

Chapter 4

Activity of the Banking Supervision Department

According to goals defined for 2007 by the Bank of Israel Banking Supervision Department, its main functions are to preserve the stability and soundness of the banking system in a dynamic economic environment, in crisis conditions and an emergency; working to bolster competition and efficiency in the sector; and maintaining fairness on the part of the banks towards their customers. In addition to these aims, the Banking Supervision Department listed as targets for 2007 the adoption and assimilation of the recommendations of the Committee on Banking Supervision (Basel II) and current international supervision methodologies, while enhancing connections with supervisory authorities around the world and in Israel, and signing memoranda of understanding. In order to achieve these goals, the Banking Supervision Department is working in a number of areas, of which the principal ones are regularization through directives and guidelines, conducting audits (on-site examinations), ongoing monitoring and evaluation of business activity by the banks (off-site examinations)—including an assessment of their ability to manage risks and adapt themselves to developments in the economy—and capital requirements in preparation for unexpected losses.

For the first time, this chapter will emphasize the main issues that the Banking Supervision Department must address in dealing with developing events and to achieve its goals for 2007. In contrast to previous years, the regular work of the Banking Supervision Department's various units will only be summarized in this chapter.¹

We will describe below the processes of achieving the Banking Supervision Department's goals for 2007 in various spheres, both as part of the implementation of its policy and in the handling of developing events.

¹ For a more extensive treatment, see "The Banking System in Israel," 2006 Annual Review, pp. 115–129.

1. THE GOALS OF THE DEPARTMENT

a. General

The principal activity of the Banking Supervision Department in preserving the stability of the banking system and preparing for dealing with crisis situations takes place in the framework of the regular work of its various units. The following is a descriptive summary of the banking supervision units' dealing with this activity.

Institutional Evaluation and Licensing (off-site examination): 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). This unit monitors the banking corporations, changes in the composition of their activities, and their degree of exposure to the entire array of banking risks and profit and loss factors.

Another field dealt with by the institutional evaluation unit is licensing. This involves handling requests that require a license from the Bank of Israel or the Supervisor of Banks.

Inspection (on-site examination): The inspection processes are designed to verify proper banking management, including compliance with the directives of the Supervisor of Banks in the relevant spheres and with the legal provisions concerning the areas of banking activity. The inspection reports describe any faults discovered, and set targets and timetables for correcting them.

Regularization: Regularizing banking activity is a key tool of the Banking Supervision Department in guiding the banking institutions concerning the positions and directives of the Supervisor of Banks on various banking and accounting issues. The regularization directives are designed to regularize the activity of a bank's board of directors and management, improve its internal and external reporting systems, strengthen its internal auditing, and lead to proper and cautious management of the corporations. Regularization relies on processing and analyzing the information reaching the Banking Supervision Department from various sources, which is translated into guidelines and rules of conduct imposed on the banks. These are anthologized in "Directives for Proper Banking Management," "Directives for Reporting to the Public," and "Directives for Reporting to the Banking Supervision Department."

Research Unit: The Research Unit monitors developments in banking in Israel and around the world, and keeps up-to-date on new approaches in analysis and assessment of various issues. The know-how acquired from a review of the professional literature and research studies serves as a basis for writing position papers and studies on banking supervision policy topics. The unit also helps develop tools for assessing the performance of banking institutions, formulating rules for banking regularization, and taking other measures to foster progress in Israel's banking system.

The Research Unit writes and publishes the Annual Survey of Israel's Banking System (in Hebrew and English), which analyzes developments in Israeli banking, both in the reviewed period and in the long term. The unit also writes and publishes articles for discussion on diverse banking issues.

Financial Information and Reporting: This unit is divided into two sub-units—the Information and Reporting Unit and the Financial Statements Unit. The Information and Reporting Unit receives the banks' reports to the Banking Supervision Department, and turns them into available and reliable information for the Supervisor of Banks and the employees of the Banking Supervision Department's various units. This information is used to help monitor the banks' activity. The Financial Statements Unit deals in two main fields: (1) Regularizing the directives for reporting to the public, which set rules for preparing the reports of the banking corporations to the public, and regularizing issues linked to the work of the banking corporation's auditor; (2) Preparing audits at the level of both the system and the individual bank on topics related to financial reporting to the public by a banking corporation, and to the reports by the banking corporations to the Supervisor of Banks.

During 2007 the Supervisor of Banks addressed a number of key issues in preserving the stability of the banking system, preparing for a possible crisis in a bank, and preparing for a widespread financing crisis. The topics with which the Banking Supervision Department dealt with respect to these aspects are described below.

b. The Banking Supervision Department's handling of the financial crisis²

As part of its continuous monitoring of the banking corporations' activity even before the financial crisis, the Banking Supervision Department took note of investments in hybrid instruments of the asset-backed securities type by some of the banking corporations in Israel, whether made by the banks directly or through their overseas offices. The Banking Supervision Department studied banks' exposure and initiated supervisory measures in the course of its regular work.

