

Chapter 3

Activities of the Banking Supervision Department in 2004

1. INTRODUCTION

The main task of the Banking Supervision Department in the Bank of Israel is to preserve the stability and robustness of Israel's banking system. The Banking Supervision Department operates concurrently to increase competition in the system and to guarantee fair customer-bank relations, while ensuring that banks' managements and boards of directors meet appropriate standards of management and oversight.¹

2. REGULATION OF BANKING ACTIVITY

The regulation of banking activity is the principal instrument of the Banking Supervision Department, enabling it to instruct banking institutions regarding the position and directives of the Supervisor of Banks on various banking and accounting subjects. The main regulatory directives issued in the course of 2004 dealt with the following subjects: procedures for extending housing loans, rotation and continuous vacation, communication between an internal auditor and the authorities responsible for external auditing of the banking corporation, embezzlement and fraud by employees, the date for the cessation of the adjustment of financial statements and the transition to reporting on a nominal basis. The preliminary draft of the guidelines on credit rating relating to companies, banks, and countries, based on the principles of the Basle II recommendations, was also published.

¹ For a detailed account of the tasks of the various units of the Banking Supervision Department, see Bank of Israel, Supervisor of Banks, Israel's Banking System, Annual Report, 2003, Chapter 5, Activities of the Banking Supervision Department.

3. INSTITUTIONAL EVALUATION AND LICENSING

The main role of the Institutional Evaluation Units is to collect and formulate the periodical assessments of the Banking Supervision Department regarding the stability and resilience of the banking corporations (including auxiliary banking corporations, banking subsidiaries, and overseas branches).

The five units responsible for assessing the banking groups and corporations operated on the basis of an annual work plan which dealt inter alia with the following topics:

- Ongoing follow-up and periodical assessment of Israel's banking institutions.
- The progress made by the banks in implementing the interim directives as regards the Prohibition of Money Laundering Order, and the actions they have taken to achieve this end.
- Banking corporations' credit exposure: foreign-currency credit and credit to the principal industries, e.g., the construction industry and the local authorities, and large exposure.
- The exposure of the banking corporations to liquidity risk in local and foreign currency.
- Regulation of the supervision and follow-up of the credit card companies.
- Examination of adherence to the directives issued by the Supervisor of Banks in various spheres, such as the procedure for appointing directors and for issuing complex tier-1 capital.

The sixth unit in the sphere of institutional evaluation, the Licensing Unit, which deals with requests which require a license from the Governor of the Bank of Israel or from the Supervisor of Banks. During the year this unit dealt with the following subjects:

- Getting the amendment to the Banking (Licensing) Law (Amendment 13) through the Knesset, inter alia in order to enable the privatization of Bank Leumi via the capital market (implementing the recommendations of the report of the Marani Commission).
- Proceeding with the privatization of Discount Bank, and in that framework examining the potential buyers;
- Dealing with the merger between the Israel Mortgage Bank and United Mizrachi Bank.
- Transferring the control core of Investec Bank (Israel) to the First International Bank of Israel.
- Continental Bank and Bank Polska Opeki Tel-Aviv were bought by and merged with Bank Hapoalim.
- World Investment Bank relinquished its license.
- The foreign banking license of Standard Chartered Bank Ltd. was canceled.
- The banking license of Poalim Capital Markets Investment Bank Ltd. was canceled.

4. INSPECTION

In 2004 the Credit Inspection Unit continued its activities aimed at ascertaining whether the processes of identifying and classifying problem loans and determining loan loss provisions against such loans were appropriate and adequate. In this framework emphasis continued to be placed this year on credit to the real-estate industry, in view of the continuing slump in it, and a thorough examination of credit to the local authorities was also undertaken. Particular emphasis was placed in 2004 on reviewing the appropriate definition of borrower groups, in the context of the changes made in Directive no. 313 of the Proper Conduct of Banking Business Directives. Concurrently, the team continued to investigate the mechanisms of the management, control and auditing of credit in various banks, paying increasing attention to the management and control systems regarding the creation of credit in the retail and commercial sectors.

In the field of information technology, emphasis was placed on inspecting high-risk activities, such as remote access to the bank's computers and on-line trading systems. Systemic inspection also focused on activities in such spheres as the back-up, endurance, and recovery of information technology systems. The inspection team responded to specific extraordinary events in the area of data security, and extended its investigation where necessary. The Data Systems Inspection Unit assists and provides professional support for processes connected with the provision of permits and the regulation of projects and activities, as well as with the continuing examination of the Banking Supervision Department's policy in the field of information technology.

Inspection activities continued in order to ensure the implementation of the directives formulated in 2003 in the framework of Directive no. 357 of the Proper Conduct of Banking Business Directives. Various inspection activities regarding the outsourcing of computer services also continued.

