	21.9
ICC	48	19	39.6
Isracard	50	13	26.0
Leumicard	47	9	19.1
Massad	32	6	
Agudat Poalei Israel	31	0	
Jerusalem	26	3	
Arab Israel	8	1	
Diners Club	11	1	
Total	**2,571**	**465**	**18.1**

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.9

Number of justified complaints, ratio of justified complaints to total complaints for which a position was taken, each banking corporation's share of justified complaints and its share of the system in the area of housing loans

				In the area of housing loans	
Banking corporation	No of complaints for which position taken	Number of justified complaints	Ratio of justified complaints to total complaints for which position taken	The bank's share of justified complaints	The bank's share in the system
			(Percent)		
Mizrahi-Tefahot	126	45	35.7	41.7	32.3
Leumi Mortgage	42	10	23.8	9.3	23.0
Hapoalim	51	18	35.3	16.7	21.9
Discount Mortgage	61	17	27.9	15.7	8.6
First International	37	14			6.5

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.10

Rate of justified complaints concerning housing loans that were properly processed by each banking corporation

Banking corporation	Inquiries and complaints referred to the bank	Inquiries and complaints that were improperly processed	Inquiries and complaints that were properly processed	Ratio of referrals whose processing was classified as "Proper" and "Particularly Good" (percent)
Mizrahi-Tefahot	199	156	43	78.4
Leumi Mortgage	83	80	3	96.4
Hapoalim	88	74	14	84.1
Discount Mortgage	81	71	10	87.7
First International	47	33	14	70.2

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

Table 3.11

Rate of inquiries and complaints concernnig housing loans that were not classified as justifed and where the banking corporation favored the complainant

Banking corporation	Inquiries and complaints referred to the bank and which were not classified as justified	Inquiries and complaints that were not classified as justified and where the bank favored the complainant	Ratio of these inquiries and complaints to total referrrals that were not classified as justified (percent)
Mizrahi-Tefahot	154	39	25.3
Leumi Mortage	73	10	13.7
Hapoalim	70	16	22.9
Discount Investment	64	9	14.1
First International	33	2	

SOURCE: The Public Inquiries Unit at the Banking Supervision Department.

(3) The ratio of enquiries and complaints that were properly processed by a banking corporation to the total number of enquiries and complaints directed at the bank

When processing customers' complaints, the Banking Supervision Department also classifies the manner in which the banking corporation processes a complaint. According to the Banking Supervision Department's perception, the manner in which enquiries and complaints which it refers to the banking corporation are processed reflects the corporation's attitude to customers' enquiries and complaints as a whole, and not only those that were received via the department. Since the corporation's processing of complaints is indicative of the importance which it attaches to the matter, the Banking Supervision Department weights this item in its overall appraisal of the banking corporation. According to this criterion, among the five largest banks, Bank Leumi achieved the best result in 2010—satisfactory processing of 98 percent of all the enquiries and complaints referred to it by the Banking Supervision Department.

Among the credit card companies, Israel Credit Cards achieved the best result, and it also satisfactorily processed 98 percent of all complaints and enquiries.

(4) The rate of enquiries and complaints in respect of which the bank ruled in the customer's favor even though they were not classified as justified.

More than one of the banking corporations displayed a willingness to examine each case on its merits, and to rule in the customer's favor even without having found his complaint to be justified. Such cases are indicative of credibility regarding the customer despite a difficulty in proving his claims, or a special difficulty from the humanitarian aspect, and the bank sometimes displays a particularly fair attitude to its customer over and above that required under the law.

c. Individual review of housing loan activity

Since a considerable proportion of the complaints submitted to the Banking Supervision Department relate to housing loans, we chose to devote a separate section for activity in that area. For this purpose, we focused on the activity of the mortgage banks and housing loan activity at the commercial banks. The data below were therefore calculated on the basis of enquiries and complaints concerning housing loan activity only.

