

Chapter 4

Activity of the Banking Supervision Department

The Bank Supervision Department is responsible first and foremost for maintaining the stability of the banking system. In addition, it is responsible for increasing competition and efficiency in the system and ensuring the fair treatment of the banks' customers. In 2009, the Department continued to deal with the ramifications of the global crisis while adopting and assimilating the Basel II guidelines.

In 2009, the Bank Supervision Department was intensively involved in issues related to the development of the financial crisis both in Israel and worldwide and its implications for the Israeli banking system, as well as strengthening the management of risk and capital by the banks. Within this framework, the Department operated on a number of levels: auditing of the banks and monitoring of their activities and management of risk; restrictions and regulation in response to global developments; improvement of disclosure in the banks' financial reports; expansion of existing reports to the Department and the addition of new ones, as new sources of risk were identified; strengthening of the dialog with the banks; and increasing cooperation with entities both inside and outside the Bank of Israel.

One of the most important steps taken by the Bank Supervision Department during this period was the effort to reinforce capital adequacy in the banking system as a buffer for absorbing unexpected losses.

This year, the Department continued with the adoption and assimilation of the Basel II guidelines both within the banks and within the Department itself. This task was completed on December 31, 2009 with focus on the implementation of the Second Pillar by both the banks and the Department. As part of this process, guidelines were assimilated within the banking system whose goal was the upgrading of the risk management frameworks, auditing and corporate governance, as well as the introduction of a structured process for the assessment of the banks' capital adequacy (known as ICAAP–Internal Capital Adequacy Assessment Process). Following this, the Bank Supervision Department modified its methods of operation in accordance with the changes in the risk management environment. These steps have positioned the Israeli banking system alongside the most advanced countries in world with respect to risk management.

This chapter contains three sections: The first describes the activities of the Department that are aimed at preserving the stability of the banking system, particularly in the context of the financial crisis, which also affected real economic activity. The second section describes the activity of the Department with regard to Basel II and the third section describes the Department's activity in the area of bank-customer relations, which is intended to ensure fair treatment of the banks' customers and to encourage competition within the banking system.

1. MAINTAINING THE STABILITY OF THE BANKING SYSTEM DURING THE FINANCIAL CRISIS

a. Actions taken by the Department to deal with the financial and real crises

The Bank Supervision Department began responding to the global financial crisis already in the summer of 2007, as the sub-prime crisis began to develop, and its activities in this area have continued until today. The actions taken during 2007 and 2008 have been reviewed in previous surveys. What follows will describe activities in 2009, which were a continuation of previous activities and in some cases an expansion.

The dramatic events in the markets in late 2008 continued to have an effect into the first three months of 2009. Therefore, during this period, the Department placed its emphasis on how the banks were dealing with the global financial crisis, including their exposure to foreign financial institutions, the assessment of their credit policies and the disclosure requirements for their financial reporting. Later in the year, most of the supervisory activity was devoted to dealing with the real effects of the financial crisis. One of the main steps taken by the Department this year was the strengthening of capital adequacy in the banking system.

On January 1, 2009, the Supervisor of Banks issued a letter on credit policy entitled "Assessments of the Value of Assets in Certain Foreign Countries and the Exposure to Borrowers with Most of their Activity in Those Countries". This followed an examination by the Bank Supervision Department which concluded that the valuation of assets in certain countries and the evaluation of credit risk due to borrowers whose main activity is located in those countries do not always take into account the uncertainty resulting from the special characteristics of those countries. The letter stressed that these characteristics require a particularly conservative approach to the assessment of credit risk arising from debts whose source of repayment is based on assets located in these countries, as well as the debts of borrowers whose main activity is located there. Among other things, the banks were asked to adopt a conservative approach in assessing the value of these debts and to consider classifying them as problematic and creating provisions for doubtful debts against them. Following that, the Bank Supervision Department investigated credit for the financing of corporate takeovers and required the financing banks to update the valuation of purchased companies and to carry out an independent review of the valuation. This requirement was meant to convey to the banks that the Bank Supervision Department attributes a high level of risk to this type of credit and that extra caution is required in its management.

In accordance with the recommendations of a report issued by the FSF (Financial Stability Forum) in April 2008, the Department issued a bulletin on January 11, 2009 which required a reliable disclosure of risks in accordance with leading disclosure practices.²

² See also Appendix 4.1 of this Chapter.

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At the beginning of March, a letter was issued by the Supervisor of Banks regarding the non-temporary decline in the value of securities, which followed the decrease in the value of investments in securities. The letter instructed the banks to recognize a non-temporary drop in value under certain conditions. The audits and disclosure requirements of the Bank Supervision Department were intended to reduce the uncertainty for investors and to increase the confidence of the public in the financial reports of the banks and in the banking system. These activities broadened the disclosure of risk—which grew as a result of the crisis—in their financial reports and in our opinion increased the confidence of the public in the banking system.

Even prior to the collapse of the Lehman Brothers investment bank, the Bank Supervision Department was preparing for further development of the crisis. The Department established designated teams and strengthened existing ones, in some cases together with other divisions in the Bank of Israel and in other cases with entities outside the Bank. Among them were teams to assess credit risk due to borrowers who are active in the capital market, to assess changes in the liquidity of the banking system, to assess trends in credit and doubtful debts, to monitor the exposure to foreign financial institutions and to strengthen the monitoring of global macroeconomic and financial developments. These teams submitted their recommendations to the senior management forum of the Bank Supervision Department.

In parallel to intensifying activity in these areas, the Department continued its ongoing assessment of individual banks, which included a continuous dialog with them. This was done in cooperation with the banking system's senior management and included increased updating of each side.

During this period, the Bank Supervision Department worked to reinforce the capital of the banking system on several levels:

- The Department worked to strengthen capital adequacy among the banks and to assess the plans to achieve a capital adequacy ratio of not less than 12 percent in terms of Basel I by the end of 2009. The target was based on a survey by the Department of capital adequacy ratios in banking systems worldwide and on the initial lessons learned from the crisis. The survey was based on an in-depth analysis of the capital structure of the Israeli banking system and stress tests to evaluate the effect of factors such as credit risk, interest rate risk and exchange rate risk on the capital base, as is the accepted practice in other countries. In view of the fear that an increase in capital requirements will hamper the expansion of bank credit and create a credit crunch, there were requests to lower the aforementioned capital adequacy target. Meetings are currently being held between representatives of the Bank Supervision Department, the banks, other authorities and industrial organizations in order to clarify the positions of the Department on the one hand and to understand the positions of those affected on the other hand.
- The Bank Supervision Department has decided that upper Tier 2 capital will be raised in the capital market, while adopting the existing leniencies in Basel II, and accordingly has worked in cooperation with the Israel Securities Authority to organize the issues in the capital market from the point of view of scheduling and the requirements for prospectuses.

- As part of the Department's policy to reinforce the capital base of the banking system, the Supervisor of Banks announced in January 2009 that a bank which is interested in distributing dividends on the basis of the results in the 2008 financial statements must request approval from the Supervisor of Banks. This step, which involved ensuring that the banks meet internal capital adequacy targets (which consisted of milestones up until the end of 2009), essentially prevented the distribution of dividends in the banking system for 2008 and thus reinforced the capital base of the banking system.
- The Bank Supervision Department took part in the creation of a plan to provide government guarantees for the raising of capital by the banks. To implement the plan, the Ministry of Finance created a NIS 6 billion government guarantee available to the banking system for the purpose of raising capital. The goal of the guarantee was to enable the banks to raise capital and to provide credit amounting to tens of billion of shekels, which would help alleviate the credit shortage and would help the private sector and the business sector weather the global economic crisis. The banks did not in fact utilize the guarantee but the fact that the government had signaled its support for the banks strengthened their ability to weather the crisis.