In the area of the prevention of money laundering, the close attention paid by the Inspection Unit to the subject and the reference to the entire banking system, which was instituted in 2003, continued in 2004. The activities of the Inspection Unit were widened, focusing on the implementation of specific topics regarding which concrete rules had been established in laws and directives. The coverage of the Inspection Unit was extended in the year under review and was also applied to subsidiaries (mainly trust companies). Considerable inputs in terms of time were devoted to this subject as well as to cooperation with other authorities.

In the area of the capital market and banks' services to customers, the inspection activities directed towards preventing conflicts of interest in the activities of banks and affiliated corporations continued. For reasons of access to inputs, the activity of the Inspection Unit in the sphere of proper disclosure and the administration of deposits on behalf of customers was curtailed in 2004.

In 2004 the Risk Management Inspection Unit concentrated on the evaluation of various kinds of risks arising from banks' transactions in the capital and money markets for themselves and for their customers; transactions undertaken on behalf of customers

on the TASE (Tel Aviv Stock Exchange), primarily on the TA25 (MAOF index) and on foreign stock markets were examined, as were transactions in instruments traded over the counter, including structured instruments. On the basis of the results of the evaluation, and with reference to the changes which the securities market has begun to put into effect as regards the provision of collateral, the regulation of the banks in the areas of transactions in the TA25 is also being reassessed.

In 2004 the Risk Management Inspection Unit dealt with preparing a detailed infrastructure with precise specifications and methodology for evaluating the management of liquidity risk within the banking system. Inspection activities also continued for assessing various aspects of the supervision and auditing of the activities of overseas branches, placing the emphasis on certain branches in off-shore banking activities.

During 2004 the activities of the unit in charge of inspecting independent banks were stopped. The maturing of processes which had essentially brought about the cessation of these banks' activities made it possible to gradually reduce the considerable inputs which had been allocated to dealing with intensive inspection of them.

In the course of the year a new inspection unit was set up to deal with the systems of control, supervision, internal auditing and functioning of the banking corporations. This unit will continue to operate in the next few years in order to establish advanced frameworks and to apply progressive and structured approaches of 'risk-focused evaluation' within the internal auditing processes of banking corporations. The products of the inspections conducted by this new unit will provide an additional database serving the long-term planning of the work of the various sections of the Banking Supervision Department.

5. THE RESEARCH UNIT

The Research Unit tracks developments in banking in Israel and abroad, obtaining up-to-date information about new approaches to the analysis and assessment of various subjects, such as the management of assets and liabilities, risk management, operational efficiency, protection against various banking risks, and methods for estimating capital adequacy in accordance with the requirements of the Basle II Committee in these respects.

During 2004 the following articles were published by the Research Unit:

- Robustness: an Index of the Resilience and Robustness of Banks in Israel. The index, which was first developed for Israeli banks, gives expression to the banks' performance in several spheres: capital, the quality of assets, management, profits, profitability, liquidity and exposure to market risks. This index, which is similar to those accepted in many western countries, is intended to enable the Supervisor of Banks to assess the situation of the various banks and to plan the intensity of their supervision. The index was published as a discussion paper in January 2005.

- **Competition in the Banking Industry: Theoretical Aspects and Empirical Evidence from Israel and Abroad.** The study examines the competitiveness of banks in Israel by means of two approaches which are commonly accepted in the up-to-date professional literature: the structural approach and the competitive threat approach. Using these two approaches it was found that there are two weak points in the competitiveness of banks in Israel: 1. There is a very high level of concentration in the system, which increases the ‘market power’ which the banks have over their customers (primarily over households); 2. The appropriate conditions do not exist for the creation of a worthy competitive threat to the banking system from nonbanking entities or from the capital market in Israel or abroad.

In addition to these studies, during 2004 the unit analyzed the factors affecting the stability of the banking system from the industry standpoint and prepared and published the annual report of the Supervisor of Banks for 2003 in Hebrew and English.

6. INTERNATIONAL RELATIONS

The main subjects which the International Relations team dealt with in 2004 were:

- The transfer of information about Israel’s banking system to various entities abroad, including supervisory authorities, international institutions, and rating agencies.
- An examination of the application of the OECD’s liberalization code in Israel.
- Ties with supervisors abroad regarding the supervision of Israeli branches.
- Preparations for the implementation of the Second Basle Committee’s recommendations.
- Assistance in the sphere of licensing in various aspects of banking supervision.
- Collecting data about and studying the subject of banking supervision abroad in the areas of regulation and implementation.

7. BANK-CUSTOMER RELATIONS

The unit deals with protecting the rights of banks’ customers in order to ensure that the banking system remains fair and stable.

a. Enquiries from the public

In 2004 the Public Enquiries Unit received 5,340 enquiries (up by 23 percent over 2003). During the year 5,467 enquiries were dealt with (an 18 percent increase over 2003), some of them having been received in 2004 and some in 2003. The number of enquiries submitted to the Supervisor of Banks has been rising consistently (Figure 3.1) as a result of heightened awareness on the part of the public of its consumer rights.

