

Chapter 4

The Banking Supervision Department's Activity in 2006

The principal function of the Banking Supervision Department is to maintain the stability and robustness of the banking system and the system's ability to meet its liabilities to depositors in a changing economic environment. The Banking Supervision Department also ensures that fairness is maintained in bank–customer relations while endeavoring to increase competitiveness and to impose suitable standards for the management and control of banking activity. For this purpose, the Department operates in a number of areas and performs on site and off site examinations. The main areas are regulatory coverage by means of directives and guidelines; inspection (audit) activity; and current monitoring of banks' business activity, including the proper management of the banks and their ability to manage risks and adapt to developments in the economy. The Department also concerns itself with relations between banking corporations and their customers and for this purpose investigates enquiries from the public and complaints by the public against banks.

1. THE DEPARTMENT'S ACTIVITIES

During 2006, the Department and its units dealt with several major topics:

- a. Instituting controls on bank charges—as part of the Bank of Israel's comprehensive efforts to seek ways of enhancing competition in the banking and financial systems, various Bank of Israel teams, mostly in the Banking Supervision Department, investigated the effects of the low level of competition on the prices of retail banking services. Several months ago the Department recommended an outline for the regulation of banking-service prices. Essentially, the outline calls for empowering the Governor of the Bank of Israel and the Supervisor of Banks, by legislation, to:
 - determine the structure of the schedule of bank charges (the list of banking services for which charges may be levied), the names of the charges to be levied, the types of charges, and how they are calculated. The purpose is to reduce the number of charges and make the structure of the schedule as simple as possible.
 - control the prices of banking services—to enhance competition and mitigate market failures, especially in competition-deficient sectors, and to ensure that a basic range

of services is equally available to all.

- establish an infrastructure of information for the public so that the public may compare the prices of banking services.

This outline served as the basis for a government-sponsored bill.

Concurrently, the Banking Supervision Department followed the discussions of the parliamentary legislation committee on bank charges. In its report, the committee adopted most of the Bank's conclusions and recommendations, including that concerning the empowerment of the Governor of the Bank and the Supervisor of Banks, by law, to control the prices of banking services.

On June 26, 2007, after debating the government's bill and private members' bills that were submitted in the matter, the Knesset passed the Banking (Service to Customer) Law (Amendment 12), 5767–2007, which integrates the provisions of the government-sponsored bill and several provisions in the private members' bills.

b. Preparations for implementation of the Basel II Accord—during 2006, a team composed of the heads and staff of the Research, Regulation, and Information and Reporting units produced an initial translation of the Basel II Accord (parts of which were distributed to the banks in March 2007). The team also established a research and practical infrastructure for continued preparations by the Department for the implementation of the Accord. In the first half of 2007, the Department established dedicated working teams for Basel II implementation, composed of staff members from all of its units. In July 2007, the Department circulated a draft of a complete directive in regard to Basel II, embodying all aspects of the agreement.

c. Deployment of the emergency economic system—pursuant to a government resolution adopted on November 13, 2005, and the approval of the Supreme Emergency Economic System Committee, it was decided that the Bank of Israel would set up and operate an emergency financial authority. The Bank began to formulate an emergency deployment plan for this special financial authority and the banking system at large. The work is being performed in conjunction with outside consultants and is being assisted by the banks' emergency officers. During the Second Lebanon War (summer 2006), the Banking Supervision Department was in charge of operating the financial system under emergency conditions. The Department, in conjunction with the banks, took several measures to keep the financial system going in as regular a manner as possible, with emphasis on leniencies for residents of northern Israel. The main actions taken, in conjunction with the banks, to allow citizens to continue receiving essential financial services were care in keeping ATMs filled, opening of enough bank branches (subject to instructions from the security services), invoking a contingency arrangement allowing customers of all banks to withdraw cash at any bank, activation of mobile branches, referral of customers of closed branches to alternative branches and call centers, opening of branches on short notice (subject to instructions from the security services), and urging the banks to be considerate of the inhabitants of the north in view of the state of war.

Readying the financial authority for its work is expected to continue in 2007 and has become an important topic in the Department's efforts. One of the Department's three goals for 2007, according to the Bank of Israel work plan for the year, is to enhance the financial system's ability to function in emergencies.

Below is a brief survey of the activities of the Department and its units in 2006.¹

2. REGULATORY COVERAGE OF BANKING ACTIVITY

The Department's regulatory directives are intended to cover the activity of the banks' boards of directors and management, improve the internal and external reporting systems, strengthen the system of internal controls, and ensure that the banking corporations are managed properly and prudently. The directives are collated in files on the "Proper Conduct of Banking Business," "Reporting to the Public," and "Reporting to the Banking Supervision Department."

The main regulatory directives published in 2006 concern the management of credit facilities in current accounts, procedures for the issue of housing loans, safekeeping of documents, capital ratios, descriptions of banking corporations' business, predictive information in reports of boards of directors, and measurement and disclosure rules pertaining to all transactions involving transfer and service of financial assets and settlement of liabilities.

3. INSTITUTIONAL EVALUATION AND LICENSING

The main function of the Institutional Evaluation Unit is to collate and compile the Banking Supervision Department's periodic assessments on the extent of the banking corporations' stability and robustness (including in this respect auxiliary corporations, banking subsidiaries, and overseas offices).

