Bank of Israel
Supervisor of Banks

June 23, 2019
390-H

To: The banking corporations and credit card companies

Attn: Chairperson and CEO

Re: Encouraging innovation at banks and acquirers

In recent years, we have seen rapid technological development in Israel and worldwide, which has affected the world of finance as well. This development impacts the environment in which banking corporations[1] act, and ultimately on the manner of their activity as well. In addition, the technological development also affects the supervisory processes required in the changing environment.[2]

The changing activity environment includes the creation of new business models in the financial sphere, as well as new players: fintech companies and big-tech companies (such as Google, Amazon, and Facebook), that are interested in offering financial services to customers. The banking activity and financial services that banks provide to their customers are becoming increasingly based on new technologies, among others in the areas of facial recognition, cloud computing, artificial intelligence, and machine learning. These technologies enable financial entities to increase their efficiency, to improve their internal processes, and to expand the services they provide to their customers, including innovative payment services, information processing services, financial consulting services, chatbots, and automation of processes.

The technological changes present significant challenges alongside opportunities for banking corporations. Innovation enables a banking corporation to offer new products to its customers and to provide them with faster and better service, in cooperation with fintech companies designated for specific issues, to find additional sources of activity and to make use of designated technologies in order to streamline processes, strengthen the risk management and to increase efficiency on its current expenditure side. Yet at the same time, this development enables new players that are not banking corporations to provide

---

[1] Including merchant acquirers.

[2] For further discussion, see the Sound Practices document published by the Bank for International Settlements in February 2018, which details, among other things, fintech developments' ramifications on banks and on banking supervisors.

financial services, which until recently were the almost exclusive purview of the banking corporations, and to compete against banking corporations. These technologies also incorporate new risks.

The Banking Supervision Department had already defined as a supervisory target the promotion of integrating technological innovation in banking several years ago, with the goal of allowing innovation in banking services and products, in the services provided to the customer and in the payments sphere, and removed many barriers in the area of e-banking, cloud, etc. The banks internalized the value in innovation, they invested and continue to invest in a range of their activities, through collaboration with fintech companies. The results can be seen in the field, among other things in the past 3 years' rapid growth in the percentage of banking activity carried out via direct means rather than through a branch, and in the range of banking and financial activities that can be carried out via digital means. With the goal of advancing to another stage of encouraging innovation, and with an understanding of the challenges, this paper is intended to sharpen and outline the supervisory principles in this area, while defining the expectations of banking corporations and clarifying the supervisory aspect:

1. **In accordance with the requirements of Proper Conduct of Banking Business Directive no. 301, the banking corporations are required to formulate a clear and holistic strategic approach regarding adopting innovation in their banking activity.** In formulating the approach to the issue, the banking corporation is to take into account, among other things, the pace of technological development in finance and in general, and to the realization of its business strategy. It is important that the banking corporation establish goals at the banking corporation level as well as at the division level, and verifies that resources are allocated to the issue of innovation that will make it possible to implement the strategy established (management, budget, human resources, training, and so on). It is also important that the strategy in this area is reflected from the board of directors and from management to all the banking corporation's employees, is reflected in the banking corporation's work plans at the division level as well, will be reflected in the banking corporation's reports to the public, and that it will be monitored after implementation.

2. The banking corporations shall ensure that the strategic approach to innovation, based on the implementation of technological abilities, will refer to, among other things: improvement of the customers' experience in banking services—both for households and for businesses; improvement and automization of operational processes at the banking corporation (back office, customer service centers, etc.); improved

effectiveness of internal controls and risk management systems including regulatory aspects (RegTech); and enhanced competitiveness of the banking corporation.

3. **The banking corporation are to be aware of the various risks deriving from the implementation of new and innovative products and services** (among others, operational risks and outsourcing, information security and cyber, fraud and embezzlement risks, compliance and AML risks, conduct risks, protection of customer privacy risks, and others); and to verify that there are adequate control processes for appropriate management of those risks.
4. The Banking Supervision Department encourages the banking corporations to create **an experimental environment** ("Sandboxes" that will allow pilots to be conducted, whether in the protected environment with dummy data or in the production environment with actual data), which will enable them to examine new ideas that are formulated in the technological area, including through collaboration with fintech companies, and adjusting them to processes and products existing at the banking corporation.
5. **The Banking Supervision Department is aware that initiated experiments of innovation at times include the materialization of risks, and understands that this is an unavoidable part of the process of change.** Therefore, **creating an experimental environment**, through examining the risks and creating an efficient and coordinated process for trying the new initiatives, and primarily through limiting the scope of activity in advance and in a documented manner, **will be an easing consideration in the Banking Supervision Department's examination and compliance processes** (examinations, sanctions, etc.) should the risks materialize.
6. The Banking Supervision Department **works and will work to remove regulatory barriers** to innovation and to building infrastructures that will make it possible to promote innovation, such as composing and updating banking directives regarding communication, cloud technology, and other directives, and establishing a standard for open banking. To that end we established, at the end of 2016, a designated division at the Banking Supervision Department—the Technology and Innovation Division.
7. **The Banking Supervision Department holds and will continue to hold a dialogue and conversation with fintech companies in Israel and abroad,** with the goal of encouraging collaborations between banking corporations and fintech companies, to allow fintech companies access to the financial sector and ultimately to lead to expansion of financial services for customers.
8. **The Banking Supervision Department will act to coordinate and will promote collaborations with other regulators in Israel and abroad,** to the extent necessary, in order to create a regulatory environment that supports innovation.

In conclusion, the banking corporations' business environment has been changing rapidly and materially in recent years, and will continue to change in the coming years as well—the entry of new players, new services, through new channels and changes in customers' activity patterns. **All these require that the banks accelerate the pace of examining new technologies and the possibilities open to them to adopt those technologies.** All this is with the management of the new as well as the traditional risks, which are also impacted by the changing environment, at all levels of the circles of control.

The board of directors and management are to verify that within the framework of the board committee for information technology and technological innovation's discussion of the banking corporation's strategic plan in the innovation area, the principles noted in this letter are dealt with, and that these principles are integrated into the banking corporation's annual work plans.

Sincerely,

Hedva Ber

Dr. Hedva Ber
Supervisor of Banks