Some 788 (26.4 percent) of the 2,980 enquiries regarding which a stand was taken in 2004 were found to be justified or partly justified. In the last few years there has been a downward trend in the proportion of complaints found to be justified, mainly due to the comprehensive treatment provided by the Banking Supervision Department in the area of bank-customer relations, which has led to an improvement in the day-to-day functioning of the banking system vis-à-vis its customers. 1,311 enquiries were requests for information and questions of clarification (Table 3.1). When a complaint is found to be justified or partly justified the bank must correct the injustice that has been inflicted on the complainant, and the treatment may have concrete results, e.g., repayment of money, payment of compensation, and/or accession to the complainant's request. The amounts paid by the banks to their customers in 2004 in the wake of the treatment of complaints found to be justified amounted to NIS 2,436,324.

The main subjects of complaints were mortgages, bank deposits, bank charges, and checks (Table 3.2). As regards the distribution of complaints on which a stand was taken and treatment of which was concluded in 2004, by banks (Table 3.3), Mizrahi Bank was found to have the highest rate of justified complaints (30.4 percent) out of all complaints, while Bank Leumi had the lowest rate (19.4 percent).

The activity of the Public Enquiries Unit is not restricted to requiring banks to make amends in specific instances. Dealing with a particular complaint is apt to have repercussions on the banking corporation in general, or even on the entire banking system, leading to money being returned to groups of customers, procedures being altered, instructions issued, etc. Table 3.4 shows the general and specific subjects which have arisen from complaints submitted by members of the public and as a result of whose treatment money has been repaid to large groups of customers (most of whom were not even aware of the problem and had not complained about it). In 2004 these payments amounted to about NIS 51 million, most of it due to the repayments that Bank Leumi was required to make for the Leumi-Phone charges it deducted unjustly from some of its customers.

Figure 3.1
Complaints and Enquiries from the Public Received by the Banking Supervision Department, 1987-2004

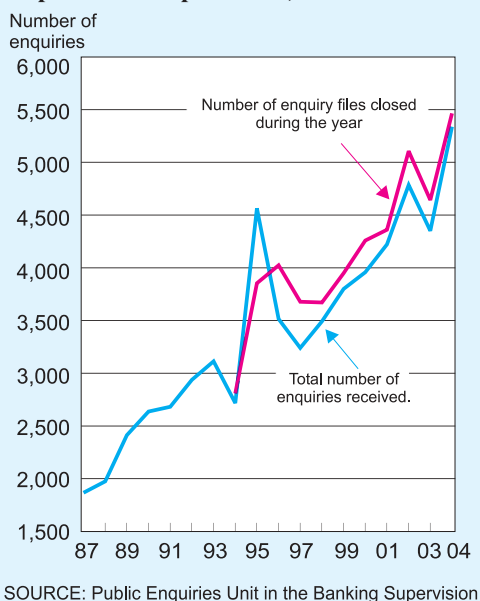


Table 3.1
Investigation of Complaints and Enquiries from the Public, 2003 and 2004

	2003		2004	
	Number	Percent of total %	Number	Percent of total
Complaints on which decision was made				
1. Complaints found wholly or partly justified	727	15.7	788	14.4
2. Complaints found unjustified	1,764	38.0	2,192	40.1
Total	2,491	53.6	2,980	54.5
Complaints on which no stand was taken				
1. Process stopped due to legal proceedings	141	3.0	200	3.7
2. Process stopped for other reasons	279	6.0	448	8.2
3. Not within Unit's jurisdiction	239	5.1	280	5.1
4. Unable to take a stand	251	5.4	248	4.5
Total	910	19.6	1,176	21.5
Enquiries				
1. Requests	399	8.6	460	8.4
2. Clarifications	844	18.2	851	15.6
Total	1,243	26.8	1,311	24.0
Total number of complaint and enquiry cases closed	4,644	100.0	5,467	100.0

SOURCE: Supervisor of the Banks

Table 3.2
Complaints and Enquiries from the Public, by Subject, 2003-2004

Subject	Total complaint and enquiry cases closed during year		Total number found justified ^a		Percent of total complaints on the subject ^b	
	2003	2004	2003	2004	2003	2004
	(Number)				(percent)	
Credit	231	275	17	31	12.8	17.4
Collateral	23	27	4	5	25.0	41.7
Implementation of court orders	123	123	21	20	27.3	26.0
Debt collection	182	227	11	23	16.2	23.5
Debit by authorization	124	72	34	20	38.2	38.5
Bank debts to customer	83	113	17	13	34.0	22.8
Long-term savings	225	263	34	28	47.9	30.1
Bank account	853	808	129	119	29.5	29.0
Debit card	328	290	79	58	34.3	26.9
Foreign currency	173	121	24	5	19.8	7.5
Bank documents	110	130	17	8	41.5	14.3
Mortgages	832	1,161	142	188	30.7	32.8
Securities	143	220	10	32	13.5	25.4
Branches	80	88	21	6	45.7	13.0
Forwards	14	17	1	4	11.1	30.8
Fees and commissions	340	637	52	80	24.3	17.7
Third party guarantees	71	61	13	15	40.6	51.7
Checks	399	481	76	94	36.0	33.9
Other banking services	184	231	23	39	22.5	27.9
Other ^c	126	122	2	0	25.0	0.0
Total	4,644	5,467	727	788	29.2	26.4

^a Including complaints found to be partially justified.