The five units responsible for evaluating banking groups and corporations operated under an annual work plan that focused on the following matters, among others:

- regular monitoring and periodic evaluation of banking corporations in Israel;
- regular monitoring of banking subsidiaries abroad and subsidiaries that are credit-card companies;
- banking corporations' exposure to credit, market, liquidity, and operating risks;
- monitoring banking corporations' implementation of legislative provisions flowing from the recommendations of the Bachar Committee;

¹ For an itemized description of the functions of the Department's units, see Bank of Israel, Banking Supervision Department, Israel's Banking System, 2003, Chapter 5 – Activity of the Banking Supervision Department.

- examining competition in the banking system;
- privatizing the Postal Bank and integrating it into the banking system as a competitor.

The sixth member of the institutional evaluation array, the Licensing Unit, deals with license applications that the Bank of Israel receives. This unit concerned itself with the following matters during the review year:

- proceedings related to the privatization of Bank Leumi le-Israel, Ltd. –examining the group of candidates for the purchase of the bank that submitted the winning bid in the tender conducted by M.I. Holdings, Ltd. and the Accountant General of the Ministry of Finance on behalf of the State;
- opening branches of foreign banks in Israel;
- authorizations for the formation of auxiliary corporations;
- permits for the holding of controlling equity in foreign companies;
- a permit allowing First International Bank of Israel, Ltd., to control Otsar Hahayal Bank, Ltd.;
- merger of the First International Mortgage Bank, Ltd., and Atzmauth Mortgage and Development Bank, Ltd., with the First International Bank of Israel, Ltd.;
- cancelling the financial-institution licenses of Tefahot Underwriting Company of the Mizrahi Group, Ltd; of “Mashavim” United Mizrahi Bank Issuing Company, Ltd; and of “Gahalet” Gmul Hisachon Lehinuch Ltd;
- dealing with various issues flowing from Amendment 13 to the Banking (Licensing) Law, including interpretation, enforcement, and licenses.

4. INSPECTION

The Credit Risk Inspection Unit made its planned transition from sample-based inspections to process-based inspections of systems of credit management, command, and control. The Unit drew up a comprehensive inspection specification based on international standards in order to assure advanced management of credit risks. The unit used this specification to perform its first process-based inspections of banking corporations, some inclusive and others sectoral, and will continue to conduct such inspections in 2007. Also during 2006, the Unit inspected the credit-card companies' credit risks and employed statistical models to inspect the companies' risk management. Finally, the Unit monitored actions taken by banking corporations and outside suppliers to promote advanced systems of credit rating and supportive organizational changes, on the basis of principles set forth in “Guidelines for Credit-Rating Systems,” a draft document published by the Supervisor of Banks in October 2004.

In the information technology (IT) field, the inspections emphasized issues that are noted for significant risks in IT system management, e.g., security-system management, systems that link internal networks to outside networks, and information systems that support high-risk business activity. Systemic inspection of information backup, survivability, and disaster recovery was stepped up and, where necessary, inspection

activity was expanded in order to promote system-level treatment of specific focal points of risk as part of the unit's actions in support of the implementation of Proper Conduct of Banking Business Directive 357. Moreover, expanded professional support was provided for processes related to the issue of permits, regulatory coverage of miscellaneous activities and services that banks offer their customers, and processes related to the assimilation of the Basel Committee guidelines on the management of operating risks. Testing of IT governance methods began, mainly in the context of the Unit's assessments of the adequacy of the IT risk surveys that the banks are required to prepare and the controls that the banks apply in order to mitigate the risks.

The Management, Supervision, and Control Systems Inspection Unit continued to promote the use of advanced internal-audit procedures and the application of advanced "risk-focused auditing" structural approaches in the banking corporations' internal auditing. Comprehensive inspections took place in regard to information infrastructures and the quality of the risk assessment that underlies the work plans of the banks' internal-auditing function. A model was developed for use in profiling and rating the internal-auditing environments of banking corporations and was implemented in actual inspections. The outcomes of the inspections were also used to examine processes related to the overall supervisory strategy in internal auditing. As part of this activity, a comprehensive policy document on internal auditing was drawn up. Cross-sectional inspections of the banking system emphasized actions that should be taken for the prevention of embezzlement and fraud on the basis of principles established by the Supervisor of Banks and accepted international standards for the handling of this sensitive field.

The Unit also produced draft guidelines for an "internal-auditing framework for banking corporations" and distributed them in June 2006. The guidelines set specific standards for use in evaluating a bank's control systems and may provide a basis for the application of the Sarbanes-Oxley directives and the principles derived from the future working environment under the Basel II regime.

The Risk Management Inspection Unit focused in 2006 on market and liquidity risks and various aspects of risk that stem from banks' operations in capital markets. Inspections during the year emphasized the examination and evaluation of components of the risk-management process, overall inspection framework and infrastructure aspects of various activities that create market risks. Appropriate inspection procedures were applied in the working environment of the statistical models that those involved in risk management use (assumptions, documentation, methodology, the validation process, and tests of use). These actions included the extension of substantive inspection coverage to the dealing rooms where forex market risks and NIS/forex risks are managed, with emphasis on activity in derivatives.

In regard to prevention of money laundering and financing of terror, extensive inspection coverage of the banking system continued. Apart from enforcing matters that are dealt with on the basis of rules established in law, the Unit emphasized the

examination of system preparedness, as required by Proper Conduct of Banking Business Directive 411.

5. RESEARCH UNIT

The Research Unit monitors banking developments in Israel and abroad and keeps abreast of new approaches to the analysis and evaluation of various matters—asset and liability management, risk management, operating efficiency, immunization against various banking risks, and ways to estimate capital adequacy on the basis of the new Basel II requirements.