In the three criteria detailed below, Leumi Mortgage Bank presented the best results (Tables 3.9 and 3.10).

a. The ratio of justified complaints to the total number of complaints in respect of which a position was taken;
b. The ratio of the bank's share of total justified complaints to its share in the system;
c. The proportion of enquiries and complaints that were satisfactorily processed by the bank.

The data also show that Bank Mizrahi-Tefahot was notable for its readiness to favor its customers even when their enquiries and complaints were not found to be justified (Criterion d; Table 3.11).

The Banking Supervision Department expects the banking corporations to adopt high standards with respect to their customers. This expectation will be reflected during the coming years inter alia by the criteria for the classification of complaints by their nature and the criteria for the classification of the manner in which the banks process complaints. In the future, the Banking Supervision Department is likely to attribute different weightings to deficiencies in the banking corporations' activity, and to deficiencies in the banks' processing of specific enquiries and complaints. The Banking Supervision Department will continue to attribute a positive weighting to the banks' willingness to act towards their customers at a level of fairness in excess of that prescribed by the law.

APPENDIX 3.1: EXPLANATION OF THE CRITERIA EMPLOYED IN DETERMINING THE RATING

Since 2010 the Public Enquiries and Commission Fees Unit in the Bank-Customer Division of the Banking Supervision Department has rated the five largest banks in Israel's banking system with respect to the quality of the manner in which they process their customers.

The principal objective of the rating is to appraise the quality of the manner in which the banks process customers and their complaints, as reflected by the enquiries and complaints processed at the Banking Supervision Department, from the aspect of compliance to the Supervisor of Banks' consumer directives and the assimilation of the value of fairness, which forms the basis for proper bank-customer relations.

The rating of the banks' processing of their customers is determined by weighting four criteria.

a. The ratio of justified complaints to the total number of complaints in respect of which a position was taken;
b. The ratio of the bank's share of total justified complaints to its share in the system;
c. The ratio of enquiries and complaints that were properly processed by a banking corporation to the total number of enquiries and complaints which the unit referred to the bank;
d. The proportion of enquiries and complaints in respect of which the bank ruled in the customer's favor even though they were not classified as justified.

Until 2010 the Banking Supervision Department had appraised the banks solely on the basis of the ratio of justified complaints (Criterion a). As the result of a re-examination of the matter, it was decided to base the assessment on other relevant data as well.

Set out below is brief explanation of the each of the criteria and the appraisal method:

a. The ratio of justified complaints to the total number of complaints in respect of which a position was taken

The weighting of this criterion in the general assessment is 30 percent.

Calculation of the criterion: the number of complaints against the bank in question the processing of which was completed in 2010 and that were found to be justified, divided by the number of complaints against the same bank the processing of which was completed in 2010 and in respect of which a position was taken (justified or unjustified).

M = number of complaints against the bank in question the processing of which was completed in 2010 and that were found to be justified.

E = number of complaints against the same bank the processing of which was completed in 2010, and in respect of which a position was taken (justified or unjustified).

$$P1 = M / E$$

b. The ratio of the bank's share of total justified complaints to its share in the system

The weighting of this criterion in the general assessment is 30 percent.

Calculation of the criterion: the ratio between the number of complaints against the bank in question the processing of which was completed in 2010 and that were found to be justified, and the total number of complaints against all the banks the processing of which was completed in 2010 and that were found to be justified, divided by the bank's total assets (minus business credit), as a ratio of the system's total assets (minus business credit).

M = number of complaints against the same bank the processing of which was completed in 2010 and that were found to be justified.

ΣM = total number of complaints against all the banks the processing of which was completed in 2010 and that were found to be justified.

A = the bank's total assets minus business credit, as of December 2010.

ΣA = the system's total assets minus business credit, as of December 2010.

$$P2 = (M/\Sigma M) / (A/\Sigma A)$$

A ratio of less than 1 implies that the bank's share of total justified complaints (against all the banks) is less than that bank's share in the relevant segments of the banking system (retail and commercial banking).

c. The ratio of complaints and enquiries which the bank processed satisfactorily to the total number of complaints and enquiries which the Public Enquiries Unit referred to the bank

The weighting of this criterion in the general assessment is 20 percent.