^b That were classified (justified/partially justified/unjustified)

^c Enquiries on a variety of issues.

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

Table 3.3
Distribution of the Resolved Complaints^a during 2004 by Bank

	Total enquiries (from all years) which were resolved in 2004 ^a	Total complaints (from all years) that were resolved in 2004 ^b	Justified complaints ^c	Proportion of justified complaints ^b in total complaints ^a against the bank
Hapoalim	1,134	673	193	28.7
Leumi	799	548	107	19.5
Discount	396	260	72	27.7
First International	292	198	59	29.8
Mizrahi	332	214	65	30.4
Rest of commercial banks ^d	852	548	141	26.2
Total	3,805	2,441	637	26.1
Tephahot	283	156	45	28.8
Leumi Mortgages	407	215	71	33.0
Mishkan ^e	71	44	15	34.1
Rest of the mortgage banks	154	74	20	27.0
Total	915	489	151	30.9
Total of the banking system	4,720	2,930	788	26.9

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

^b That were classified (justified/partially justified/unjustified).

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

^d Including credit card companies and financial institutions.

^e Enquiries and complaints that were received before the merger with Hapoalim in January 1, 2004.

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

Table 3.4
Total Monetary Refunds to Groups of Customers by Subject, 2004

Subject	Bank	Refund (NIS)
Leumiphone commission	Leumi	49,965.2
Charging of administrative commissions on exchange accounts	First Int'l	441.3
Inclusion of operating commission in negative capitalization differences according to the Banking Directive (Early Redemption Commission)	Tefahot	237.8
Increase of rate of commission for attorney's letter of warning before its update on the price list.	Tefahot	58.1
Over-collection on loans as a result of the interest rate not being updated (due to an error)	Massad	53.3
Erasure of positive balances on customers' accounts	Leumi Mortgages	51.5
Total		50,807.1

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

b. Bank charges

In August 2003 the Supervisor of Banks set up a team to formulate a clear policy as regards the supervision of the prices of bank services. In 2004 the team submitted its report, which included inter alia recommendations on the following subjects: the need to supervise bank charges,² criteria for intervention in the prices of bank services, proper disclosure to customers, and the cancellation of specific bank charges.

Most of the team's recommendations were adopted by the Governor of the Bank of Israel, and a proposal for an amendment to the Banking (Service to Customer) Law, 5741-1981 was prepared in which the Banking Supervision Department seeks to anchor its authority as regards the supervision of the prices of banking services. In accordance with the proposal, the Banking Supervision Department will be empowered to intervene in the prices of banking services and to determine their maximum price, in line with the rationale defined in the amendment: if the bank charges for a service are liable to prevent competition between the banking corporations, whether between them or between them and another entity providing a similar service; if the service is one which the customer is obliged to obtain from a specific banking corporation; an essential service; a service for which the bank charge taken is unjustified.

The Banking Regulations (Service to Customer) (Proper Disclosure and Presentation of Documents), 5752-1992 were amended in 2004 at the initiative of the Banking Supervision Department, and the following disclosure obligations were added to them: the obligation to inform customers of the cost of a service before the service is given and in accordance with the interface at which it is implemented (at the counter, over the phone, via a computer terminal, or via any other means which uses a monitor); the obligation to publish the full tariff and table of bank charges for the principal services on the banking corporation's website, and the obligation to display the full tariff of bank charges in a prominent place at the bank's branches.

c. Standard contracts

At the end of 2004 three requests to annul or amend discriminatory terms in standard contracts came before the courts: in a housing loan contract of First International Mortgage Bank, in a contract to extend banking services via the internet and cellular phone of

² As of 1.12.2005 the banks are required to prepare for the implementation of the regulation regarding bank charges. According to the agreed formula, a fixed charge (NIS 10), a charge on every transaction, and a charge per line in a bank statement, which are currently in force, will be canceled and customers will be able to choose between the following possibilities:

1. Payment of a fee of NIS 1.21 for every basic transaction in the deposit (such as withdrawing a check, debiting a deposit, etc.), where the minimal monthly bank charge on the deposit is NIS 10 (so that anyone undertaking up to eight transactions a month will still pay only NIS 10).
2. The basket of basic transactions agreed with the Economics Committee for a Fixed monthly fee of NIS 18, where on each additional transaction beyond those included in the basket the customer will be required to pay NIS 1.21.
3. Other baskets of transactions which the banks will choose to offer to customers.