In 2006 and 2007, the Unit published the following discussion papers:

1. The Relationship between Business Cycles and the Level and Quality of Bank Credit in View of Basel II: the Israeli Experience, (March 2006) (Hebrew);
2. Market to Book Value Ratio in Banking—The Israeli Case, (June 2006);
3. Competition in the Banking Industry: Theoretical Aspects and Empirical Evidence from Israel in an International Perspective, (July 2006);
4. Loan Pricing under Basel II in an Imperfectly Competitive Banking Market, (May 2007).

The Unit also wrote and published the Banking Supervision Department's 2005 Annual Survey, in Hebrew and English.

6. INTERNATIONAL RELATIONS

The main activities of the International Relations area in 2006 were the following:

- accompanying the IMF mission in its Article IV consultations with the Department and its inspection of various issues in banking examination;
- meetings with representatives of international rating services (Moody's, S&P, Fitch), including provision of information;
- meetings with representatives of foreign banks that engage in correspondent banking activity with Israeli banks;
- meetings with representatives of other international entities (investment houses, institutional investors, financial advisers, etc.) in matters related to Israeli banking and the regulatory environment.
- meetings with representatives of the BIS and central banks in regard to Israeli banking and the regulatory environment (mainly filling out questionnaires and providing information);
- developing relations with Mediterranean Basin and European countries as part of the "Barcelona process" (the EuroMed Market);
- reviewing various banking agreements in preparation for Wider Europe Project,

- known as the European Neighbourhood Policy (ENP);
- the implications of Israel's joining the OECD from the standpoint of banking supervision;
 - working meetings with banking supervisors in Switzerland and the UK in regard to various cross-border supervisory issues;
 - participation in the departmental array of preparations for the implementation of Basel II and additional supervision issues on the agenda;
 - launching a process that will end with the conclusion of formal cooperation agreements with supervisory authorities in countries where overseas offices of Israeli banks operate.

7. BANK–CUSTOMER RELATIONS

One of the main purposes of Banking Supervision is to protect bank customers' rights as an important factor in keeping the banking system stable and reliable. The Department safeguards customers' rights by force of the Banking (Service to Customer) Law, 5741-1981, mainly by means of the Public Enquiries Unit and the Standard Contracts and Fees Unit. Its activities include, but are not limited to, handling enquiries from the public, providing the public with information and explanatory material, identifying system-level deficiencies in banks' functioning and determining how to correct them, detecting and removing discriminatory terms in standard contracts, and dealing with matters related to bank charges.

a. Public enquiries

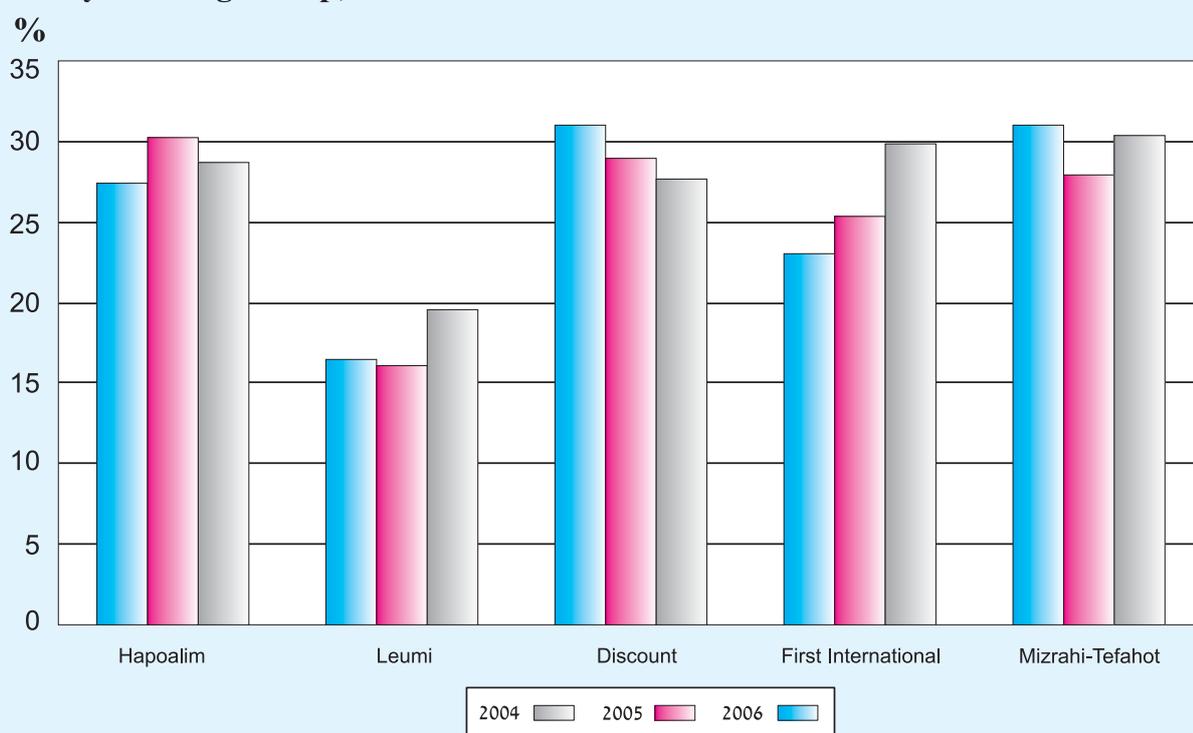
The Public Enquiries Unit operates by force of Section 16 of the Banking (Service to Customer) Law, 5741-1981, which authorizes the Supervisor of Banks to investigate enquiries from customers about their dealings with banking corporations. The Unit investigates enquiries in accordance with various legal provisions and procedures that the Supervisor of Banks issues in this matter from time to time. When the investigation of a complaint is completed, the customer is given a detailed response, including findings and conclusions, and is apprised of the Department's stance. When a complaint is investigated

Figure 4.1
Complaints and Enquiries from the Public Received by the Banking Supervision Department, 1994-2006



SOURCE: The Public Enquiries Unit of the Supervisor of Banks.