During this period, the Bank Supervision Department continued to emphasize the adoption of the Basel II guidelines by the specified date and the strengthening of the banking system's capital base. The letter from the Supervisor of Banks dated August 20, 2009 states that the banks must establish internal capital targets for an interim period, in terms of both Basel I and Basel II, until the completion of the comprehensive SREP,³ and meet those targets. The purpose of this directive is the maintenance of a capital adequacy ratio of 12 percent after the Basel II regime goes into effect.

On March 23, 2009, the Bank of Israel announced that the interest rate for April would be reduced to 0.5 percent in order to continue the reinforcement of the economy's ability to cope with the global economic crisis. This low rate of interest was maintained without change until September 2009 and the Bank Supervision Department assessed its effect on the banking system from the point of view of profitability, total bank credit to the public, spreads on credit, etc.

In order to make it easier for the banks to provide credit, the Bank Supervision Department loosened some of the regulatory restrictions:

On September 17, 2009, the Supervisor of the Banks issued a bulletin that amended the directive regarding an additional provision for doubtful debts with respect to the calculation of surplus indebtedness in the construction and real estate industry and allowed an expansion of credit to infrastructure projects in the building stage.

An additional leniency was introduced in a letter from the Supervisor of Banks on May 14, 2009 regarding the calculation of the additional provision for indebtedness for which the bank has no updated financial report, i.e. receivables that were acquired in factoring transactions.

Following the sharp increase in the provision of variable-rate housing loans during the first half of 2009 as a result of the prevailing low rate of interest, the Bank Supervision

³ See also Box 4.2 in this chapter.

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Department assessed the implications of this phenomenon on the banks. As a result, the Supervisor of Banks issued a letter of clarification to the banking system during August. The letter pointed out that an increase in the shekel rate of interest, and with it monthly repayments, are liable to create difficulties in the redemption of loans and therefore the banks are requested to use caution in the marketing and approval of variable-rate housing loans. This includes emphasis on the ratio between the monthly repayment and the borrower's disposable income, also assuming a higher rate of interest than that which prevailed when the loan was provided.

One of the lessons learned from the crisis involved the compensation schemes for employees within the system of incentives. This encouraged the banks to take on excess risk in the short run while not sufficiently taking into account the long-run risks, thus creating one of the factors that led to the crisis. As part of the adoption of the FSF report and with the goal of reducing risk in the banking system, the Supervisor of Banks issued a letter on April 5, 2009 concerning the compensation policy of the banks. The banks were required to adopt an appropriate compensation policy by December 31, 2009, which would be decided on by the Board of Directors according to guidelines set out by the Supervisor of Banks. These included: bringing incentives into line with the overall profitability of the organization and the bank's long-term goals; avoidance of risk-free incentivization beyond the bank's appetite for risk; and the basing of incentives on risk-adjusted profit and the cost of capital. In addition, the banks were required to implement strict supervision and monitoring of compensation policy. It was also specified that agreements concerning severance pay for members of senior management would take into account actual performance over time, the reason for leaving, etc. The Bank Supervision Department is closely monitoring the banks' compliance with these directives.

In view of the effects of the global crisis on foreign countries in which Israeli banks are active, the Bank Supervision Department issued a requirement for the disclosure of exposure to foreign countries. Thus, the banks were required to investigate and decide whether the existing conditions in the foreign country are causing liquidity problems that can be expected to have a material effect on their repayment ability. In addition, the Department updated its directives regarding the measurement of fair value, disclosure of fair value and the identification and presentation of declines in value of a non-temporary nature, following the publication of amendments to the relevant FASB.

On June 7, 2009, the Bank Supervision Department published a proposed outline of International Financial Reporting Standards (IFRS) to replace the American standards. The outline differentiates between the adoption of international standards relating to a bank's core business and those not related to its core business.

In this context, the Bank Supervision Department acted to consolidate its positions with respect to the securitization of housing loans in Israel, in view of the lessons learned from the financial crisis. In August 2009, a letter was issued by the Bank Supervision Department whose goal was to enable the banks to prepare themselves for the requirements of the Bank Supervision Department regarding their planned

securitization of housing loans. The main addition related to the bank's holdings of bonds that will be issued by the SPE (Special Purpose Entity). In order to reduce the moral risk and as part of the lessons learned from the crisis it was decided that the securitizing bank will hold at least 10 percent of each type of bond to be issued by the SPE.

The second half of 2009 was characterized by stability in the global financial system although the effects of the crisis on real activity were still significant. As a result of the failures in the corporate bond market and the arrangement reached for the debts of the Africa Israel Company, the work of the Bank Supervision Department focused on credit risk and the management of risk in the banking system.

On October 12, 2009, the Supervisor of Banks issued a letter regarding the points to be focused on in the management of credit risk, which included the requirement to devote special attention to the financial situation of sensitive borrowers. The banks were asked to perform a comprehensive review of their credit portfolios with the goal of identifying borrowers with specific risk characteristics, such as, for example, high leverage, and following that to determine whether there is a need to update their rating and their debt arrangements, to enhance their collateral, to put them on a watch list, etc. In addition, the letter stated that any plan of action in this area requires approval by the board of directors and the Bank Supervision Department.

As part of the regulatory measures taken by the Bank Supervision Department to strengthen the management of credit risk by the banks, a letter was issued on December 10, 2009 to the banking system regarding the lessons learned from the financial crisis with respect to the management of credit risk. The letter presented specific points to be emphasized in examining the exposure to credit risk.

As a result of the lessons learned, which increased the importance attributed to the management of risk in the banking system, and as part of the adoption of Basel II, the Supervisor of Banks decided on December 22, 2009 that each bank will have an independent risk management unit that will be led by a head risk manager in order to strengthen the bank's ability to ensure cautious risk management. The letter defines the guidelines for the functions of the head risk manager and of risk managers in general and in particular their status, role and responsibility.

The actions taken by the Bank Supervision Department described above were accompanied by ongoing communication with the banking system and with other professional bodies in Israel and worldwide.

b. The ongoing activity of the Bank Supervision Department to maintain the stability of the banking system

Activities to maintain the stability of the banking system are carried out on an ongoing basis on a number of levels:

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The first level⁴ involves periodic assessment of the banks by the Bank Supervision Department, including auxiliary companies, banking subsidiaries and branches abroad, regarding the banks' degree of stability, their resilience and their management methods. This monitoring includes the continuous updating of the risk assessment for each bank. This enables the creation of activity agendas that will facilitate the early identification of negative and exceptional developments in the banks' activity and risks. This is accomplished by, among other things, the monitoring of the bank's reports and material from external sources, the protocols of board of directors meetings and accompanying material, reports of the internal auditor, the summary of exposures, the external accountant's report, meetings with members of senior management, etc.

The Bank Supervision Department also deals with requests that require licensing by the Governor of the Bank of Israel or the Supervisor of Banks, including investigation of candidates for control or the holding of controlling interests in a bank, the assessment of whether individuals are fit for holding a senior position in the banking system, the creation of subsidiaries, branching policy, the activity of foreign banks in Israel, etc. This is in addition to the various enquiries and requests from the banks, whether the activity requires approval or not.