When the crisis broke in the US, initially in the subprime mortgage market segment, the Banking Supervision Department bolstered its monitoring activity. Among the actions taken were the institution of special requirements for reporting to the Banking Supervision Department on the extent of exposure to the crisis; a requirement for broad disclosure in the banking corporations' quarterly financial statements of investments in asset-backed securities (the requirement went into effect with the financial statements for September 30, 2007); and a requirement that the boards of directors of banking corporations conduct a comprehensive discussion on exposure to the crisis, including a requirement for a reassessment of investment policy in the field, risk management policy, and control and supervision processes for this activity.

Following the information delivered to it and the reports issued to the public, the Banking Supervision Department focused on banking corporations with substantial

² For a more extensive treatment of the financial crisis, see Box 3.1.

activity in financial instruments that were exposed to the crisis. Of these, the bank identified as the most exposed was Bank Hapoalim (Table 1 in Box 3.1). The purpose of the measures taken in the framework of increased monitoring of banking corporations by the Banking Supervision Department was to verify that these banking corporations had really taken steps to properly estimate the fair values of these financial instruments and the level of exposure to risks derived from the holding of these instruments, and had considered means of dealing with the risks.

We emphasize that the crisis is not yet over, and the Banking Supervision Department's handling of it has consequently not yet been concluded. In early 2008 the Supervisor of Banks announced his intention to require, as of 2009, that the capital adequacy ratio maintained by the banks be no lower than 12 percent. Other actions likely to be taken by the Banking Supervision Department almost certainly include a requirement that the banks increase their level of liquidity, and a requirement that the banking corporations draw appropriate conclusions from the current crisis from both business and risk management perspectives.

c. A directive on measuring and disclosing impaired debts, credit risk, and loan-loss provision

The directive was formulated following thorough discussions conducted over the past four years with the banking corporations and their auditors. It greatly improves the quality of the information communicated by the banking corporations and credit card companies to the public and the Banking Supervision Department.

This directive adjusts the rules governing reporting to the public by the banking corporations to those applying to banks in the US and other developed countries. The directive substantially upgrades the standards for measuring and disclosing credit risks in the statements of the banking corporations and credit card companies, and creates a uniform basis for comparison. As a result, users of financial statements, including analysts, rating companies, foreign banks, overseas supervisory authorities, and other international entities will be able to analyze the financial statements of banking corporations in Israel more easily, and compare them with the financial statements of their counterparts around the world.

This adjustment of the rules also improves the capability of the banking corporations to monitor and manage credit risks, bolsters uniformity and consistency in measurement of the expected credit losses, and creates a clearer link between the changes in the quality of credit and changes in provision for credit losses.

This directive is compatible with the disclosure requirements established in the Basel II recommendations, and moves the banking system in Israel substantially towards the goal of adopting those recommendations in 2009. The following are among the issues regularized by the directive:

- A systematic and consistent procedure for determining and calculating expected credit losses, with separate treatment for large losses and groups of small debts, and

for auditing this process;

- Classification of balance sheet debts and off-balance sheet instruments (such as guarantees) according to the level of risk (risk of credit under special supervision, substandard-credit risk, impaired-credit risk);
- Debt write-off accounting, and recognition of interest income for it;
- Disclosure of credit quality and methods of measuring the loan-loss provision;
- Required documentation for establishing the process of determining the amount of loan-loss provision.

d. Inspection of control over the prevention of money laundering and financing of terrorism

In November 2007, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval) audited the arrangements by Israel, particularly those of the Bank of Israel and the banking system, for preventing money laundering and the financing of terrorism.

Founded in 1997, Moneyval has 27 member countries and two temporary members. Israel was accepted in January 2006 as an “active observer.” The goal of the organization is to verify that its members are complying with international standards for preventing money laundering and the financing of terrorism, and to conduct professional discussions and training on the subject. The members initiate bilateral arrangements based on the international standards for prevention of money laundering and financing of terrorism.

In the framework of the audit, the Bank of Israel answered a questionnaire sent by the organization addressing in detail 49 recommendations by FATF,³ including their implementation in Israeli legislation. The questions related to the supervisory approach to debts from the perspective of procedures for customer identification, intensified actions to identify high-risk customers, reporting unusual transactions, and enforcement operations in this area.

The auditors noted that in Israel, especially its banking system, an effective enforcement system for the prevention of money laundering and the financing of terrorism was in operation. During the coming weeks, the findings of the audit report will be discussed in a joint framework with Moneyval.

e. Publications by the Research Unit of the Bank of Israel Banking Supervision Department

“Loan Pricing under Basel II in an Imperfectly Competitive Banking Market,” David Ruthenberg and Yoram Landskroner, Working Paper 07.05, May 2007.

³ Financial Action Task Force (FATF) is an international organization that coordinates the campaign against money laundering. MONEYVAL operates on the basis of the standard set by FATF.

“The Characteristics of Business Firms with Outstanding Bank Credit that have Issued Bonds on the Tel Aviv Stock Exchange in Recent Years,” David Ruthenberg and Michal Zilberberg, Discussion Paper 08.01, January 2008 (in Hebrew, with Abstract in English).

2. ADOPTION AND ASSIMILATION OF “BASEL II”

a. General

In January 2007 the Supervisor of Banks announced that the International Convergence of Capital Measurement and Capital Standards framework published in June 2006 (hereafter “Basel II”) would apply to banking corporations in Israel, starting in 2009, and that every banking corporation would have to make preparations guaranteeing that it would be ready by this deadline.