Figure 4.2
Proportion of Justified Complaints out of Total Complaints,
By Banking Group, 2004-2006



SOURCE: The Public Enquiries Unit of the Supervisor of Banks.

and found to be justified, the Department acts vis-à-vis the bank to straighten out the customer's affairs. When a customer's complaint points to the existence of a problem at the system level, the Department takes actions including the amendment of procedures and the issue of instructions to the banking system or the individual bank to overhaul its working procedures. When it finds deficiencies, the Department not only corrects them but may order banks to issue refunds to customers. In 2006, the Department dealt with and responded in writing to 4,176 complaints and 3,092 requests for information and miscellaneous matters. Some 25.1 percent of the complaints on which the Department took a position in 2006 were found to be justified or partly justified. During the year, banks paid their customers NIS 2,300,000 on account of complaints that were found justified. Pursuant to information received in the course of dealing with public enquiries, groups of customers received NIS 13 million in refunds in 2006, mostly due to a refund from Bank Hapoalim because the bank had rounded the LIBOR rate up to the nearest eighth of a percentage point without properly informing its customers.

Table 4.2 shows the distribution of complaints against banks and credit-card companies that were investigated to completion in 2006. Among the five large banks, Mizrahi-Tefahot Bank had the highest share of justified complaints (31.1 percent) and Bank Leumi le-Israel had the lowest (16.5 percent). Among credit-card companies, ICC had

Table 4.1
Investigation of Complaints and Enquiries from the Public, 2006

	Number	Percent of total
Complaints on which decision was made		
1. Complaints found wholly or partly justified	2,171	38.0
2. Complaints found unjustified	596	10.4
3. Complaints found partly justified	130	2.3
Total	2,897	50.7
Complaints on which no stand was taken		
1. Treatment stopped due to legal proceedings	226	4.0
2. Treatment stopped for other reasons	379	6.6
3. Not within Unit's jurisdiction	277	4.8
4. Unable to take a stand	389	6.8
5. Not appropriate to be dealt with by the Unit	8	0.1
Total	1,279	22.4
Enquiries ^a	1,536	26.9
Total enquiries completed by the Unit	5,712	100.0

^a Not including 1,556 enquiries answered directly via e-mail.

SOURCE: Supervisor of the Banks.

the highest share of justified complaints (19.4 percent) and Leumi-card had no justified complaints at all. Handling bank customers' complaints is part of the Department's wide range of activities in protecting customers' rights, which includes additional methods of action such as directives to banks on treatment of customers, publication of documents, etc. The main topics of enquiry were housing loans, bank-account management, checks, bank charges, and credit.

b. System-level deficiencies

The information that the Department received while handling public enquiries, along with information from other sources, created a basis for attention by the Department to many matters in 2006, including issues related to early repayment of loans, methods of calculating interest, imposition of charges, etc. After the Department looked into seven main issues, the banks were asked, among other things, to make NIS 13 million in refunds to customers. Most of the refund was made by Bank Hapoalim for having rounded the LIBOR rate up to the nearest eighth of a percentage point without properly advising customers that it was doing so. The number of customers who received refunds due to the Department's treatment of these matters was 34,000.

Table 4.2
Distribution of Resolved Complaints during 2006, Commercial Banks

	Total enquiries ^a (from all years) which were resolved in 2006	Total complaints (from all years) that were classified in 2006 ^b	Justified complaints ^c	Proportion of justified complaints ^c in total complaints ^a against the bank (percent)
Hapoalim	1,334	719	197	27.4
Leumi	835	473	78	16.5
Discount	493	290	90	31.0
First International	339	195	45	23.1
Mizrahi-Tefahot	699	396	123	31.1
Union	100	59	16	27.1
Mercantile Discount	137	62	21	33.9
Otsar Hahayal	183	98	17	17.3
Yahav	94	60	15	25.0
Leumi Mortgage Bank	245	156	21	13.5
Discount Mortgage Bank	77	41	13	31.7
Credit card companies	148	106	14	13.2
Other commercial banks	1,028	242	76	31.4
Total of the banking system	5,712	2,897	726	25.1

^a Excluding enquiries in which the name of the bank was not specified.

^b Justified/partially justified/unjustified

^c Including complaints which were found to be partially justified.

SOURCE: The Unit for Public Enquiries of the Supervisor of the Banks.

Table 4.3
Distribution of Complaints against the Five Major Banking Groups^a, and Description of Banks by Size, 2006

Bank	Complaints ^b	Justified complaints ^c	Total assets ^d	Number of branches	Deposits of the public ^d
Hapoalim	34.7	37.0	35.2	33.1	34.3
Leumi	22.8	14.6	31.0	25.6	31.7
Discount	14.0	16.9	13.5	16.5	13.5
First International	9.4	8.4	8.5	10.2	8.7
Mizrahi-Tefahot	19.1	23.1	11.8	14.6	11.8
Total	100	100	100	100	100

^a Excluding subsidiaries.

^b That were classified (justified, partly justified or unjustified).

^c Including complaints which were found to be partially justified.

^d At December 2005 prices.