As part of the assessment of the banks' resilience and the soundness of their risk and capital management process, drafts of internal assessments made by the banks of their capital adequacy (known as the Internal Capital Adequacy Assessment Process (ICAAP))⁵ were analyzed during the year. These were submitted by the banks for the first time on June 30, 2009. Their goal was to prepare the banking system and the Bank Supervision Department for the adoption of the Basel II regime in 2010. Basel II will require an assessment process that links the level of capital that the bank is required to maintain and its level of risk exposure.

The second level of activity⁶ is the implementation of comprehensive and in-depth on-site inspections at the banks by the five designated inspection units that specialize in the following areas: credit risk, corporate governance, liquidity and market risk, information technology (IT) risk, money laundering and customer relations. The goal of the inspection is to examine the proficiency of risk management and the handling of these issues by the bank. Emphasis is placed on determining to what extent the bank is following the directives and instructions of the Supervisor of Banks. The auditing reports have several functions: to provide warnings of deficiencies and defects; to require the banks to rectify the problems and to provide a timetable for this to be done; and finally to provide support for the assessment of the banks' stability and the regulation of the banking system.

⁴ The Off-Site Evaluation Division is responsible for the activities described below. See the organizational chart at the end of this survey.

⁵ For more details on the ICAAP structure, see Box 4.2 below.

⁶ The On-Site Inspection Division within the Bank Supervision Department is responsible for these activities. See the organizational chart at the end of this survey.

i. The unit for credit inspection

The main goal of this unit's inspection activity is to examine how the banks actually manage credit risk. This is carried out through, among other things, assessing the bank's credit policy and its assimilation, the process for credit approval and implementation, the monitoring of these processes and the assessment of the process for identifying and classifying problematic debts. In addition, inspections are carried out for credit to large groups of borrowers. The goals of the inspections and their order of priorities are determined according to the levels of complexity and credit risk built in to the various activities on the one hand and the quality of the bank's management and oversight abilities on the other.

ii. The unit for inspection of corporate governance⁷

This inspection team works to assimilate appropriate supervisory and internal auditing frameworks within the banks and to assess the efficiency and functioning of the banks' auditing and supervisory bodies, i.e. the board of directors, senior management, the risk management system, internal auditing and the compliance officer.

During 2009, emphasis was placed on assessing the work of the board of directors in their two main functions: the formulation of policy and the monitoring of the bank's management. The inspections were based on innovative auditing techniques whose goal is to strengthen the culture of corporate governance and to improve the work of the board of directors as part of the Department's policy of enhancing the culture of corporate governance among the banks.

iii. The unit for inspection of liquidity and market risk

This unit carries out inspections of the following areas: management of the bank's assets and liabilities with emphasis on the management of market risk, liquidity risk, risk arising from the activity of the trading rooms, risk arising from the activities of a bank's customers in the capital market, etc.

The inspection process includes assessing the various entities that have a role in the management and monitoring of risk, the integrity of the procedures, the adequacy of models used to estimate market and liquidity risk, in particular the methods, documentation and validation process, and the operational infrastructure in the area being inspected.

The inspection is based on the relevant Proper Conduct of Banking Business Directives regarding risk management, in particular the management of liquidity risk, and on the relevant guidelines for risk management included in the Second Pillar of the Basel II rules and according to "best practices".

During 2009, the audits focused on the management of liquidity risk, whose importance has increased as a result of the global financial crisis.

⁷ For more details on corporate governance, see Box 4.1 below.

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iv. The unit for inspection of information technology

The centrality of information technology (IT) in banking activity is continually increasing and with it the associated risk. The inspections of the Bank Supervision Department are meant to assess the management of IT risk by the banks, including the risks to data security. The correct management of IT risk is meant to assist the bank in maintaining its assets and protecting the integrity of its customers' financial assets and their confidentiality. In 2009, attention continued to be devoted to major IT risks, which are derived from the major processes and changes in the field, the potential risks in the banking system's connection to external networks for various purposes, outsourcing risk, etc.

During 2009, the Bank Supervision Department dealt with exceptional events and major IT failures in the banking system and the drawing of conclusions in order to prevent their recurrence.

v. The unit for money laundering and customer-bank relations

The Bank Supervision Department performs inspections related to bank-customer relations and the prohibition of money laundering and funding of terror, which are liable to expose the banks to regulatory and legal risks, operational risk and risk to reputation. The inspections take a risk-oriented view of the administrative, organizational and operational structure of the bank and whether they are complying with the laws and regulations relating to the areas under their responsibility. Furthermore, the inspection is designed to strengthen the banks' organizational culture and corporate governance and to increase the awareness and sensitivity to these areas. The effort against money laundering and the funding of terror has international ramifications that can cause harm to the banking system and even to the Israeli economy as a whole.

During 2009, monitoring continued regarding the prohibition of money laundering and funding of terror, with focus on the changes introduced into the directive prohibiting money laundering in the context of credit card companies, which went into effect during the second half of 2007. The monitoring also focused on the prohibition of the funding of terror. In the area of bank-customer relations, inspections were begun regarding the ability of customers to move between banks.

The Bank Supervision Department's third level of activity involves the regulation of bank activity and the formulation of regulatory policy.⁸ The goals of the regulations are to achieve proper and cautious management among the banks, to regulate the activity of the bank's board of directors and management, to strengthen the systems for risk management and internal auditing and to improve the internal and external systems for reporting to the public. The Bank Supervision Department is also responsible for the banks' rules of measurement, disclosure and reporting in their financial statements and

⁸ The Policy and Regulation Division within the Bank Supervision Department is responsible for this activity. See the organization chart at the end of this survey.

in their reports to the Bank Supervision Department,⁹ which in this context it publishes quarterly and annual data on the banking system.¹⁰ In 2009, with the development of new sources of risk, the Bank Supervision Department imposed new requirements for reporting to the Department and to the public. These included a detailed report containing information on liquidity, country and other risks, some of which is also provided in reports to the public. The goal of these reports is to improve disclosure to the public and to increase confidence in the banking system.

Regulatory activity is based on the processing and analysis of information that is obtained by the Bank Supervision Department from various sources, particularly information from the banking system itself and information on regulatory developments abroad. The information is used in the regulation and behavioral rules imposed on the banks.¹¹ These are documented in the Proper Conduct of Banking Business Directives, the Directives for Reporting to the Public and the Directives for Reporting to the Bank Supervision Department. The directives issued to the banks this year can be found in Appendix 4.1 at the end of this chapter according to the data of their issue.

The reports received by the Bank Supervision Department constitute the basis for the analysis of risk and the identification of sources of risk on the level of the individual bank and the banking system as a whole. The Bank Supervision Department performs an annual survey of the Israeli banking system, which describes the main developments in the banking system from an annual and longer-term view. In addition, quarterly surveys are carried out in order to monitor the developments in the banking system shortly after they occur. The Department monitors macroeconomic developments and developments in the markets in both Israel and abroad in order to identify any changes that will affect the stability of the banking system. Thus, for example, during the crisis, the Bank Supervision Department performed stress tests on the banking system in order to assess its resilience to the realization of risk, as described in Chapter 3 of this survey.¹²

International Relations

The Bank Supervision Department maintains ongoing contact with regulatory authorities abroad. This connection is essential in view of globalization, the increased international activity of Israeli banks, the interest of foreign investors in the Israeli banking system

⁹ These activities are implemented by the Financial Reports Unit of the Policy and Regulation Division within the Bank Supervision Department. See the organizational chart at the end of this survey.