Calculation of the criterion: the number of complaints and enquiries the processing of which was completed in 2010, and the manner in which they were processed by the bank was found to be satisfactory, divided by the total number of complaints and enquiries the processing of which was completed in 2010 and which the unit referred to the bank.

T = the number of complaints and enquiries the processing of which was completed in 2010 and the processing of which by the bank in question was found to be satisfactory.

B = the total number of complaints and enquiries the processing of which was completed in 2010 and which the unit referred to the bank.

$$P3 = T / B$$

NOTE: For the purpose of examining this criterion in 2010, no distinction was made between types of deficiencies in a bank's processing of a complaint or inquiry. Such a distinction (a minor delay in replying, non-enclosure of relevant documents, a deficiency in the content of the reply or a particularly serious deficiency) will be made from 2011 onwards.

d. The proportion of enquiries and complaints in respect of which the bank ruled in the customer's favor even though they were not classified as justified.

The weighting of this criterion in the general assessment is 20 percent.
Calculation of the criterion: the number of complaints and enquiries the processing of which was completed in 2010 and where the bank ruled in the customer's favor even though they were not classified as justified, divided by the total number of complaints and enquiries the processing of which was completed in 2010 and which the unit referred to the bank, minus complaints that were found to be justified.

L = the number of complaints and enquiries the processing of which was completed in 2010 and where the bank ruled in the customer's favor even though the unit did not classify them as justified.
B = the total number of complaints and enquiries the processing of which was completed in 2010 and which the unit referred to the bank.
M = the number of complaints against the same bank the processing of which was completed in 2010 and that were found to be justified.

$$P4 = L / (B - M)$$

Each criterion—$P1, P2, P3$ and $P4$—was assigned a numerical score in accordance with an appraisal scale determined by the Banking Supervision Department.
The general, summary assessment was based on the equation:

$$G = 0.3 * P1 + 0.3 * P2 + 0.2 * P3 + 0.2 * P4$$

For each numerical score, a verbal appraisal was determined with the following values: particularly good, good, satisfactory, needs improvement, needs substantial improvement, and deficient. The general evaluation of the bank from the aspect of its relations with customers as reflected by clarification of the public's complaints is published in a verbal format only.

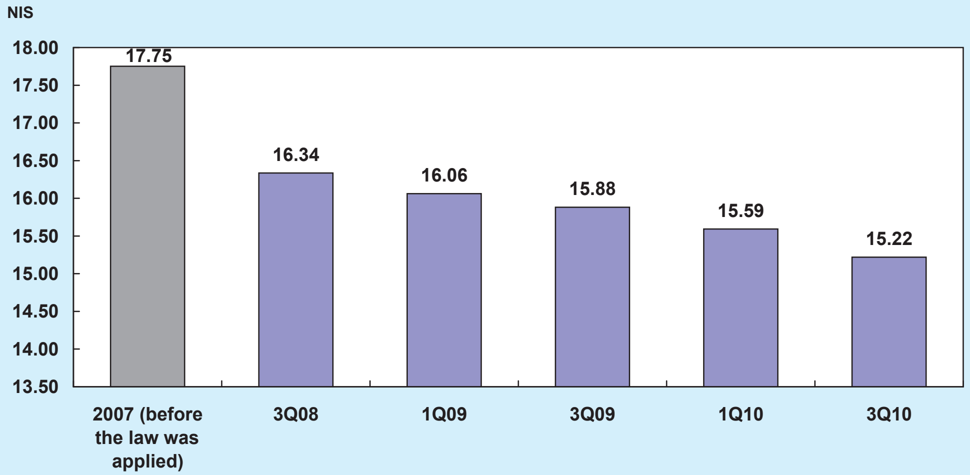
5. REVIEW OF MAIN DEVELOPMENTS IN THE AREA OF FEES