SOURCE: Public Enquiries Unit of the Banking Supervision Department.

c. Information

In 2006 the Department added a new section on banking consumerism to the Bank of Israel web site in order to enhance customers' awareness of their consumer rights. Bank customers and the public at large may visit the site for information on various aspects of managing their banking activity—current accounts, deposits, credit facilities and loans, credit cards, checks, bank charges, housing loans, etc. The topics were chosen on the basis of the experience that the Department has amassed in dealing with consumer issues and customers complaints. Apart from information on banking affairs, the site contains consumer-related directives from the Department, miscellaneous surveys and publications, statistical data about the handling of public enquiries, applications to the Standard Contracts Court, etc.— in addition to the copious information that the public receives in responses to its inquiries by telephone, standard mail, and e-mail.

The public was given a great deal of information after the Proper Conduct of Banking Business Directive on the management of credit facilities in current accounts went into effect in 2006. The new directive is meant to eliminate the practice of allowing customers to overrun their approved credit facilities in large sums and on a long-term basis, to reduce the uncertainty that such overruns cause customers and banks, and to improve the national payment ethic.

The Department established a control room that stayed in touch with the banks and monitored developments in this matter in order to assure a sound transition to the new pattern of activity. The Department also opened a telephone call center to answer customers' questions about the directive and to provide immediate assistance to those who encounter problems in regard to its implementation.

d. Bank charges

The Department drew up a proposal for regulatory coverage of the prices of banking services, focusing on empowering the Supervisor of Banks, by legislation, to impose price control on banking services when previously determined reasons for such action apply. The proposal also empowers the Supervisor to determine the entire structure of the banks' schedule of charges, the services for which charges would be imposed, the charges themselves, types of charges, and how they are calculated—all for the purpose of making the schedule as simple as possible. The proposal also includes measures that will make customers more knowledgeable about the prices of banking services and allow them to compare one bank with another—measures such as reducing the number of charges, standardizing the structure of the schedule and the names of the banking services, establishing separate schedules of charges for certain customers, cutting costs, and making it easier to switch banks, etc. The Department also continued to go about its regular work in regard to bank charges and reviewed dozens of rate adjustment requests. In some cases, the Department intervened after performing these reviews to prevent the updating of rates or the introduction of a new charge. The Department also issued

directives about how the charges should appear on the schedule in order to make them more transparent and to enhance disclosure to customers.

e. Standard contracts

The Department's activity in regard to standard contracts is based on the Standard Contracts Law, 5743-1982, which aims to protect customers from discriminatory terms in standard contracts. Banking corporations use hundreds of documents and forms that meet the definition of "standard contracts" in the law. The Department vets important phrasings in contracts between banks and their customers in order to pinpoint discriminatory terms and have them modified or cancelled. The Bank of Israel asked the Standard Contracts Court to strike down discriminatory terms in Bank Hapoalim's contracts for the provision of online and cellular-phone banking services. Its reasoning in doing so was that such banking services have long since become commonplace and widely used around the world, including in Israel. On February 9, 2006, the court handed down its ruling on the Bank's request, accepting most of the Bank's claims about the tacitly discriminatory nature of several clauses in the contract and ordering Bank Hapoalim to annul or modify them. In the aftermath of the verdict, the Supervisor of Banks instructed the banks to amend contracts that pertain to the provision of online and cellular-telephone services and to excise the clauses that the court found to be discriminatory. Two additional requests to annul or modify discriminatory terms in standard contracts are pending before the court today: First International Mortgage Bank's housing-loan contract and Mizrahi-Tefahot Bank's bank-guarantee contract under the Sales (Dwellings) (Assurance of Homebuyers' Investments) Law, 5735-1974.

8. INFORMATION AND REPORTING

a. Information and Reporting Unit

Each year the Information and Reporting Unit receives more than 4,000,000 items of information from around 120 entities that the Department supervises (banks and auxiliary corporations). The data arrive in some 450 different reporting tables and are aggregated in around 60,000 series. Today, the Department's databases contain more than 20 million pieces of information in statistical systems and more than 30 million in individual systems. The Information and Reporting Unit processes the data and converts them into information that the Department, the Bank of Israel's supervisory and other units, and the public at large (in Israel and abroad) can use handily. The Unit uses this information to monitor the banks' activities and stability by checking their compliance with the quantitative limits set forth in the Banking (Licensing) Law and the Proper Conduct of Banking Business. The Unit receives information on the basis of reporting directives that it writes and updates. It gives the banks feedback by