Basel II stresses the link between the total capital that a banking corporation must maintain to offset its risks and the strength and effectiveness of its risk management and internal auditing procedures. Basel II is designed to encourage banking corporations to develop better risk management techniques; to identify, measure, monitor, and oversee their risks; and to use those techniques properly.

Basel II is divided into three pillars:⁴

The first pillar is minimum capital requirements. This consists of the capital requirements in respect of each of three risks: (i) credit risk (Basel II allows the calculation of capital requirements in respect of credit risk using two alternative approaches: the standardized approach and the internal ratings-based (IRB) approach), including capital requirements in respect of securitization exposure; (ii) market risk (Basel II allows the calculation of capital requirements in respect of market risk using either the standardized or the IRB approach); and (iii) operational risk (Basel II allows the calculation of capital requirements in respect of operational risk using the basic indicator approach, the standardized approach, or the internal models approach).

The second pillar is the supervisory review process for capital adequacy.

The third pillar is market discipline.

The Banking Supervision Department plans to work towards the adoption and assimilation of the Basel II recommendations in the Israeli banking system, together with the upgrading of the risk management system, auditing and corporate governance in banking corporations, and adjustment of the method for supervising the banks to a risk-oriented supervision format.

⁴ For a more extensive treatment, see “The Banking System in Israel,” 2006 Annual Review, pp. 98–103.

The first and second pillars of Basel II

The Banking Supervision Department has announced that in the first stage it expects banking corporations to ensure that they meet the requirements of the standardized approaches of the first pillar of Basel II by the end of 2009. At the same time, the Banking Supervision Department made it clear that it was encouraging the banking corporations to make preparations that would enable them to adopt in the next stage at a suitable future date the more advanced approaches, based on IRB for credit risks. The Banking Supervision Department said this was because these approaches were the best global practice in the field, and the effort to gradually adopt them was important for upgrading the quality of credit risk management in Israel.

The Banking Supervision Department also announced that it expected every banking group and banking corporation to implement the Basel II recommendations in the framework of a comprehensive multi-year work plan that would address all the aspects affected by implementation of the recommendations, and which would be based on the results of a regular and detailed gap analysis survey. The work plan of every banking group and every banking corporation belonging to it should include an appropriate multi-year budget allocation.

b. Internal deployment

Preparations at the Banking Supervision Department for implementing Basel II are in the format of a multidisciplinary project, with representatives of most units of the Banking Supervision Department taking part in the process. A steering committee for the project was set up in this framework during 2007, headed by the Supervisor of Banks. A project coordinator and six specialized work teams for formulating the requirements for the banking corporations in various areas were also appointed.

c. Tasks and work stages in the project

- The internal organization stage—This stage includes the setting up of work teams, approval of their work plans, issuing of preliminary requirements for the banks (including, among other things, the appointment at each banking corporation of a person at the executive level to take charge of the implementation of Basel II, quarterly reporting to the board of directors, and the appointment of liaison personnel at the banks for the Banking Supervision Department's work teams). This stage was completed by mid-2007.
- Formulating requirements—By the end of 2008, the work teams are scheduled to focus on the formulation of requirements for the standardized approaches, the IRB approach, and the second pillar, including risk management. First drafts in each of these areas were distributed to the banking corporations during 2007. In addition to these drafts, frequently asked questions and answers containing additional clarifications were distributed to the banks.
- Regularization of the Banking Supervision Department's work on a risk-oriented

format—The Department plans to formulate a redefinition of the supervisory process by mid-2009, including a blueprint for evaluation of a banking corporation.

- Monitoring of the banks' readiness—through various means, including distribution of a uniform questionnaire to assess the readiness of each bank, and meetings with bank employees at various levels. This monitoring will take place mostly in 2008 and 2009.
- The regularization stage—the integration of a provisional directive concerning Basel II in the Supervisor of Bank's various directives, depending on the area. This stage is scheduled to start in 2009.

d. The teams' method of working with the banking system

The Banking Supervision Department has established the objective of promoting the project in cooperation with the banking corporations. In this context, regular discussions are held with the banking corporations during the formation of a provisional directive concerning Basel II. A number of work teams consisting of employees of the Banking Supervision Department and the banking corporations have also been established. These teams have formulated recommendations on specific questions.

In addition, the banks have been asked to respond to a quantitative impact study (QIS), whose purposes are to promote assimilation of Basel II by banking corporations in Israel, examine the effect of implementing the standardized model on the ratio of capital to risk components, and assist in adapting the directive to the banking system in Israel.

The third pillar of Basel II

The Banking Supervision Department has notified the banks that they will be asked to meet all the disclosure requirements included in the third pillar of Basel II, from the report for 2009 onward.

In early 2007, a draft was distributed comparing the disclosure requirements of Basel II to the current directives for reporting to the public and the disclosure that large banks in the US usually provide. The draft included the principal changes expected to apply in disclosure by the banking corporations when the Basel II disclosure requirements are adopted. The draft also established a road map for full implementation of the Basel II disclosure requirements from the report for 2009 onward.

A provisional directive was published in 2007 in the directives for reporting to the public, requiring banking corporations, from the annual report for 2007 onward, to meet the part of the Basel II requirements that are fulfilled by the large banks in the US, and that do not require disclosure of data that will exist only when the other pillars of Basel II are implemented.