The Banking Supervision Department's analysis of the data which it gathered regarding common banking services for households reveals the following principal findings:

- During the past two years, a 13 percent real decrease was recorded in the actual average cost of common current account services for households (Figure 3.4), and the cost of holding a credit card fell by over 20 percent in real terms (Figure 3.6). The downtrend encompassed the five largest banks and the credit card companies.
- The high degree of variability between the banks and the credit card companies is continuing:
- Bank Yahav is the least expensive bank for common current account services, which are significantly less expensive than at other banks. Among the five largest banks, Bank Hapoalim and Bank Leumi are the least expensive, while First International Bank is the most expensive for common current account services (Figure 3.5).
- The average cost of holding credit cards (local, international and gold): Isracard is the least expensive, while Israel Credit Cards is the most expensive (Figure 3.7).
- The competitive behavior by the banks among households has increased:

Via marketing campaigns, the banks are offering new and existing customers a full or partial exemption from commission fees.

Figure 3.4
Development of actual average monthly expenditure per household on common demand deposit services (including credit line) at the five largest banks, 2007 to 2010



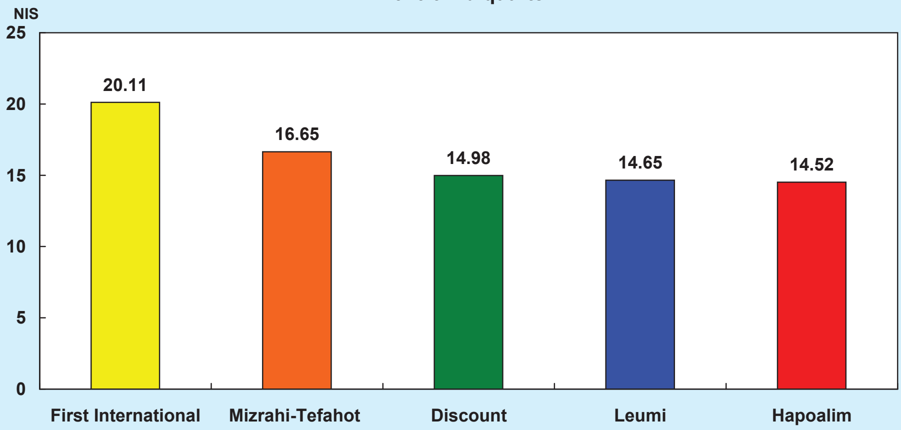
SOURCE: Reports to the Banking Supervision Department.

For numerous population groups such as soldiers, students and pensioners, the banks are offering exemptions and large discounts on current accounts (including credit lines). The weighted average cost for these groups at the five largest banks is NIS 5.4 (Figure 3.8).

Even customers who are not in the population groups eligible for an exemption or discount receive substantial discounts.

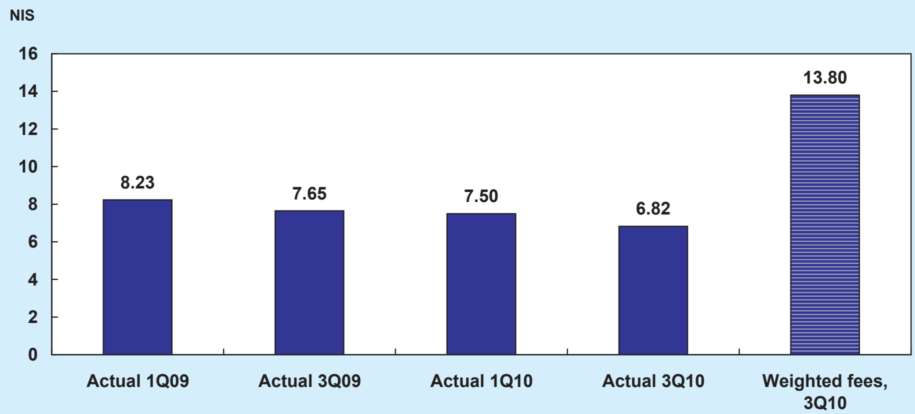
The growing competition among the banks for new and established customers among households is also apparent from the banks' marketing campaigns, which offer customers a full or partial exemption from commission fees.