sending them aggregate data that serve them as a management tool and allow them to compare their data with those of the system at large. Each year, the Unit deals with more than 3,000 requests for information from Israel and abroad. The requests are diverse—around 1,300 requests from the public for information about mortgage interest rates (including early repayment charges) and types of mortgages, more than 500 from various entities and the public for information about interest rates at regular banks, some 100 for information about returned checks and how they are distributed, about 500 from students and researchers for information about topics related to the banking system, and around 100 (mainly from banks) about the policy on branch locations and branch regionalization. The other requests are submitted by various private and public entities that need information about various areas of banking such as credit concentration, actions taken at the Bank of Israel's initiative—such as reducing credit overruns, the types of checks that were returned, and the segmentation of Israel's financial system—and information about credit-card companies. The Unit receives many enquiries about interest rates in credit and deposit markets, segmented in various ways, and about the “gray market.” Other requests for information concern specific bank accounts (e.g., from members of a deceased person's family who do not know where the deceased kept accounts). The Unit does not possess this kind of information and has to leave these enquirers in the dark. In some cases, enquirers settle for the provision of data by e-mail or facsimile; in other cases, the Unit staff prepares large Excel files that it sends to enquirers in other ways. The Unit routinely refers enquirers, after explaining the essence of their economic or financial problems and ways of solving them, to the exact location at the Bank of Israel web site where they can find the desired information. Occasionally, “public employee” certification has to be issued so that data may be presented to a court of law. Notably, almost every enquirer asks for further explanations after receiving the data, consuming a great deal of staff time. Many enquiries come from abroad, e.g., from research institutes, economic consulting agencies, or official institutions such as the IMF and the BIS. The information provided helps these entities to analyze Israel's financial system and, at times, to determine its country rating. The Unit publishes (in print and online) the maximum allowable interest rate on the gray market, the average interest rate that mortgage banks use in calculating early repayment, and miscellaneous publications: (1) “Annual Information on the Banking Corporations” that provides five-year information about the Israeli banking system,² (2) “Current Information on the Banking Corporations,” a loose-leaf binder containing up-to-date information about the banking system as is received during the year, (3) “Main Data on the Activity of Each Bank,” a quarterly publication comparing the banks on the basis of information culled from their financial statements to the public, and (4) the “Book of Branches,” a guide to the branches of banking institutions that provides identifying particulars of all bank branches in Israel. The last-mentioned publication, available only at the Bank's web site, is updated every week. The Unit, in conjunction with the Financial Statements Unit, checks the banks in order to verify reports and examine the reliability of the data

² Also available at www.bankisrael.gov.il, under “Publications and Information.”

that the Department receives. By identifying deficiencies that surface in inspections and internal examinations, the Unit improves the reporting system and the data that the banks provide. The Unit also takes part in cross-sectional analyses, including examining the fitness of investors, preparing for Basel II, and establishing a format of financial reporting to the public by credit-card companies, starting in December 2006.

b. Financial Statements Unit

The Unit is active in two main fields:

(1) Regulation

Guidelines on preparing reports to the public, which establish rules for preparing banking corporations' reports to the public (both annual and quarterly; the annual statement comprises the report of the Board of Directors, management's review, a statement regarding disclosure, the report of the Board of Directors and the Management about their responsibility for the annual statements, and the financial statements), as well as topics associated with the work of banking corporations' internal auditors.

In 2006, the Unit completed regulations and directives for reporting to the public on the transfer and service of financial assets and the settlement of liabilities. In regard to the topics discussed in detail below, the Unit wrote drafts in 2006 on which discussions were completed in early 2007. The banking corporations' reports to the public, including those submitted in 2006, were adjusted to reflect the requirements in the following matters:

- establishing a format for credit-card companies' reports to the public;
- aligning the calculation of return on equity with the accepted practice abroad;
- aligning the Directives on Reporting to the Public with U.S. Accounting Standard 21—earnings per share;
- aligning disclosure in the Directives on Reporting to the Public with two amendments to the Securities Regulations (Periodic and Immediate Reports and Preparation of Annual Financial Statements) (Amendment 1 and Amendment 2, 5766–2006).

In 2006, the Unit sent guidelines to all banking corporations about how to apply the Directives on Reporting to the Public in various situations, including disclosure of outsourcing agreements in regard to bank information systems; accountancy handling of goodwill and intangible assets in accordance with U.S. Accountancy Standard 20 (Amended); reporting on housing loans in statements of banking corporations' boards of directors; accountancy handling of bonds held by banking corporations in their function as market makers; classification of problematic debts under Proper Conduct of Banking Business Directive 325, "Management of Credit Facilities in Current-Accounts," and the securitization of housing loans.

The Unit also continued to deal with several important regulatory issues that had been of concern to it in the past:

a. Issues related to financial reporting by banking corporations: alignment of the rules concerning measurement and disclosure of problem debts and loan-loss provisions with the accepted American practice; adapting disclosure to Pillar 3 of Basel II and International Financial Reporting Standard 7 (IFRS 7); securities lending and buyback transactions—treatment for the purpose of calculating capital ratio; Section 404 of the Sarbanes-Oxley Act concerning management's responsibility for and assessment of the internal control function in financial reporting and CPA's opinion about the management's assessment; treatment of securities for sale for the purpose of capital-ratio calculation; and alignment of accountancy handling of depreciation of assets with U.S. Accountancy Standard 15.

b. Issues related to compulsory proper banking management norms: Directive 303 concerning communications between CPA-auditors with persons in charge of overall control, and Directive 305 concerning chief accountants.

(2) Inspections at the system and individual banking corporation levels

The inspection activity addressed itself to proper disclosure in banks' reports to the public and banks' returns to the Department (in conjunction with the Information and Reporting Unit). As by-products of these areas of attention, the Unit dealt with current issues in banking corporations' financial reporting (responding to banks' enquiries, handling occasional accountancy issues, instructions to specific banks and the system at large, etc.). The inspections performed during 2006 focused on risk-weighted capital ratios and investments in securities (both in conjunction with the Information and Reporting Unit).

9. CHECKS WITHOUT COVER

The number of restricted accounts and customers who were restricted due to account restrictions trended upward gently during the review year. In the aftermath of the Second Lebanon War, the Checks without Coverage (Limits of the Incidence of the Law) Regulations, 5766–2006, were amended so as to require banks to subtract from the total number of checks refused in a given account those rejected due to insufficient funds between July 12 and September 15, 2006, and to rescind any restrictions that had been applied to customers due to these checks. The banks complied with the amendments in December 2006 by cancelling some 15,000 account-restriction transactions.