3. INCREASING COMPETITION AND EFFICIENCY IN THE BANKING SYSTEM

a. Preparation by the Banking Supervision Department for implementation of the “Fees Law”⁵

Following the work of the teams for fostering competition set up at the Bank of Israel, recommendations for granting the Bank of Israel and the Banking Supervision Department authority to control the prices of banking services in various ways were formulated. The parliamentary investigative committee responsible for this issue in the first half of 2007 endorsed the Bank of Israel’s recommendations in its final report. This was followed by enactment of the Banking (Service to Customer) Law (Amendment 12) (2007), which grants the Bank of Israel the right to control banking fees.

The main authority granted to the Bank of Israel under the law is the authority to set a uniform and clear list of banking services for which the banking corporations are entitled to charge fees. As part of this, the Banking Supervision Department was authorized to greatly reduce the number of fees in order to foster competition in the banking system by bolstering transparency of banking service prices and the ability of customers to compare fees.

Thus the Banking (Service to Customer) (Fees) Rules, 5768–2008, were promulgated under the Law. They include a complete and uniform fee schedule as well as restricted schedules regarding three central consumer topics: current accounts, mortgages, and credit cards. Rules were also established for informing customers of these fees and schedules. For example, it was determined that the restricted schedules would be available to all comers at bank branches, ATMs, and on the bank’s website. These rules will go into effect on July 1, 2008. The fee schedules will apply to both individual customers and small businesses with annual turnovers of up to NIS 1 million.

The schedule was drawn up after a detailed and accurate examination of all the common banking services for private and small business customers, a comparison with the situation overseas, and after hearing comments by the banking corporations. The Banking Supervision Department’s many years of experience in dealing with banking fees and handling thousands of queries from the public, including consumer organizations, was applied in preparing the price list.

The number of common fees was actually reduced to one third of the previous number; the number of fees charged for banking services totals 70, compared with about 200 before the change. The number of fees was cut by eliminating some of them, and consolidating fees charged for essentially similar services.

Among the main fees eliminated were a fee for preparing documents when arranging a credit framework, a payment fee for interest and/or a dividend, a collection fee, and transaction registration fees in a business account (for a small business), and in a foreign currency account.

⁵ The Banking (Service to Customer) Law (Amendment No. 12) (2007).

Prominent examples of consolidated services include all current transactions in a current account (about 15 transactions). Till now, different fees were charged for each of these transactions. The new price list will have only two fees: a fee for direct transactions in a current account (by Internet, telephone, or ATM), and a fee for transactions in a current account through a teller, with no distinction between different types of transaction. The main comparison that a customer can make in order to know in which bank it is cheaper to keep a current account therefore involves only these two main fees.

Another significant change involves fees related to credit transactions. For example, till now customers were charged a fee for preparing documents for allocation of a credit framework, in addition to interest on the credit. The amount of this fee was determined according to the volume of the credit framework. A monthly NIS 4 credit allocation fee was also charged. Under the new price list, a private customer who has not utilized his credit framework will pay only for the credit allocation, while a customer who has utilized his credit framework, whether all or in part, will be charged only interest.

The Banking Supervision Department believes that implementation of the price list for fees and the abbreviated price lists will constitute the beginning of a process that will lead to reduction of fees for bank services provided to private and small business customers, and will aid customers in comparing the prices of services.

Following implementation of the price list, the Banking Supervision Department plans to establish an information infrastructure for the public for comparing bank services prices. This service will contribute to stronger competition in this area.

b. Work teams for fostering a more advanced structure in Israeli banking

Over the past year the Banking Supervision Department formed work teams for the purpose of formulating policy documents on various subjects for the advancement of the Israeli banking system.

The subjects these teams are dealing with include the following:

- Encouraging the entry of foreign banks into the Israeli banking system—The team examined the Banking Supervision Department's policy with respect to the entry of foreign banks and encouraging expansion of activity in branches of foreign banks in the retail sector. This is aimed at making the banking system more stable and augmenting competition in the retail sector.
- Founding of an Internet (virtual) bank—Following an inquiry by entrepreneurs to the Banking Supervision Department concerning the founding of an Internet bank in Israel, a team was set up to examine the practicality of the entrepreneurs' business plan, the ability of the Internet bank to operate according to the business plan, and whether the Internet bank meets the usual standards for reliability and stability in the Israeli banking system. At the same time, a process of evaluating the fitness of the entrepreneurs was begun.
- Development of the repo market—In early 2007, a directive of the Banking Supervision Department regularizing the accounting treatment of repo transactions went into

effect. This directive is part of the actions taken by the Bank of Israel to develop the repo market in Israel. The Bank of Israel has assigned a special team to the matter, with the participation of the Banking Supervision Department and representatives of other departments.

- Development of supervisory infrastructure for securitization transactions—During 2007, the Banking Supervision Department dealt with arrangements for securitization processes. A Bank Supervision Department team is formulating a draft directive listing the operational requirements for carrying out a securitization procedure according to the American standard and the recommendation of the “Haimowitz-Asher Committee.”⁶

4. INTERNATIONAL RELATIONS

The International Relations Unit is responsible for relations with supervisory authorities around the world. Dealing with this sphere is essential, given globalization, increased international activity on the part of Israeli banks and interest on the part of overseas investors in the Israeli banking system, and the Basel Committee recommendations, which stress the importance of cooperation and sharing of information among supervisory authorities around the world. The international relations sphere focuses on active monitoring of the policies and arrangements of important supervisory authorities around the world and assistance in the licensing function in matters requiring specific expertise in overseas affairs, analysis of trends and developments in overseas banking having consequences for Israeli banking, and regular links with international supervisory authorities and entities aimed at developing information channels.