¹⁰ The Information and Reporting Unit of the Policy and Regulation Division within the Bank Supervision Department is responsible for obtaining the banks' reports, processing them and improving them if necessary and transforming them into accessible information that serves the goals of the Department and for making them available to the public on the Bank of Israel's Internet site. See the organizational chart at the end of this survey.

¹¹ The Regulation Unit of the Policy and Regulation Division within the Bank Supervision Department is responsible for this activity. See the organizational chart at the end of this survey.

¹² These activities are implemented by the Economic Unit of the Policy and Regulation Division within the Bank Supervision Department. See the organizational chart at the end of this survey.

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and the recommendations of the Basel Committee, which emphasize the importance of cooperation and the sharing of information among regulatory authorities worldwide.

In 2009, the character of the Department's international activity was affected by the global financial crisis and involved the monitoring and distribution of information to the Department's staff which was related to negative developments abroad. This included the preparation of periodic surveys whose goal was to provide updates on the main developments abroad regarding macroeconomic variables, regulation and the financial system in general.

The Bank Supervision Headquarters—Preparation for Emergencies

In accordance with the government decision on November 13, 2005 and with the approval of the Supreme Committee for the Economy in Time of Emergency, it was decided that the Bank of Israel would create and operate a designated Financial Banking Authority.

The Financial Banking Authority is responsible for the preparations for emergencies and the operations of the commercial banks, the credit card companies, the Automated Banking Services and the Automated Clearing House (Masav) during those emergencies. These bodies are under the oversight of the Bank of Israel in normal times. The Financial Banking Authority is headed by the Supervisor of Banks.

The Financial Banking Authority is responsible for emergency preparations and during an emergency for the operation of those entities which the Bank of Israel oversees in normal times.

In 2009, the Financial Banking Authority continued to advance various initiatives in order to increase the preparedness of the banking system for emergencies. These efforts are based on, among other things, the emergency plan prepared last year. In this context, the Supervisor of Banks instructed the banks to maintain plans for the recovery from a disaster and the continuation of business activity in order to ensure its ability to operate on an ongoing basis and to limit losses in the event of severe disruptions in business activity.

In view of the increasing incidence of the A/H1N1 flu and its spread throughout the world, the Supervisor of Banks instructed the banking system to include a scenario for a pandemic¹³ in the plans for recovery from a disaster and the continuation of business activity.

In 2009, the Financial Banking Authority participated in two main exercises: "Turning Point 3," a national emergency exercise which took place at the end of May, and an internal exercise at the Bank of Israel in September, which examined the preparedness of the backup staff for emergency situations. The two exercises simulated a war scenario.

¹³ This is a situation in which an infectious disease spreads rapidly through a large population and a large geographic area, such as a continent and perhaps even the whole world, and has the potential to cause serious disruptions in economic activity. For more details on this issue, see the Internet site of the World Health Organization: http://www.who.int/csr/disease/avian_influenza/phase/en.

Box 4.1

Corporate Governance

Corporate governance is defined as the system of relations between a company's executive, its board of directors, its shareholders and other parties of interest. During the last decade, the concept of corporate governance has received increased attention as a result of the need to create appropriate management and monitoring mechanisms within corporations in general and within banks in particular.

a. The development of corporate governance in Israel

In 1999, the OECD published a collection of guidelines and rules for effective corporate governance. Over the years, they became the basis for codes of corporate governance in many countries, including Israel. In 2006, the Committee for the Assessment of the Corporate Governance Code (the "Goshen" Committee) issued a report containing recommended corporate governance regulations that would be worthwhile adopting as the standard in Israel.

b. Corporate governance in the banks

Due to the importance of the banks as intermediaries in the economy and the need to protect customers' deposits, corporate governance in the banks has become increasingly important to the stability of the financial system. Corporate governance in the context of banks primarily involves the setting of business targets, the definition of risk appetite, the creation of an organizational structure and a hierarchy of authority and responsibility, the establishment of a stable and independent internal auditing framework (auditing of risk, the compliance function and internal auditing) and the fulfillment of reporting requirements to shareholders, while taking into account the welfare of other parties of interest that protect the welfare of depositors.

c. The Basel Committee Guidelines for the Strengthening of Corporate Governance

The Basel Committee issued a document of guidelines in early 1999 (which was updated in 2006) to help Bank Supervision in various countries encourage sound and stable corporate governance. The Bank Supervision Department adopted the Basel Committee's document of guidelines and in March 2008 published a draft on strengthening corporate governance among the banks. According to the Basel guidelines, corporate governance is an important component of the Second Pillar

and also serves as a basis for the allocation of capital as part of the ICAAP at each bank and as part of the SREP following that. The need to assimilate these guidelines among the banks took on increased importance as a result of the lessons learned from the recent financial crisis. Following are some of the highlights of the Basel guidelines:

1) The board of directors: It is the board of directors that bears the overall responsibility for the bank. It formulates the bank's overall strategy and oversees its assimilation. The board of directors supervises the activity of senior management in implementing the policy of the bank and achieving its targets. The members of the board of directors will have the appropriate training and a clear understanding of their functions in order to ensure that they are able to exercise sound and objective judgment.

2) Senior management: The function of senior management is to ensure that the bank's activities are consistent with its business strategy, risk appetite and the policy approved by the board of directors. Senior management is responsible for the development of processes for the identification, monitoring and auditing of the risks to which the bank is exposed, the preservation of its organizational structure and ensuring that the allocation of authority is implemented effectively.

3) Risk management and internal auditing: An independent entity for risk management is critical within a bank. This body should have sufficient authority, power, independence, resources and direct access to the board of directors. Risks need to be identified and monitored on an ongoing basis by all the units in the corporation and should be consistent with any change in the bank's business mix and the macroeconomic environment.

4) Compensation scheme: The compensation scheme should be decided on by the Board of Directors and monitored by it. An effective compensation scheme should have the following traits, among others: it should be consistent with the bank's overall profitability and long-term goals; it should not encourage risk-taking beyond the corporation's risk appetite; it should be based on risk-adjusted profit and cost of capital; and should be aimed at achieving the general objectives of the bank, including those related to risk management and compliance with the law and regulations.

5) Organizational structure: It is the responsibility of the board of directors and the senior management to understand the bank's organizational structure and to ensure that it is clear-cut and uncomplicated and that it clearly defines spheres of responsibility, authority and lines of reporting.

6) Reporting to the public and transparency: The bank should submit appropriate reports to its shareholders, depositors, other relevant holders of shares and market players.

d. The increasing importance of corporate governance as a result of the financial crisis

The recent financial crisis, which began in the US in mid-2007 and then spread to the rest of the world, increased the importance of appropriate and effective corporate governance, particularly among banks. One of the main reasons for the intensity of the crisis and collapse of banks worldwide, particularly in the US, was the poor management of corporate governance. Thus, boards of directors did not fulfill their primary duty of independent and sound oversight of management and they failed to exercise independent judgment, primarily due to their lack of appropriate training; many banks adopted risky and unmonitored credit policies, which were based on short-term profit; the management of risk in banking systems worldwide failed as a result of investment in destinations that were not consistent with the bank's risk appetite and the only partial implementation of the rules of corporate governance; and the compensation models encouraged disproportionate risk-taking, with little consideration taken of long-term risk.

e. The regulation of the banks in order to encourage appropriate corporate governance