Until the revised regulations cancelled the restrictions, the number of restricted accounts had risen to 179,223 at the end of November 2006, 1.4 percent over the year-earlier period. By year's end, however, after the restrictions were removed, there were 161,013 restricted accounts, 8.9 percent fewer than there had been a year earlier. The number of restricted customers also declined after the new regulations were applied. At

the end of November 2006, there were 102,387 restricted customers, 2.6 percent more than a year earlier, and after the amendments were implemented there were 87,936, 11.8 percent fewer than a year earlier.

The Bank of Israel web site was visited 149,597 times in 2006 as against 144,000 times in 2005, a 3.8 percent increase. The answerphone service received 36,021 calls in 2006 as against 27,600 in 2005; the 30.5 percent upturn is consistent with the Department's policy of making information available to the public via advanced media.

Table 4.4
Restricted Customers and Accounts, 2004–06

	2004	2005	2006	Percent change in 2006
Restricted accounts	175,540	176,770	161,013	-8.9
<i>of which</i> For checks returned	105,050	102,682	87,289	-14.9
Restricted customers	98,605	99,760	87,936	-11.8
Under ordinary circumstances ^a	36,411	35,071	25,501	-27.2
Under aggravated circumstances ^b	32,448	31,230	26,446	-15.2
Under special circumstances ^c	29,746	33,456	35,989	7.5

^a A restricted customer under ordinary circumstances is a customer with one restricted account; such customers may operate other accounts, but may not open new accounts.

^b A restricted customer under aggravated circumstances is a customer with two accounts restricted in the same year or who has an account restricted for the second time within three years; such customers may not draw checks on any account.

^c A restricted customer under aggravated circumstances is a customer who has had all accounts restricted by the head of the Bailiff's Office or by the Rabbinical Courts (for a period of up to 5 years).

SOURCE: Reports to the Supervisor of Banks.

Table 4.5
Public Enquiries and Complaints Regarding Checks without Cover, 2005-06
(End-of-year figures)

	2005	2006	Percentage change in 2006
In writing	1,399	1,449	3.5
Appeals to courts	805	863	7.2
Via answerphone	27,600	36,021	30.5
To Bank of Israel web site	144,000	149,597	3.8
By phone to the Unit	7,000	8,500	21.4

SOURCE: Public Enquiries Unit of the Banking Supervision Department.

10. PROHIBITION OF MONEY LAUNDERING—LEGISLATION AND REGULATION (2006)

a. Legislation and regulation

An amendment to the Prohibition on Money Laundering (The Banking Corporations' Requirement regarding Identification, Reporting, and Record-Keeping to Prevent Money Laundering and the Financing of Terrorism) Order, 5761–2001 (hereinafter: the Order) was gazetted at year's end. The amendment included three main components: (1) inspection and reporting requirements were added under the Prohibition on Terrorist Financing Law, 5765-2004: inspection of the identification particulars of parties to a purchase transaction against identification particulars of terror organizations and declared terrorists; and reporting requirements on the basis of size and type of transaction—the reporting threshold for transactions with high-risk countries and territories was set at NIS 5,000; (2) the incidence of the Order was extended to the banking corporations' credit-card subsidiaries, and additional changes were made in view of the authorities' and banks' cumulative experience in applying and enforcing the provisions. Concurrently, regulations from the Minister of Finance under the Prohibition on Terrorist Financing Law were gazetted. The new regulations, together with the Order, add another layer in the legislative web that aims to prevent the financing of terrorism without disrupting correspondent banking relations with Palestinian banks.

b. Inspection and the Sanctions Committee

The series of inspections undertaken to ensure the banks' implementation of the legislative restrictions against money laundering continued in 2006, with emphasis on know-your-customer issues and detection of unusual transactions.

Apart from corrective measures in response to deficiencies that are uncovered in the examinations, in cases of grave violations the examination findings are forwarded to the Sanctions Committee for Banking Corporations regarding the Prohibition of Money Laundering. The committee did not convene in 2006.

APPENDIX 1

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2006

Jan. 15	<p>The international rules have transformed the production and safeguarding of documents related to traded-securities activity and the ability to reconstruct transactions and situations into an issue that should be cemented in binding directives. Accordingly, a new Proper Banking Management Directive requires banking corporations to retain documents related to negotiable securities for a period of at least seven years from the receipt of the document or the performance of the transaction, whichever is later. Also, banking corporations must establish rules for the protection of said documents from human and natural damage, the control of access to such documents, and for the release of approved contents, where necessary.</p> <p>The directive went into effect on April 1, 2006.</p>
January 22	<p>Pursuant to amendments to the Banking (Service to Customer) (Date of Debiting and Crediting of Checks) Directives, 5752-1992, and the Banking (Service to Customer) (Interest Calculation Methods) Directives, 5751-1990, the Proper Banking Management Directive concerning the business day of banking corporations was amended. The amendments redefined the “banking business day” and extended it to 18:30 on ordinary weekdays and to 14:00 on Fridays and days preceding festivals as set forth in the definition of the “banking business day” in Section 1 of the Banking (Service to Customer) (Date of Debiting and Crediting of Checks) Directives, 5752-1992 (except for the eve of a sabbatical day, the eve of Purim, the eve of the Ninth of Av, and the day preceding the eve of Yom Kippur).</p> <p>The amendments to the directive went into effect on February 21, 2006.</p>
January 25	<p>To make it easier to assimilate the Proper Banking Management Directive concerning the management of credit facilities in current accounts, transitional directives were set forth:</p> <p>(a) A banking corporation may unilaterally offer a credit facility to a customer who has not concluded a credit-facility agreement until January 1, 2007. The interest rate for said credit facility shall not exceed the rate actually charged to customers of the same type.</p> <p>(b) A banking corporation that allows a current account to have a negative balance that exceeds the facility approved and agreed upon with the customer is entitled to charge penalty interest until July 1, 2006.</p>