Signing memorandums of understanding (MoUs)

Under Amendment 13 of the Banking Ordinance, the Supervisor of Banks is entitled to communicate to the authorized authority in the host country of an overseas office of an Israeli banking corporation information, on a consolidated basis, essential for effective supervision, and to pass such information about a foreign banking corporation operating in Israel to the authorized authority in the mother country. The Banking Supervision Department is acting to institutionalize the arrangements for exchanging supervisory information with overseas supervisory authorities concerning Israeli and foreign banking corporations with international activity by signing MoUs.

The Banking Supervision Department is in the advanced stages of negotiations on an agreement with the Supervisor of Banks in Turkey, where a subsidiary of Bank Hapoalim operates. The Banking Supervision Department is also in an early stage of exchanging questionnaires with American supervisory authorities.

⁶ The Committee for Examining Aspects Relating to the Issuing of Asset-Backed Bonds (Securitization). The report (in Hebrew) is available on http://www.isa.gov.il/Download/IsaFile_49.pdf.

5. UPGRADING THE CAPABILITY OF THE FINANCIAL SYSTEM IN ITS READINESS FOR AN EMERGENCY

In 2007, the Banking Supervision Department undertook many actions in this sphere. The most important of these were constructing a deployment plan for an emergency, in cooperation with an external company, meetings of a biweekly forum, establishing an equipped headquarters in Jerusalem, participating in a exercise in the framework of the government's emergency office ("Melach," its Hebrew acronym) and carrying out a major exercise within the Bank of Israel, holding meetings with designated entities, coordination with other authorities on regulatory affairs, continued application of the lessons of the Second Lebanon War, an examination of the question of cash for an emergency, and upgrading the reporting system for the banks. This activity will continue in 2008, and the Banking Supervision Department's emergency deployment plan is expected to be put in place.

6. MAINTAINING FAIRNESS TO CUSTOMERS OF THE BANKING SYSTEM

a. Introduction

One of the Banking Supervision Department's principal goals for 2007 was the maintaining of fairness in relations between the banks and their customers. Activities aimed at achieving this goal are carried out by the units responsible for the relevant areas.

Bank-Customer Relations Unit: Protecting the rights of the banks' customers constitutes an important element in the maintenance of stability and reliability in the banking system. The Banking Supervision Department therefore acts to identify faults in the banks' handling of their relations with customers, and to devise ways to correct these faults. A large proportion of the Banking Supervision Department's resources is devoted to this activity, which includes handling of queries from the public by the Public Enquiries Unit, handling general issues arising from the public's queries and other information obtained by the Banking Supervision Department, and handling the question of fees and uniform contracts used in the banking system.

Checks Without Cover: This Unit acts on information received from the commercial banks and other sources, such as the Bailiff's Office and the rabbinical courts, and from a sophisticated computer system relating to those drawing checks without cover. The system is designed mostly to apply the stipulations of the Checks Without Cover Law, 5741-1981, amended in 1992, and to serve as a warning and deterrent in order to reduce the volume of such checks. The section's main functions include defining customers restricted in aggravating circumstances and sending notices to these customers, monitoring court hearings, and communicating information about ordinary restrictions and special restrictions to the banks.

Box 4.1**The Banking Supervision Department's Handling of the Heftsiba Affair****Introduction**

On August 6, 2007, the Court issued a stay of proceedings against Heftsiba, following that company's collapse. In an affidavit submitted to the Court, the collapse was alleged to be the largest to date of a construction group in Israel. The affair has, and is likely to continue to have, serious implications for the construction sector in Israel, and to a certain degree for the economy and Israeli society in general.

As soon as the collapse became known, in order to make a decision about the mode and extent of its intervention in the matter, the Banking Supervision Department began to collect information from the banks and apartment purchasers in all facets relating to the Heftsiba Affair, particular from the banks that had provided the company with credit through the project finance method (hereafter—"the lending banks").¹

Cross-referencing information received from both the banks and the apartment purchasers enabled the Banking Supervision Department to obtain an initial picture of the number of projects covered by the banks and their construction stages, the number of apartments in each project, the number of apartment purchasers lacking guarantees under the Sales (Apartments) (Assurance of Investments of Persons Acquiring Apartments) Law, 5734–1974,² the number of housing units sold without the banks' knowledge, etc.

Following the collapse of Heftsiba, the absence of security of any type whatsoever meant the purchaser's exposure, in the framework of a receivership process, to additional financial demands as a condition for receiving possession

¹ The financial coverage method is a method for financing construction projects, under which the contractor manages his finances through a special bank account in which purchasers of apartments deposit payments for them. Receipts from apartment purchasers are deposited in this account, and through it the lending bank provides credit for construction. At any given time, the balance of credit reflects the progress of the project. At the same time that it provides credit to the project developer, the lending bank provides a guarantee for the apartment purchasers.