In recent years and in parallel to the assimilation of Basel II in Israel and the drawing of conclusions from the financial crisis, the Bank Supervision Department has worked in various ways to provide focused regulatory guidance in order to help the banks change the orientation of the board of directors and senior management in the spirit of Basel II and has emphasized the importance of efficient corporate governance among the banks. As part of its activity to strengthen the frameworks of corporate governance among the banks, the following measures have been taken:

- Regulatory modifications: the issuing of new directives and the amendment of existing ones, such as the Directives for Reporting to the Public, the requirement to carry out a survey of gaps relative to the Basel guidelines and the closing of those gaps and a reassessment of the Proper Conduct of Banking Business Directive no. 301.
- The publication of directed bulletins and the definition of principles: a document of guidelines for the positions of head risk manager and independent risk manager at the bank, a bulletin on compensation policy in the banks, etc.
- Training and seminars: A conference on the achievements and challenges in the adoption of Basel II and a seminar on "The Board of Directors in a bank: Challenges in an era of increased corporate governance".
- Ongoing dialog with management and supervisory entities within the banks (board of directors, senior management, risk managers and internal auditors), including periodic meetings between the Supervisor of Banks and the banks' boards of directors.
- Periodic comprehensive assessment: reading of protocols of board of directors meetings on an ongoing basis and review of drafts ICAAPs carried out by the banks.
- Auditing: Assessment of the effectiveness of the board of directors (including performance and characteristics).

2. ADOPTION AND ASSIMILATION OF THE BASEL II DIRECTIVES

During 2009, the Bank Supervision Department continued its activity in preparation for the final stages in the adoption and assimilation of the Basel II directives and prior to their full implementation in the Israeli banking system by December 31, 2009.¹⁴

Starting from December 31, 2009, the banking system in Israel has been operating according to the Basel II directives, including the Standard Approach to the measurement of capital adequacy. Thus, the long process of preparation and assimilation, which began in January 2007 with the declaration of the Supervisor of Banks regarding the adoption of the Basel II guidelines, has been completed. This was a joint process of the Bank Supervision Department and the banking system, who together made a critical contribution to the implementation of the directives and their assimilation.¹⁵

On December 31, 2008, the Supervisor of Banks issued a temporary directive for Basel II, according to the decided-upon timetables and as a result of the close and continuous cooperation with the banking system. This directive reflects the position of the Supervisor on each of the issues in which he has discretion. These positions take into account those of foreign regulatory authorities on these same issues, as well as their compatibility with the Israel's laws and regulations and the characteristics of the Israeli economy, if relevant.

During 2009, the Bank Supervision Department completed its preparations for implementing the directives, which included dialog with the banking system, as follows:

- Completion of the preparation for the implementation of the First Pillar: Starting in December 2008 and during the course of 2009, the banks submitted data on capital adequacy to the Bank Supervision Department, as required both by the new directives (according to the Standard Approach) and the previous directives (Proper Conduct of Banking Business Directive "Minimum Capital Reserve Ratio"). This period served as a trial period for the implementation of the directives both for the banking system and the Bank Supervision Department. During this period, the reported data was reviewed, qualitative questionnaires were examined and a continuous process took place between the Bank Supervision Department and the banks for the enhancement of data and the change in directives or provision of clarifications as needed.
- Preparation for implementing the Second Pillar: The directives of the Second Pillar require that the banks implement and assimilate the Internal Capital Adequacy Assessment Process (ICAAP) and require the Bank Supervision Department to regularly carry out a review and evaluation process in order to ensure the integrity of the ICAAP. For further details on ICAAP, see Box 4.2 below. In order to achieve these goals, the Bank Supervision Department worked during the year to strengthen and upgrade regulatory processes through the

¹⁴ For more details and a survey of additional aspects of Basel II, see the 2007 Annual Survey of the Banking System in Israel, Chapter 4.

¹⁵ For further details on Basel II, including its various pillars, see page 136–38, *ibid.*

implementation and assimilation of a risk-focused regulatory approach. According to this approach, each bank's main lines of business are segmented, including the analysis of the main risk implicit in each activity. In addition, the systems for risk management, auditing and corporate governance are assessed for each bank. During 2009, the Bank Supervision Department assimilated risk-oriented regulatory principles among its staff, as well as the Basel II guidelines, through training sessions, workshops and seminars, both in Israel and abroad. The leading banks in the banking groups were asked to submit drafts ICAAP reports by June 2009 in order for them to serve as a basis for the individual discussions with each of them regarding steps to be taken in order to implement and assimilate ICAAP. The ICAAP reports were studied and analyzed and following exhaustive discussions by the management of the Bank Supervision Department regulatory guidelines were decided on with regard to the improvements required in the banks' reporting. At the end of the last quarter of 2009, exhaustive meetings were held with the bank managements during which the fundamental positions of the Bank Supervision Department were communicated. The date for submitting the official ICAAP reports was set for the end of June 2010.

- Completion of the preparations for the implementation of the Third Pillar: Starting from the Annual Report to the Public for 2009, the banks include an additional disclosure in accordance with the disclosure requirements of the Third Pillar. These include qualitative and quantitative disclosure, which will be updated on a quarterly basis and is meant to provide important data on the implementation of the Basel II recommendations, capital components, exposure to risk, the risk assessment process and the assessment of the bank's capital adequacy.

Box 4.2 **The ICAAP**

The Internal Capital Adequacy Assessment Process (ICAAP) is intended to ensure that the banks maintain an adequate level of capital which will serve as a buffer for all of the risks implicit in their businesses and to encourage the banks to develop and implement appropriate processes for the management of risk. The process combines, among other things, the setting of capital targets, capital planning processes and the assessment of capital using a variety of stress tests. At the same time, the Bank Supervision Department will review and evaluate the bank's ICAAP in a process known as SREP (Supervisory Review and Evaluation Process) in order to ascertain whether the level of capital and the capital targets are adequate, in addition to requiring modifications that strengthen corporate

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governance, risk management and internal auditing. As part of this review, the Bank Supervision Department will likely require an addition to capital by the bank. The review of the ICAAP by the Department is part of the working framework for risk-based supervision (RBS) which evaluates, among other things, a bank's risk profile and its quality of risk management.

The ICAAP should consider the bank's strategic plan and how it takes into account macroeconomic factors. In addition, the bank should decide on an internal strategy for maintaining capital levels, which takes into account not only the current level of risk but also factors such as the expectations of an increase in loans, future sources and uses, the dividend distribution policy and any change in capital requirements as a result of changes in the economic situation, as required by the First Pillar.

The bank will have a clear and approved capital plan that will include the bank's goals and the time horizon for their achievement, as well as a general description of the capital planning process and the factors in this process. In addition, the plan will describe how the bank intends to comply with capital requirement in the future and any other relevant capital restriction and will include an outline of how unexpected events will be dealt with (for example, through the raising of additional capital, the limitation of business activity or the use of techniques for risk reduction).

The bank will carry out appropriate stress tests and will include them within the ICAAP results in order to ensure that its level of capital is sufficient to withstand these events. The stress tests will take into account, for example, the specific risk of the geographic areas in which the bank is active and the effect of changes in the business cycle. The bank will analyze the possible effect on its performance as a result of new legislation and the activities of competitors and other entities in order to determine which changes in its environment it can withstand.

The banks were required to present an ICAAP report to the Bank Supervision Department. This document presents an up-to-date and forward-looking evaluation of the bank or the banking group (according to circumstance) with respect to the level of exposure to various risks and the level of capital required now and in the future, as well as management and policy tools that were adopted for the management and reduction of risk and to ensure capital adequacy at all times. The ICAAP report will be used by the Bank Supervision Department in evaluating the process of managing the various types of risk and the allocation of capital against them and the bank's corporate governance environment in which the ICAAP is implemented. The report constitutes a basis for dialog between the Bank Supervision Department and the banks, which centers on the bank's main business results as they appear in the report.