Bank Hapoalim, and in a bank guarantee contract under the Sales (Housing)(Guarantee of Investments of Home-Buyers) Law, 5735-1974 of Tefahot Bank.

On 10 June, 2004 the Standard Contracts Court handed down its decision on the request to cancel discriminatory terms in the contract to manage a demand deposit of Bank Leumi, in which it accepted most of the arguments put forward by the State Counsel and the Supervisor of Banks, and ordered that the many discriminatory clauses in that contract be annulled or amended. The bank appealed against the decision of the court. After the bank had announced that it would appeal, the State Counsel also submitted his own appeal.

d. The Supervisor of Banks' position on class action law-suits

During the course of 2004 the position of the Supervisor of Banks, represented in these procedures by the Legal Department of the Bank of Israel, was expressed on three subjects arising from class action suits brought against banking corporations:

Claim T.A. 1618/03 'Aviv Legal Services Ltd.' v. 'Bank Hapoalim.' This claim concerned the imposition of a recording fee for debiting and crediting the customer's deposit while charging the fee repeatedly even though the transaction was canceled by the customer. In the opinion submitted to the court, the Supervisor of Banks asserted that in those circumstances the bank was not entitled to debit the customer's account for the recording fee.

Claim T.A. 1957/03 'R-On Investments Ltd.' v. 'The First International Bank of Israel Ltd.' This claim concerned the rounding of the Libor interest rate to the nearest one-eighth of a percent on bank loans in foreign currency or indexed to foreign currency. The opinion of the Supervisor of Banks submitted to the court was that the bank was not entitled to round the Libor interest rate to the nearest one-eighth of a percent, as the agreements regarding the loan did not meet the requirements of proper disclosure with respect to the way the interest rate would be determined.

Claim E.A. 3955/04 Raizel, Arie v. 'Bank Leumi Le-Israel Ltd.' and 'Leumi Card Ltd.' In this claim the Supervisor of Banks was asked by the court to address the question of the legality of deducting a bank charge known as A 'restricted responsibility fee' from customers who were in possession of a debit card. The Supervisor of Banks informed the court that in his opinion the deduction of the fee was not illegal.

8. INFORMATION AND FINANCIAL REPORTING

a. The Information and Reporting Unit

This unit is responsible for receiving reports from the banks intended for the Supervisor of Banks and turning them into accessible and reliable data which can serve the Supervisor

and the employees in the various units of the Banking Supervision Department. During 2004 the unit assimilated a reporting system regarding the prohibition of money laundering, since this subject was given precedence over others. In the course of the year the unit processed over 2,000 requests for information from various segments of the economy. In the framework of its ongoing work the unit publishes (both in hard copy and on the internet) the maximum and average interest rate in the 'gray market' for the purposes of the mortgage banks, thereby enabling them to calculate the charge for repayment before the due date on a fortnightly basis.

In addition, the unit issues several periodical publications: 1. *Annual Information on the Banking Corporations*, a booklet containing five-yearly data on Israel's banking system³; 2. *Current Information on the Banking Corporations*, a folder containing up-to-date information received during the year on Israel's banking system³; 3. *Main Data on the Activities of Each Bank*, a quarterly publication in which a comparison of the banks is undertaken on the basis of information extracted from their published financial statements.

b. Financial Statements Unit

This unit deals with two main areas:

1. Regulation of the directives regarding the guidelines for preparing reports for the public, which give instructions for drawing up the banking corporations' reports for the public, as well as subjects connected with the work of a banking corporation's internal auditor.
2. Undertaking audits of subjects connected with the banking corporations' financial statements to the public.

In addition, and alongside the above activities, the unit also deals with current subjects connected with the financial statements of the banking corporations.

Note that the main guidelines for preparing reports were formulated by the unit in 2004, and require that personal and individual statements be submitted by the CEO and the chief accountant regarding the efficiency of the open audits of the banking corporation's quarterly and annual reports, in accordance with section 302 of the Sarbanes-Oxley Law.

With regard to the topics listed below, draft directives have been prepared which are currently in the final stages of discussion. The reports to the public of the banking corporations have been brought into line with most of the requirements contained in these drafts.

Accounting treatment of legally contingent liabilities, in accordance with US Accounting Standard no, 5.

³ This is also available on the Bank of Israel's website, www.bankisrael.gov.il, under 'Publications and Information.'

Adoption of the rules determined in the updated regulations concerning securities and in the guidelines issued by the Securities Commission, inter alia, as regards the description of the business of the corporation and information about future projections.