² A guarantee under the Sales (Apartments) (Assurance of Investments of Persons Acquiring Apartments) Law is one of the five alternative securities mentioned in the law. Under the law, the seller must provide such a guarantee to any purchaser who has paid over 15 percent of the purchase price. This guarantee ensures the return of the apartment purchaser's money in the event that the seller is unable to transfer ownership or other right in the apartment, as agreed in the sale contract, due to a lien on the apartment or on the land on which the apartment is being built, or due to an order for obtaining assets, a liquidation order, or an order for the appointment of a receiver issued against the seller or owner of the above-mentioned land.

of the apartment and cancellation of the lien on it in favor of the lending bank for the project, if such a lien exists.

The extent of intervention by the Banking Supervision Department

Following initial processing of the data received, it was learned that many apartment purchasers had been left without any legal security for the money they had paid to Heftsiba. In some cases, it was also found that the reason for the absence of any security was the bank's direct or indirect mismanagement. The apartment purchasers' money had been deposited in accounts other than the project accounts.

In view of these findings, it was decided that the handling of queries from the purchasers, who were the main victims in the entire affair, would be in two stages. In the first stage, immediate relief would be provided to the apartment purchasers in order to minimize their damage, subject to the authority granted to the Banking Supervision Department. In the second stage, the banks' behavior would be examined, conclusions drawn, and methods of preventing similar occurrences considered.

Accordingly, the complaints received were sorted, and principles for handling Heftsiba victims were formulated from the banking perspective. Five hundred and seventy-three queries have been received to date, and the amount of assistance to purchasers totals NIS 140 million.

Judicial decisions in principle

In the course of handling the public's queries, two main legal disputes of principle were raised and decided by the court:

The subordination of liens: The court ruled, based on the legal view of the Banking Supervision Department, that any guarantee issued by a lending bank must be subordinate to the bank's lien in respect of the project, since the right to issue guarantees was already included when the money was deposited in the project account.³ The court's decision paved the way for apartment purchasers to receive guarantees for money deposited in the project accounts.

The transfer of money to the project account: Another court ruling enabled the banks to comply with the position of the Supervisor of Banks by transferring

³ The actual issuing of the letter of guarantee is a purely technical matter, since from a legal standpoint the guarantee had already been created before the collapse.

funds to the project accounts in cases in which the Supervisor of Banks found that the bank had acted incorrectly.⁴

These rulings streamlined the handling of the public's queries and the implementation of the principled positions of the Banking Supervision Department about the banks in this matter.

Conclusions

As part of the process of drawing conclusions following Heftsiba's collapse, the Supervisor of Banks issued Directive No. 326 of the Proper Conduct of Banking Business, which arranged the method of payments by apartment purchasers to the project account and secured their money. Under this directive, a bank will issue payment coupons to each contractor with whom it signs a project finance agreement. Each payment coupon will be designated solely for a specific apartment in a specific project. An apartment purchaser will make all the payments he owes to the contractor using these payment coupons. This will ensure that the money reaches its destination—the project finance account. Payment through these payment coupons will secure the apartment purchasers' money, since the payment itself will be considered as a payment obligating the bank to issue a guarantee to the purchaser for the amount paid. In order to prevent fraud, the apartment purchaser will be able to check on the website of the lending bank, by telephone, or at a branch of the lending bank that the coupons that he has received from the contractor correspond to the exact figures at the bank.

This method also ensures that the apartment purchasers' money reaches its proper destination—the project account. This is of supreme importance in the successful construction of a project. It also safeguards the apartment purchasers' money, since the arrival of the funds at their destination will require the bank to provide them with a guarantee for their money.

In addition, the Banking Supervision Department issued an appendix to this directive containing a template for a guarantee for apartment purchasers. The template is designed to establish uniform and fair wording in the banking system, and to prevent the inclusion of terms unfair to the apartment purchasers.

The Heftsiba affair constituted an opportunity to pinpoint loopholes in the laws and regulations, and to correct them in a rapid and thorough regularization procedure. These arrangement procedures determined by the Banking Supervision Department following the affair will have a crucial effect on mortgage holders in general in Israel.

⁴ The Court thereby altered its previous ruling, under which the banks should have transferred these funds to separate accounts, not to the financial coverage accounts.

b. Handling the public's complaints and queries

The Banking Supervision Department handled 3,122 complaints and 2,846 requests for information and other requests in 2007. In addition, 10,000 telephone queries were answered, in which an initial answer was provided for bank customers on various matter related to their transactions.

An examination of the figures for the banking system as a whole shows that 25.4 percent of all complaints in 2007 for which a position was established were found to be wholly or partly justified. The main subjects of the queries, as reflected in the summary, were management of a bank account, fees, mortgages, and checks (Table 1). After no significant change in the proportion of queries on matters such as checks, bank fees, and credit over the previous five years, the proportion of queries concerning bank account management rose steeply in 2007. This increase can be attributed to a large degree to the implementation in 2007 of Directive 325 on "Managing Credit Frameworks in Current Accounts," which caused a rise in the proportion of complaints and the number of requests for information and clarifications in the matter.