3. BANK-CUSTOMER RELATIONS¹⁶

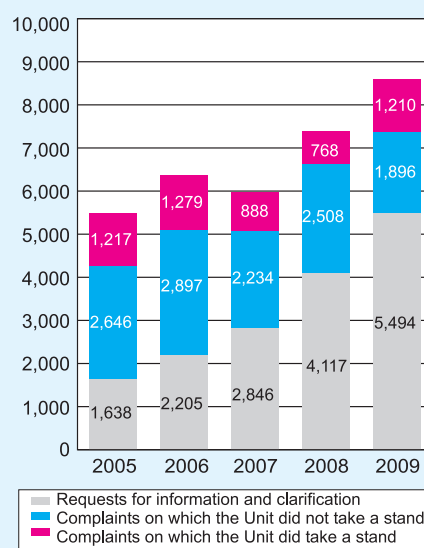
In addition to maintaining the stability of the banking system, the Bank Supervision Department also set targets for bank-customer relations. These include: maintaining fair treatment of the bank's customers, including the protection of consumer rights; the implementation and enforcement of legislation and regulations relating to bank-customer relations; the encouragement of competition in the banking system; and increasing the public's awareness of their consumer rights with respect to the banks.

In order to achieve these targets, the Bank-Customer Relations Division within the Bank Supervision Department works on several levels: the investigation of complaints or enquires from the public regarding the banks and credit card companies, including clarifications and provision of information; consumer regulation through legislation and Proper Conduct of Banking Business Directives in the area of bank-customer relations; compliance with the directives issued by the Supervisor of the Banks and other regulations by the banks and their enforcement; provision of consumer information to customers and increasing the awareness of their rights; management of the check without cover systems and solving problems that arise in this area; and the implementation and enforcement of regulations regarding bank fees, including increased transparency of the prices of banking services. Enquiries to the Bank Supervision Department can also be made by telephone and initial information and assistance is provided to telephone enquirers.

a. Results of the investigation of enquiries from the public

In 2009, the Bank Supervision Department dealt with 8,600 enquiries and complaints from the customers of the banks and credit card companies.¹⁷ These consisted of 3,106 complaints and 5,494 enquiries and requests for information (Figure 4.1). In the case of 1,735 complaints (not related to Heftziba), a position was taken as to whether they were justified or not.

Figure 4.1
The Total Number of Complaints and Enquiries Handled by the Public Enquiries Unit, 2005-09



SOURCE: Bank of Israel.

¹⁶ The activities described in this section are the responsibility of the Bank-Customer Relations Division within the Bank Supervision Department. See the organizational chart at the end of this Survey.

¹⁷ The Public Enquiries and Fees Unit of the Bank-Customer Relations Division is responsible for the activities described below.

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A total amount of about NIS 10.5 million was returned to customers as a result of justified enquiries and complaints that resulted in refunds to groups of customers (not including assistance to the Heftziba apartment owners).

Over the years there has been a significant upward trend in the number of enquiries and complaints by bank customers to the Public Enquiries Unit within the Bank Supervision Department, with their number doubling since 2000. The reasons for this include, among others, the efforts of the Department to make it easier to submit enquiries, including via the Internet, and exceptional events such as the collapse of the Heftziba Company and the reform of bank fees.

The data for 2009 presented below (not including complaints related to Heftziba which are discussed separately) show that 26.3 percent of the total complaints against the banks and the credit card companies for which a position was taken in 2009 were found to be justified (Table 4.1).

In recent years, there has been a noticeable downward trend in the proportion of enquiries and complaints related to mortgages, which fell to only 8.9 percent in 2009 as compared to an average of 17.4 percent in the previous three years (Figure 4.2). The Department attributes this decline to the comprehensive regulatory activity in 2007, which amended the procedures regarding availability of information to the customer,

Table 4.1
Distribution of Justified Complaints*, by Bank, 2009

	Number of complaints on which a decision was made ^a	Number of justified and partly justified complaints	Justified and partly justified complaints as percentage of those on which decision was made
Hapoalim	359	111	30.9
Mizrahi-Tefahot	284	93	32.7
Leumi	258	44	17.1
Discount	228	57	25.0
First International	103	34	33.0
Discount Mortgage	84	18	21.4
Yahav	60	17	28.3
Otsar Hahayal	57	13	22.8
Mercantile Discount	48	19	39.6
Leumi Mortgage	46	8	17.4
Union	42	7	16.7
Isracard	39	9	23.1
CAL	38	6	15.8
Other banking corporations	37	12	32.4
Leumi Card	22	2	9.1
Massad	20	5	25.0
Jerusalem	10	2	20.0
Total	1,735	457	26.3

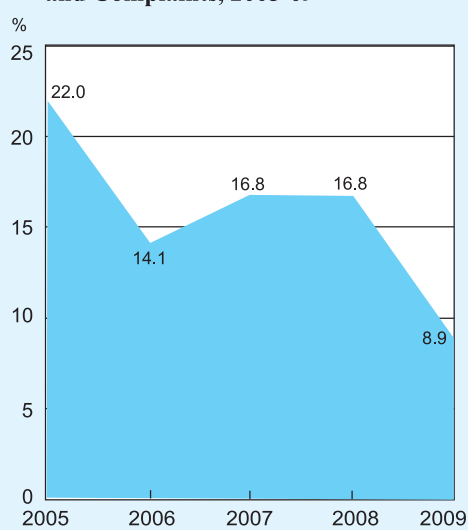
* Not including complaints related to the Heftziba construction company.

^a Justified, partly justified, or unjustified.

early redemption of loans and procedures relating to insurance policies. The regulation of these areas is meant to encourage competition in the mortgage market, primarily with regard to the recycling of housing loans.¹⁸

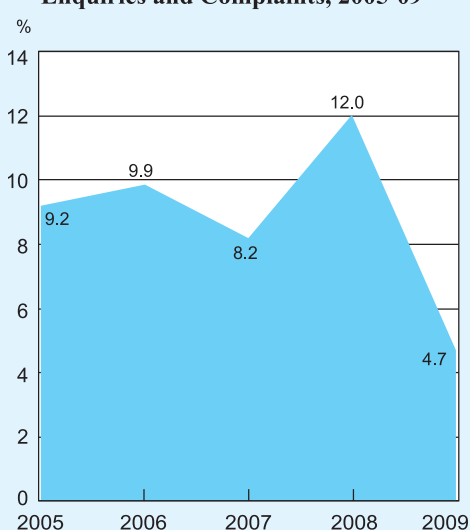
The significant decline in the number of enquires and complaints submitted to the Bank Supervision Department was also evident with regard to bank fees.¹⁹ In 2009, the proportion of enquiries in this area was only 4.7 percent, as compared to an average of 9.8 percent during the previous four years (Figure 4.3). The Department attributes this decline to the regulatory activity that was part of the reform of bank fees. Among the areas in which there was a particularly large decline in the number of complaints and enquiries were current account fees and the full disclosure of fees. In the past, enquiries relating to bank fees were among those most frequently submitted to the Department. The number of these enquiries reached a peak in 2008, during the preparations for the implementation of the reform of bank fees. As part of the reform, the prices of basic banking services were lowered, the total number of fees was reduced and the transparency of prices to the customer was increased.