Concurrently, treatment of the following principal regulatory issues continued: accounting treatment of transactions involving the transfer of financial assets, including repurchasing transactions, borrowings of securities, and securitization; adapting the rules regarding the measurement and disclosure of problem loans and loan-loss provision to the standards accepted in the US; housing credit—reducing the provision in accordance with the extent of arrears, etc.

The work of the internal auditor:

In 2004 the unit completed the regulation of the following subjects connected with the work of a banking corporation's internal auditor:

Directive no. 303 of the Proper Conduct of Banking Business Directives—regulating communications between the internal auditor and the authorities in charge of the external auditing of the audited entity.

Additional auditing regulations and auditing instructions were imposed on a banking corporation's internal auditor; these were issued by the American Institute of Certified Public Accountants and the American Council for Supervising Public Corporations;

The audits undertaken in 2004 focused primarily on the following subjects:

1. Proper disclosure in the financial statement to the public;
2. Minimum capital ratio.

9. CHECKS WITHOUT COVER

The Checks Without Cover Section is responsible for receiving and processing reports on restricted accounts and customers from the commercial banks and additional entities,⁴ and instructs them on subjects associated with the computerized systems and controls required in order to implement the Checks Without Cover Law, 5741-1981. The unit also cooperates with the police force in dealing with cases involving fraud, and acts to improve the systems dealing with persons who issue checks without cover.

At the end of 2004 there were 175,540 restricted accounts, an increase of 4 percent over 2003. There were 98,605 restricted customers, a rise of 1.1 percent over 2003. In 2004 the number of ordinary restricted customers fell for the first time after a long period in which this figure had risen, and slipped from 40,848 in 2003 to 36,411 (Table 3.5). This trend appears to be associated with the accelerated economic growth evident in 2004.

The number of customers restricted in aggravated circumstances—persons with files in the Execution Office or men who refuse to grant their wife a divorce—was up by 21.7

⁴ Such as the Execution Office and the rabbinical courts.

percent in 2003 and amounted to 29,746. Most of the increase stemmed from the growth in the number of persons with files in the Execution Office (Table 3.5).

Table 3.5
Restricted Customers and Accounts, 2002-04

	2002	2003	2004	Percent change 2004 vs. 2003 (%)
Restricted accounts	149,616	168,722	175,540	4.0
<i>of which</i> for checks returned	95,196	105,434	105,050	-0.4
Restricted customers	85,465	97,481	98,605	1.2
<i>of which</i> under ordinary restriction ^a	36,007	40,848	36,411	-10.9
Under aggravated circumstances ^b	29,956	32,198	32,448	0.8
Under special restriction ^c	19,502	24,435	29,746	21.7

^a A customer under ordinary restriction is restricted in one account and is allowed to use other accounts but may not open new accounts.

^b A customer restricted under aggravated circumstances is restricted in two accounts and may not draw checks on any of his/her accounts.

^c A customer under special restriction is restricted by the Director of the Executive Office or by a rabbinical court.

SOURCE: Reports to the Supervisor of the Banks.

In 2004, too, the number of visitors to the Bank of Israel's website continued to rise, and amounted to 126,000—up by 44.8 percent over 2003; the number of calls to the IVR (integrated voice response) of the Telemesser company also rose, and stood at 25,000—up by 13.6 percent over 2003. This trend is consistent with policy of the Supervisor of Banks regarding making information available to the public in up-to-date forms, and was accompanied by a 14.3 percent decline in the number of telephone calls to the Bank to ascertain information and obtain clarifications⁵ (Table 3.6).

⁵ The Checks Without Cover Unit also publishes daily files of accounts and customers which are restricted under special circumstances (and are permitted to be published) on the Bank of Israel's website as well as via the IVR of the Telemesser company. The object of this is to make the information accessible to individuals and firms, thereby enabling them to examine in real time whether the checks they have received have been drawn on restricted accounts and whether their customers are restricted in special circumstances. Voice messages regarding restricted accounts and customers (which it is permitted to publish) may be obtained from the Telemesser company, tel: 1212-332-755.

Table 3.6
No. of Public Enquiries and Complaints Regarding Checks Without Cover, 2003 and 2004

Enquiries	2003	2004	Percent change 2004 vs. 2003
In writing	1,234	1,283	4.0
Appeals to courts	876	794	-9.4
Via phone answering service	22,000	25,000	13.6
Via phone to the Unit	7,000	6,000	-14.3
Via Bank of Israel web site ^a	87,000	126,000	44.8

^a On the Bank of Israel site <http://www.bankisrael.gov.il>

SOURCE: Unit for Restricted Checking Accounts of the Bank of Israel

10. PROHIBITION OF MONEY LAUNDERING: LEGISLATION AND REGULATION

a. Legislation and regulation

The draft of a second amendment to the Prohibition of Money Laundering Order (Compulsory Identification, Reporting, and Record-Keeping by Banking Corporations), 5761-2001 (henceforth, the Order) was prepared; during the course of 2004 the Banking Supervision Department worked on the Order in conjunction with the Legal Department. The purpose of this was to incorporate in the Order the obligations to be imposed on banking corporations under the Prohibition of Financing Terrorism Law, 5765-2005, as well as to include in it the legal requirements under the Prohibition of Money Laundering Law, 5760-2000 applicable to credit card companies which are auxiliary corporations. Discussions are currently being held regarding the draft of the second amendment.