February 19	After an amendment to the Securities Regulations systematized the rules of disclosure concerning information that must appear in a prospectus, significantly expanded the extent of compulsory disclosure in periodic statements, restructured the periodic statements, and established requirements in the disclosure of predictive information, the directives regarding reporting to the public were augmented with an ad hoc provision concerning description of the banking corporation's business and predictive information in reports of the Board of Directors.
March 9	The financial-institution license of Gahalet Savings, Ltd., was cancelled.
April 10	BNP Paribas SA was granted a banking license.
May 25	State Bank of India was granted a banking license.
May 29	The increase in banks' activity in buyback transactions and securities lending in recent years made it necessary to establish measurement and disclosure rules for these transactions. It was also necessary to update the rules of measurement and disclosure for other transactions in which financial assets change hands, including securitization transactions. Accordingly, a new provision in the directives concerning reporting to the public adopted the measurement and disclosure rules in the U.S. accountability standard regarding all transactions related to the transfer and service of financial assets and the settlement of liabilities.
May 29	<p>After the Standard Contracts Court ruled on a request to revoke and revise discriminatory conditions in Bank Hapoalim's contract for the provision of online and cellular-telephone banking services, the banking corporations were asked to amend several sections in contracts that they regularly use:</p> <ol style="list-style-type: none"> 1. Responsibility for unauthorized transactions in a customer's account—deletion from the contract of any provision that explicitly or implicitly absolves the banking corporation of responsibility for unauthorized transactions in a customer's account. 2. Responsibility for malfunctions, mishaps, etc. In any provision in a contract that absolves the banking corporation of responsibility for malfunctions and mishaps, including those in communication lines, software, service provided by a third party, etc., the exemption shall be limited to cases in which said malfunction and mishap is not within the banking corporation's control and in which the banking corporation made a reasonable effort to prevent it.

3. Affirmations concerning awareness of risks—deletion from contracts of any affirmation or statement that is attributed to the customer (and is printed in the contract) concerning the customer's awareness of various risks related to the service.

4. Responsibility for forwarding information—deletion from contracts of any provision that absolves the banking corporation or any third party, explicitly or implicitly, of responsibility for the wording of any information from the banking corporation to a third party incidental to the provision of the service, for the purpose of providing the service and as an inseparable part thereof, or for the use thereof.

5. Cancellation of contract—creation of symmetry between the customer's right to cancel a service contract and the banking corporation's right to do so. (Obviously, asymmetry to the customer's benefit is permitted.)

6. Cutback in service—the banking corporation must give customers at least 14 days' prior notice about a cutback in service.

June 4 The Department published draft guidelines relating to an internal-control framework that is tailored to the characteristics of the control infrastructure required for management of the totality of risks in banking corporation activity. The draft set criteria for the activation of an effective internal control system at the banking corporation for its full range of activities.

The principles expressed in the guidelines about the structure and evaluation of the internal audit framework also form a basis for processes that are being performed under guidelines that the Department has already forwarded to the banking corporations. The guidelines deal with implementation of the provisions of the Sarbanes-Oxley Act of 2002 concerning the evaluation of controls for financial reporting and the implementation of principles derived from the future working environment under the Basel II regime.

June 18 Cumulative experience showed that it was necessary to systematize the handling of requests for recognition of deferred letters of guarantee. Accordingly, the Proper Banking Management Directive concerning minimum capital ratio was amended and a procedure was established for the submission of requests for the Department's recognition of the inclusion of deferred letters of guarantee in secondary or tertiary capital. Furthermore, in certain cases, e.g., an issue of letters of guarantee by means other than a prospectus, assuming that it meets all the conditions set forth in the Directive, the banking corporation need not obtain the Department's prior approval but must advise the Department of its action.

June 20	The financial institution licenses of "Mashavim" United Mizrahi Bank Issuing Company, Ltd, and Tefahot Underwriting Company of the Mizrahi Group Ltd were cancelled.
June 28	The licenses of the First International Mortgage Bank, Ltd, and of Atzmauth Mortgage and Development Bank, Ltd, are revoked.
August 28	Draft guidelines for the management of operating risk, based on the Basel II standards, were published as part of a comprehensive strategy meant to strengthen the banking corporations' environment and array of controls.
December 17	<p>Several leniencies and transitional provisions were appended to the Proper Conduct of Banking Business Directive concerning the management of credit facilities in current accounts:</p> <ol style="list-style-type: none"> 1. The period in which a banking corporation may provide a unilateral credit facility even to customers who have not concluded a credit-facility agreement was extended to July 1, 2007. 2. To prevent the return of checks in cases of small overruns of credit limits, banking corporations were allowed to disregard the instructions in the directive in regard to overruns that do not exceed NIS 1,000, provided that they do not persist for long.
December 18	A Proper Banking Management Directive concerning cash withdrawals from ATMs went into effect on January 1, 2007. The Directive states that every bank must install an ATM in an exterior wall of every branch (or within a radius not exceeding 500 meters from the branch). However, banks may request an exemption from this instruction in view of several criteria, including the location of the branch, the characteristics of activity at the branch, unique features, the banking corporation's contribution to the deployment of ATMs, and repeated vandalism of ATMs.

Banking Supervision Organizational Structure