Figure 4.2
Enquiries and Complaints about
Mortgages as Share of All Enquiries
and Complaints, 2005-09



SOURCE: Bank of Israel.

Figure 4.3
Enquiries and Complaints about Bank
Fees and Commissions as Share of All
Enquiries and Complaints, 2005-09



SOURCE: Bank of Israel.

¹⁸ The Regulation (Bank-Customer) Unit in the Bank-Customer Relations Division is responsible for consumer relations.

¹⁹ The Public Enquires and Fees Unit in the Bank-Customer Relations Division is responsible for the implementation of legislation regarding bank fees.

b. The handling of the Heftziba affair by the Bank Supervision Department

The Bank Supervision Department began to deal with enquiries regarding Heftziba near the time of the company's collapse in August 2007. Following the implementation of its positions in the banking system, the Department announced in March 2009 that enquiries regarding Heftziba should be directed to the banks from that point onward. The Department would only become involved if needed.

By April 30, 2010, the Heftziba apartment owners had been provided with assistance in the amount of about NIS 282 million as a result of the intervention of the Supervisor of Banks, according to the following breakdown:

- a. Guarantees were issued with respect to payments totaling about NIS 59 million that had been deposited in the projects' accounts.
- b. Conditions were cancelled for payments in the amount of NIS 98 million that had been secured by conditional guarantees.
- c. Payments in the amount of about NIS 74 million which had been deposited in the various Heftziba accounts were distributed to the projects' accounts.
- d. Guarantees in the amount of about NIS 43 million were issued regarding payments deposited in the projects' accounts.
- e. Payments in the amount of about NIS 8 million, which were deposited in various accounts belonging to Heftziba and for which there was no lending bank, were returned to the apartment buyers.

c. Handling of checks without cover²⁰

In 2009, the Bank Supervision Department dealt with 2,300 written enquiries related to restricted accounts and restricted customers and also dealt with telephone enquiries in this regard.

In addition, the Department dealt with appeals that had been submitted to the courts by customers who had been restricted according to the Law for Checks without Cover—1981. During the year, 951 new appeal files were opened in the courts. 1,079 appeal files—some of which had been opened in past years and some this year—were closed during the year once the deliberations were completed. In about one third of the cases, the restriction was cancelled following the deliberations.

Towards the end of the year, the Bank Supervision Department began to input reports on special restrictions (put in place by the courts in bankruptcy proceedings) received from the official receiver. It is expected that the input process of reports from previous years will be completed in the first quarter of 2010. As a result, the number of “special restrictions” in the system rose, as did the number of restricted customers and restricted accounts in the Bank of Israel's system for checks without cover.

²⁰ The activities described in this section are the responsibility of the Checks Without Cover Unit of the Bank–Customer Division of the Bank Supervision Department. See the organizational chart at the end of this Survey.

The number of regular restricted customers stood at 38,193 at the end of 2009, which represents a small increase relative to the previous year. In contrast, the number of restricted customers in serious circumstances declined somewhat and stood at 27,989 at the end of the year. The total number of restricted customers in the system stood at 110,408 at the end of 2009 (Figure 4.4).

The total number of restricted accounts grew to 194,553 at the end of the year, compared to 190,651 at the end of 2008, which represents an increase of 2 percent.

d. Bank fees

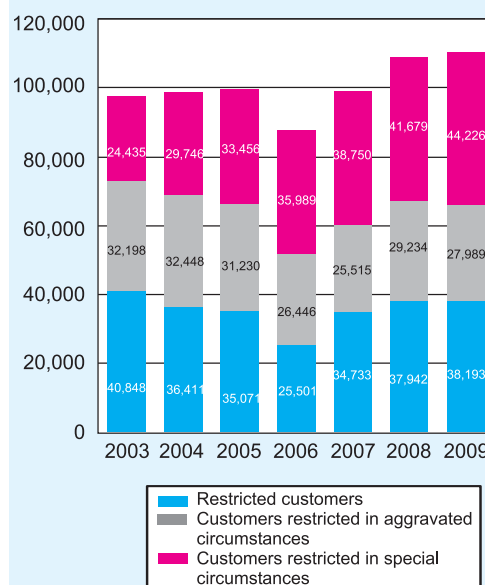
One of the objectives of the Bank Supervision Department is to increase competition and efficiency in the banking system.

In 2009, the Department continued in the exercise of its legal authority, including the monitoring of the prices of bank services, the publishing of price comparisons and information and enforcement.

In parallel to the regulatory activity to streamline the move from one bank to another, infrastructure was created to enhance price competition among the banks and credit card companies in the household sector. With increased consumer awareness among customers, banks are providing significant discounts on their official price lists.

The Bank Supervision Department is continuing in its efforts to increase the transparency of prices also through the publishing of price comparisons and the provision of calculators for comparing costs according to a personal consumption profile. One of the reasons this is being done is to assist the customer in assessing terms, in carrying out negotiations with the banks and in choosing the best terms. At the same time, the Department is continuing its gathering of data on the prices of banking services, its reporting to the Knesset and the public as to the effect of the reform on the household sectors for the five large banking groups and its presentation of comparisons of the actual bank fees paid by the public.

Figure 4.4
Number of Restricted Customers, 2003-09



SOURCE: Bank of Israel.

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APPENDIX 4.1

ACTIVITY OF THE BANK SUPERVISION DEPARTMENT IN 2009

January 1

An examination showed that the valuation of assets in high-risk countries and the estimated credit risk with respect to borrowers whose main activity is located in those countries does not sufficiently take into consideration the significant component of uncertainty that is a result of the unique characteristics of those countries. Therefore, the banks were asked to include a separate description of credit policy towards borrowers whose main activity is located in these countries and/or debts whose source of repayment is based on assets located in those countries. The description will include, among other things: a list of countries and/or regions and their characteristics, quantitative restrictions with regard to the aforementioned credit exposure, the approach that would be used in providing credit, the methodologies for classifying credit as problematic and the provision for doubtful debts.

In addition, it is required that the aforementioned approach be applied for the classification of debts as problematic and/or the creation of the provision for doubtful debts against them already in the reports for December 31, 2008.

January 11

As part of the adoption of the Financial Stability Forum (FSF) recommendations and in view of the crisis in the financial markets, explicit requirements were included in the Directives for Reporting to the Public with regard to the disclosure of a bank's exposure to certain types of instruments.

February 11

In order to convey to the public that the auditing of the bank's financial statements is carried out in accordance with the highest existing standards and in order that the users of these financial statements be aware of the standards according to which the accountant's audit was performed, a Proper Conduct of Banking Business Directive was issued regarding "The Auditing Accountant: Performance of an Audit and Review according to Specific US standards".

March 2

In view of the global financial crisis and the decline in the value of financial assets, and in accordance with published information in the US, a clarification was issued as to which conditions are to be fulfilled for the banks to be required to recognize a loss due to the drop in value of securities and what documentation is required in order to support the conclusion that the drop in the value of the securities is temporary.

April 5

As part of the adoption of the FSF recommendations and with the goal of reducing the risk resulting from excessive compensation schemes, the banks and corporations under their control were required to adopt appropriate compensation policies no later than December 31, 2009.

May 14

In order to make it easier to provide credit, the Supervisor of Banks distributed a letter in which he related to the calculation of the additional provision for liabilities for which the bank does not have an up-to-date financial statement, i.e. receivables that were purchased in factoring transactions.