Directive no. 411: at the beginning of 2005 an amendment was made to Directive no. 411 of the Proper Conduct of Banking Business Directives, and henceforth this directive will be known as the 'Prevention of Money Laundering and Financing of Terrorism, and the Identification of Customers' Directive. The amendment comes in the framework of the international war on money laundering and the financing of terrorism, which has also found expression in the regulations issued by the Basle Committee and in legislation in Israel. The main points of the amendment are as follows: acceptance of all the requirements regarding the identification and recognition of customers and the prevention of the financing of terrorism; additional guidelines for dealing with the risk implicit in the action of depositing checks, especially a negotiable check and checks drawn on a bank outside Israel; expansion of the criteria for classifying countries as high risk, as well as preparing a list of countries to and from which the transfer of money requires closer monitoring; acceptance of the requirement that the policy regarding the

prevention of money laundering and financing of terrorism should be determined and implemented on a group basis.

b. Audits and sanctions committees

The Sanctions Committee regarding violations by the banking corporations of the prohibition on money laundering decided on the cases of nine commercial banks and two mortgage banks in 2004. The committee found that the banks had violated specific provisions of the law with regard to the prohibition of money laundering. In most of these instances the committee was content to issue a written warning and did not impose a pecuniary fine—primarily because the violations occurred soon after the introduction of the legislation and the regulations. However, some banks which were late in preparing for the subject and were found in the audit to be deficient in several respects were fined—even though since then most of the faults have been corrected.

The main defects concerned the processes of identification and verification when an account was opened, including receiving a statement from beneficiaries and holders of a controlling interest and preservation of identifying documents. Faults were also found in the processes of transferring the reports to the Prohibition of Money Laundering Authority, in reports on the size of the transaction, and in reports on exceptional transactions. The committee sent these banks a written warning.

In the course of 2004 a series of audits was undertaken of mutual (trust) companies which are auxiliary corporations. These audits examined the implementation of the provisions of the legislation regarding the prohibition of money laundering. The audits revealed faults and violations and even serious infringements in some of the trust companies. Some of the defects were corrected in the wake of the audit. The infringements will be dealt with by the sanctions committee, which will shortly be convened.

Appendix 3

Activities of the Banking Supervision Department in 2004

7 January

Following the publication of an announcement regarding accounting policy on critical subjects by the US Securities Authority, the guidelines regarding the preparation of reports for the public were amended, and a provisional directive was issued determining criteria for maintaining and improving the reliability of the financial statements of the banking corporations.

19 January

The Proper Conduct of Banking Business directive dealing with housing loans was amended. The main changes were:

1. Mortgage banks are not permitted to extend variable-interest loans with a significant reduction in interest during the initial period and high interest in the remaining term of the loan. Banks wishing to give their customers reductions should do so throughout the term of the loan.
2. In order to enable customers to make comparisons between banks and loans, the information which a bank must provide in writing to potential borrowers has been expanded, and this must now include information about the direct and indirect costs of the loans as well as the other housing loans offered by the bank.
3. Approval in principle to extend a loan, including the interest rate, must be given on the basis of the information supplied by the customer regarding the asset, without the necessity to provide documents. In addition, the number of days for keeping the interest rate from the day the approval in principle for the loan is given and until the documents are provided by the customer has been extended from ten to fourteen days.
4. In order to avoid double debiting when paying insurance premiums (by the banking corporation and the external insurance company) because of faults in the processing of the external policy by the bank, or because there is a delay, without the customer or the insurance company being aware of this at the time, the banking corporation is required to furnish the borrower with written confirmation of the insurance policy as soon as it is issued.

These amendments to the directive were effective as of 1 April, 2004.

27 January

A new directive of the Proper Conduct of Banking Business Directives was issued regarding rotation and continuous vacation. A banking corporation must determine a

policy regarding the rotation of tasks among managers and employees which refers inter alia to identifying sensitive posts regarding which there should be rotation, and the maximum time a manager or employee should spend in each of these positions, as well as identifying sensitive positions regarding which it is not possible to institute rotation, and special internal audits in such cases.

In addition, a banking corporation must specify a minimum quota of vacation days which each manager or employee of the corporation is required to take continuously. As far as persons in sensitive positions are concerned, the quota shall be not less than ten working days, whereas for others it shall be not less than six working days. During the continuous vacation the employee shall not be permitted enter the bank.

The directive regarding continuous vacation went into effect on the day it was published, and the directive regarding rotation went into effect on 1 July, 2004.