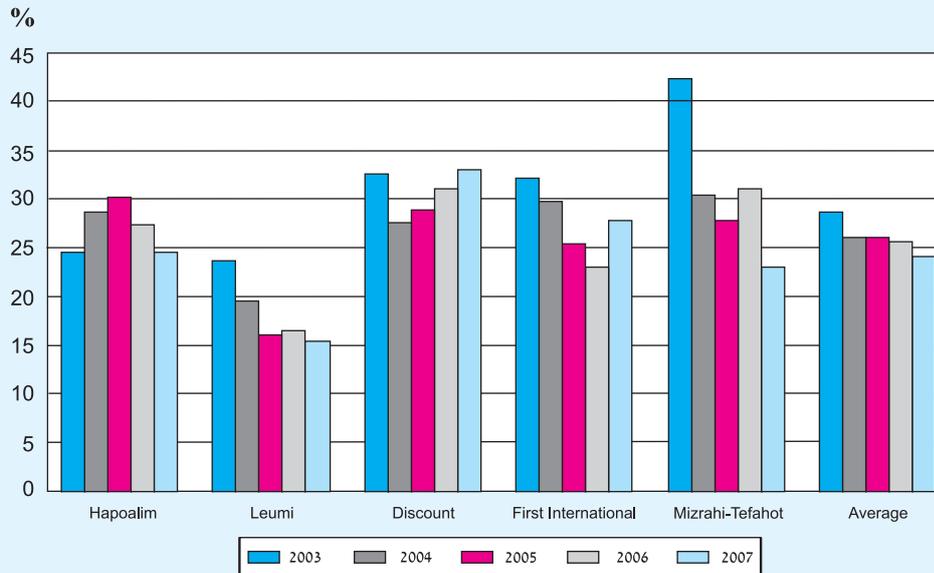
On the other hand, the proportion of queries about mortgages, which accounted for a significant proportion on total queries to the Banking Supervision Department's Public Enquiries Unit in previous years, fell in 2007. Among other things, this drop can be attributed to recent revisions in Directive No. 451 of the Proper Conduct of Banking Business concerning housing loans, which went into effect during 2007. The Banking Supervision Department believes that these changes will also help reduce the proportion of queries about mortgages in the coming years.

In continuation of the downward trend in recent years, the average proportion of justified complaints in the five major banks fell again in 2007 to 24.2 percent, compared with 28.7 percent in 2003 (Figure 4.1). This trend towards improvement is explained mostly by an improvement in the figures for Bank Leumi and Mizrahi Tefahot Bank. On the other hand, the proportion of justified complaints about Israel Discount Bank rose for the fourth straight year (Figure 4.1).

Among other things, the consistent decline in the rate of justified complaints can be attributed to the Banking Supervision Department's extensive activity in recent years in the area of bank-customer relations: handling and correcting faults in individual queries, pinpointing and correcting system-wide faults and failures, and revision, regularization, and legislation in the field. Furthermore, partly as a result of this activity in recent years, awareness of the issue of service at banking corporations has been on the rise. As a result, banks have invested resources in dealing with the matter, which has also played a role in lowering the rate of justified complaints.

For the five largest banks in the system, a comparison of the proportion of justified complaints with the banks' size shows that the best ratio is at Bank Leumi, and the worst is at Israel Discount Bank. An examination of the total number of queries about a bank compared with its size shows that the best ratio is at Bank Leumi, while the worst is

Figure 4.1
Proportion of Justified Complaints out of Total Complaints, the Five Major Banking Groups, 2003-07



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

at Mizrahi Tefahot Bank. The credit card companies have a very low rate of justified complaints, continuing a trend that began in 2004.

In the course the Banking Supervision Department's handling of the public's complaints, and as part of the relief that it provides for complainants, the banks were required to reimburse customers whose complaints were found to be justified. Compensation paid to bank customers following the handling of the public's queries totaled NIS 3 million.⁷

c. Complaints against Israel Discount Bank Ltd.

In addition to the Heftsiba affair, in which the Banking Supervision Department handled an exceptional number of queries, it handled dozens of queries concerning the "subsidized mortgages" media campaign.⁸ This campaign led to a steep increase in the number of mortgages requested, which the bank was not able to deal with. The

⁷ This sum does not include the relief provided to Heftsiba victims who complained to the Banking Supervision Department.

⁸ The bank offered an attractive interest rate, compared with the interest rates offered at that time by other banks providing mortgages.

Banking Supervision Department received 137 queries relating to this campaign, and the exceptionally high proportion of justified complaints against the bank (73.4 percent) was due to the handling of these complaints.

d. Pinpointing and correcting system-wide faults

The information obtained by the Banking Supervision Department in the course of handling the public's queries and from other sources constituted a basis for its handling of many topics during 2007. Among other things, topics related to the premium charged for insuring a property, early repayment of loans, and fees charged were addressed. Various means were employed for handling these subjects. The main ones were as follows:

Reimbursements to groups of customers: As a result of the handling of system-wide faults, the banks were required make reimbursement totaling NIS 13 million to their customers, among other things. This was due mostly to reimbursement by Mizrahi Tefahot Bank for overcharging on property insurance premiums for its mortgages.