Figure 3.5
Distribution of average monthly expenditure per household on common demand deposit services (including credit line) at the five largest banks, 2010 third quarter



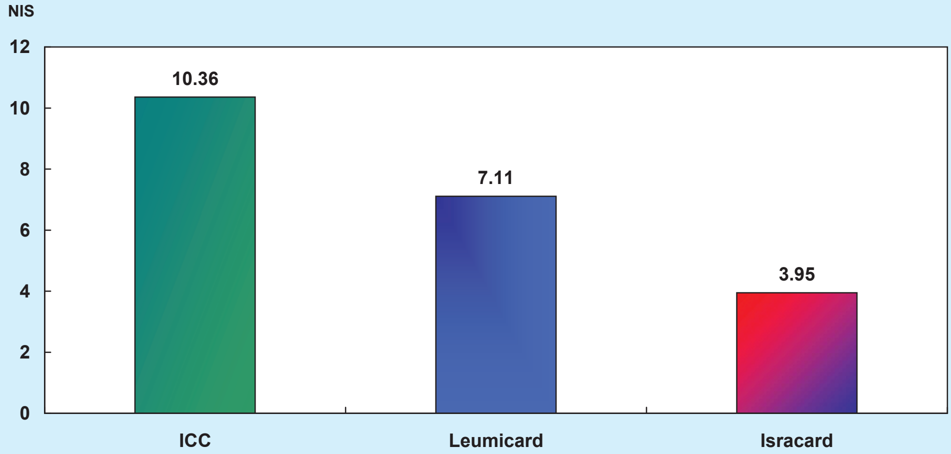
SOURCE: Reports to the Banking Supervision Department.

Figure 3.6
Development of actual average monthly expenditure on the holding of a credit card (local, international and Gold) in the banking system, 2009 to 2010



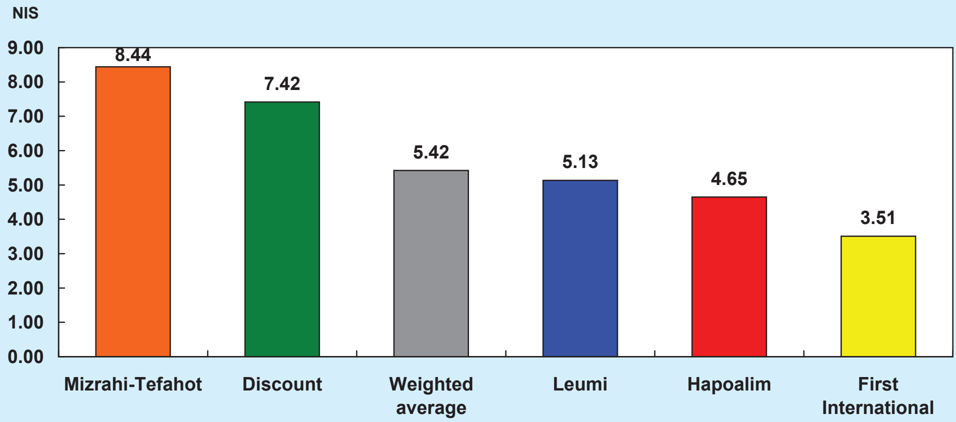
SOURCE: Reports to the Banking Supervision Department.

Figure 3.7
Distribution of average annual expenditure on the actual holding of a credit card in respect of the most common cards, 3Q10



SOURCE: Reports to the Banking Supervision Department.

Figure 3.8
Actual average monthly cost of managing a demand deposit for population groups (young people, soldiers, students, pensioners and customers club, 3Q10



SOURCE: Reports to the Banking Supervision Department.