28 March

The license of the 'World Investment Bank Ltd.' was revoked.

27 May

The license of the foreign bank, 'Standard Chartered Bank Ltd.' was revoked.

28 June

In the wake of the amendment of the directive concerning the procedures for extending housing loans, clarifications were published in the form of questions and answers.

16 August

In the wake of varied marketing campaigns by the banks and the investment by them of considerable resources and efforts in an attempt to gain new customers, a clarification to the Proper Conduct of Banking Business Directives was published regarding offering financial inducements to customers. The clarification states that providing a financial incentive to buy a specific product or service, whether in advance or retroactively, in the form of a voucher or a loan which gradually dwindles, or in any other way, is like a benefit in kind and hence contravenes the directives.

30 August

Following questions which arose from audits, the discussions of the Committee Regarding the Imposition of Financial Sanctions on Banking Corporations Concerning the Prohibition on Money Laundering, and the ongoing treatment of the subject, clarifications were published concerning the Prohibition of Money Laundering Law, 5760-2000 and the Prohibition of Money Laundering (Compulsory Identification, Reporting and Record-Keeping by Banking Corporations) Order, 5761-2001.

26 October

The preliminary draft of the guidelines regarding the credit rating of companies, banks, and countries, which was formulated in the Banking Supervision Department, was published. The draft, which was based on the principles of the Basle II Recommendations formulated in a lengthy process of international discussions, was intended first and foremost to advance the level of risk management, including the management of capital adequacy. The draft that was submitted to the banks included basic standards for constructing and operating rating systems, estimating risk components, and examining the validity of the systems and the estimates. Special emphasis was placed on the supervisory and auditing mechanisms of the rating systems, and in particular on the involvement of the management and the board of directors and their responsibility for the adequate functioning of the rating systems and the reliability of the rating model. The Banking Supervision Department will hold discussions with the banks on the basis of the document that was circulated.

15 November

In the wake of the publication of new directives by the US Securities Authority regarding statements about disclosure in the quarterly and annual reports of companies, a statement was added to the directives regarding reporting to the public regarding disclosure in banking corporations' financial statements.

Following the publication of accountancy regulations (conflict of interests and damage to independence as a result of other employment), and the regulations of the US Securities Authority regarding the independence of accountants, the directive of the Proper Conduct of Banking Activity Directives regarding an accountant who conducts an audit of a banking corporation was amended. The directives determine the level of independence required from accountants who audit banking corporations in order to maintain the high level of independence expected in their professional work.

30 November

Auditing accountants are required to implement at least the American audit standards and audit guidelines published by the American Council of Certified Accountants. In view of the implementation of these auditing standards, and in order to regulate various aspects of their implementation, the directive of the Proper Conduct of Banking Business Directives dealing with the detailed report of the auditing accountant was replaced by a new directive concerning his communication with the authorities in charge of auditing the banking corporation. The main points of the directive are:

1. The Supervisor of Banks is entitled to demand any information that is generated in the course of the communication between the auditing accountant and the authorities in charge of auditing the banking corporation, and to use this information as he sees fit.

2. Significant findings and subjects which are relevant for the approval of the financial statement shall be reported to the authorities in charge of auditing the banking corporation before the date for the approval of the financial statement.
3. The auditing accountant shall consider applying to the Supervisor of Banks under certain circumstances, which are specified in the appendix to the directive.
4. The auditing accountant is required to identify any substantial weakness in the internal auditing and to report it to the banking corporation.

2 December

In the wake of the new government guarantee issued to the Israel Company for the Insurance of Foreign Trade Risks under the Foreign Trade Guarantees Law, 1959-5719, it was determined that:

1. Credit covered by the company's guarantees will not require the allocation of capital (weighted at 0 percent) in order to meet the requirements of the Proper Conduct of Banking Business directive dealing with minimum capital ratio.
2. The company's guarantees may be discounted in order to meet the restrictions regarding large exposure and a group of borrowers.

9 December

Following amendment no. 21 to the Banking Order, 1941, which requires a banking corporation to report to the Supervisor of Banks if there is a reasonable suspicion that one of its employees or a member of its staff has been involved in fraud, the directive of the Proper Conduct of Banking Business Directives dealing with fraud by employees and staff members was amended. The directive now determines the method of reporting to the Supervisor of Banks, the time of the report, the minimum amount to be reported, and other particulars.

13 December

The date on which the adjustment of financial reports is to cease and these reports are to be submitted on a nominal basis, in accordance with accountancy standard no.10 of the Israel Accounting Standards Board, was determined as 1 January, 2004. For the reporting period beginning on that date the reported amounts, as defined in the standard, are those adjusted to the CPI of the month of the transition plus nominal amounts added after the transition and less amounts deducted after the transition. In the wake of this, interim regulations were determined regarding the reporting procedure of banking corporations in their financial statements for 2004.

Banking Supervision Department Organizational Structure