An amendment to the directives of the Supervisor of Banks: During the year, the rules for providing housing mortgages were revised. The revisions focused mostly on matters relating to insurance and recycling loans (in order to make it easier for borrowers wishing to recycle their loans).

e. The uniform contracts used in the banking system

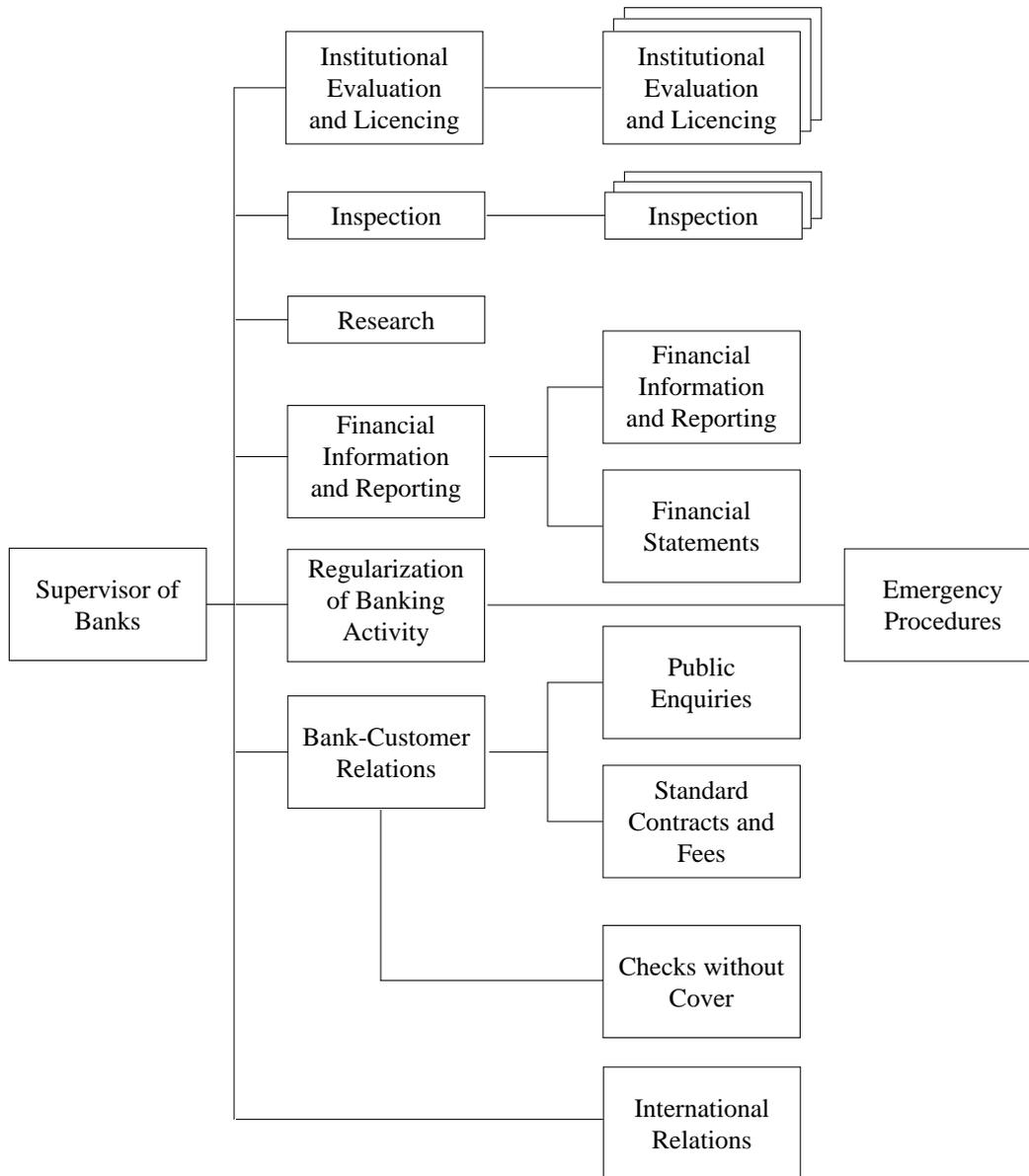
In 2007, the Uniform Contracts Court published a verdict on a request submitted by the Supervisor of Banks to eliminate discriminatory terms on a guarantee issued to apartment buyers by Mizrahi-Tefahot Bank. The Court gave the status of a verdict to the agreements between the bank and the Banking Supervision Department. These agreements eliminated many discriminatory terms in the guarantees of Mizrahi Tefahot Bank for safeguarding the rights of apartment purchasers.

Table 4.1

Distribution of the Main Subjects of Public Enquiries, 2003–07 (percent)

	2003	2004	2005	2006	2007
Bank accounts	18.4	14.8	15.5	17.4	20.5
Mortgages	17.9	21.2	20.8	17.8	14.3
Fees	7.3	11.7	9.5	9.2	9.6
Credit	5	5	8	8.7	8.7
Checks	8.6	8.8	10	10	8.5
Debit cards	7.1	5.3	6	3.8	4.6
Long-term savings	4.8	4.8	6	4.2	4.3
Securities	3.1	4	4	3.9	3.8
Other	27.8	24.4	20.2	25	27.7
Total	100	100	100	100	100

**Banking Supervision
Organizational Structure
December 2007***



* A change to the structure of the Banking Supervision Department is planned to take place in 2008, and the new structure will be shown in the 2008 Annual Survey of Israel's Banking System.