June 7

In view of the progress in the adoption of international standards in Israel, an outline was sent to the banks concerning the adoption of international standards of financial reporting.

The target date for reporting by the banks according to international standards with regard to activities that are not within the bank's core business is January 1, 2011. From that date onward, the banks will be required to update their accounting treatment of these areas on an ongoing basis, in accordance with the directives for the transition to the new international standards that are to be published and in accordance with the clarifications to be issued by the Bank Supervision Department.

The preliminary target date for banks to begin reporting according to the international standards with respect to activities within the bank's core business is January 11, 2013 and the final decision in this regard will be made during 2011.

June 9

Recently, there has been increasing use of the Internet to carry out illegal transactions, such as illegal gambling, and there has been increasing involvement of organized crime in these activities. This situation increases the exposure of credit card companies to exploitation for the transfer of funds as part of money laundering activities. As a result, the Bank Supervision Department issued clarifications regarding the management of risks arising from the use of credit cards for the performance of illegal transactions via unsigned transactions (e.g., by phone or internet).

June 11

In view of the increasing exposure to environmental risks, the banks were required to recognize that the identification and estimation of environmental risk is part of an appropriate process of risk assessment for a bank and to work towards the assimilation of the management of exposure to environmental risk as part of the array of risks facing the banking group. This includes procedures for identifying material risk when providing

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credit and the inclusion of risk assessment in the periodic assessment of the quality of credit that has already been provided.

June 15

Amendments were made to the Directives for Reporting to the Public with respect to the requirements of Clause 404 of the Sarbanes-Oxley Law as specified in the Proper Conduct of Banking Business Directive for “Monitoring and Procedures Regarding the Disclosure and Internal Auditing of Financial Reports”.

August 17

On May 16, 2009, Amendment no. 29 to the Law of Debt Collection–1967 went into effect. Among other things, it introduces significant changes in the alternative housing arrangement. Due to a lack of clarity regarding the application of the law and its scope regarding various events that occur during the life of a loan guaranteed by housing collateral or a mortgage on a residential home, a letter was sent to the banks clarifying the position of the Bank Supervision Department regarding various scenarios in this context.

August 18

As a result of the increase in new floating-interest-rate housing loans, the banking corporations were required to act with the necessary caution in marketing and making such loans available. Emphasis was placed on the ratio of the monthly repayment to the borrower’s income also at rates of interest higher than that prevailing when the loan was made.

August 18

In order to make it easier for the public to receive announcements according to the Rules of Banking (Service to the Customer) (Full Disclosure and Provision of Documents)–1992, by means other than Israel Post, the Bank Supervision Department issued a bulletin that describes the notifications that the banks can send by means of email or via the bank’s Internet site and the conditions for doing so.

August 24

As a result of the introduction of a new instrument, i.e. repo transactions in government bonds and *makam*, which will be carried out through the MTS system and the TASE clearinghouse, which serves as the central counterparty for these transactions, and in order to reduce the uncertainty implicit in this instrument and make it possible for the banks to prepare for activity in this area at the earliest possible opportunity, clarification was provided regarding the allocation of capital required from the banks against these transactions.

August 25

Following enquiries by the banks regarding the securitization of housing loans which they are planning, the Bank Supervision Department consolidated its positions on the fundamental issues that arose during the processing of these enquiries and issued a consolidated version regarding the traditional securitization of housing loans in Israel.

September 6

The publication of new accounting standards in the US regarding the transfer and service of financial assets and the consolidation of variable-interest entities significantly changes the accounting treatment of transactions involving the transfer of financial assets in general and in particular redefined the conditions required for a bank to remove financial assets from its books through securitization transactions and to consolidate special purpose entities. As a result, banks were required to ensure that from January 1, 2010 onward their accounting treatment, including disclosure, is in line with the revised version of the relevant accepted accounting practices in the US.

September 17

Liabilities of corporation whose main business is infrastructure projects in the process of being built are classified in the Construction, Real Estate and Building Materials Manufacturing and Commerce industry since projects of this type are subject to significant construction risk. As a result, some of the banks are approaching the industry limit established in the Proper Conduct of Banking Business Directive 315 and exceeding that limit requires an additional provision. Therefore, the directive was amended and the restrictions were eased regarding the calculation of surplus indebtedness in the construction and real estate industry for a bank that meets the conditions stated in the directive.

October 12

As a result of the global crisis, the banks were required to give special attention to the financial situation of sensitive populations of borrowers, including, among others, companies with a relatively high rate of leverage, borrowers who finance their activity in the capital market to a significant extent and are depending on that to recycle their debt, borrowers whose main activity is located in countries that have experienced crises in their main area of activity and borrowers whose repayment ability is based to a significant extent on performing assets whose level of liquidity has declined. The banks have been asked to create a list of characteristics according to which such borrowers will be identified. After their identification, the banks will be required to determine whether there is a need to change the internal rating for these customers and also to identify customers with whom the bank will be required to reach a debt arrangement, require stronger collateral and classify as problematic or create a provision for doubtful debt for them.

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October 13

Following the publication of temporary directives regarding a “Working Framework for the Measurement and Adequacy of Capital” (Basel II) and “Quarterly Reporting on the Measurement and Adequacy of Capital” (Directive for Reporting to Bank Supervision), disclosure requirement that were included in the Third Pillar of the Basel II Working Framework were integrated within the Directives for Reporting to the Public. The disclosure requirements are aimed at helping users of reports to the public evaluate important data that is included within them regarding the implementation of the Basel II recommendations concerning capital, exposure to risk and the risk assessment process and accordingly to assess the bank’s capital adequacy.

December 10

In view of the findings regarding the regulatory measures taken by the banks and in view of the events of the global financial crisis, a letter was issued that requested the response of the banks on the following points in order to strengthen the system for credit risk management:

1. Leveraged financing.
2. Dependence on personal guarantees.
3. Amortization tables which are shorter than the term of repayment ability according to the assessment of the bank.
4. Classification of debts as debts in rescheduling of problematic debt.

December 10

As part of the response to enquiries from the public it was found that in the case of early redemption of loans resulting from the payment over time of credit transactions using a credit card, some of the credit card companies collect an early redemption fee for each loan, based on Part 3 of the full list of fees found in the first addition to Banking Rules (Service to the Customer) (Bank Fees)–2008. Therefore, the Bank Supervision Department issued a clarification stating that due to the special character of these loans, whose goal is the redemption of credit provided for credit card transactions, the issuers are not permitted to collect an early redemption fee for each and every one of the loans of this type but rather one fee only for the early redemption of all the transactions, in accordance with Part 6 of the full list of bank fees.

December 22

In accordance with the guidelines of the Basel Committee and the European Committee of Banking Supervisors, a document was published which defines the position of Head Risk Manager and the function of risk manager in a bank and describes their status, function and responsibility.

The banks were required to make preparations for the implementation of the guidelines and to submit the planned structure of risk management to the Bank Supervision Department by March 31, 2010.

December 31

Following the publication of US standards regarding “Measurement of Fair Value” and “The Fair Value Option for Financial Assets and Liabilities” and the publication of guidelines and clarifications regarding internal auditing of the fair value valuation of financial instruments, an additional goal of the amendment is to integrate the following standards for financial reporting within the Directives for Reporting to the Public:

1. Accounting policy, accounting changes, changes in the exchange rate, profit per share, share-based payment, hyperinflationary economies and interim reports.
2. Amalgamation of businesses, consolidated reports and investments in subsidiaries.
3. Decline in the value of assets, leasing, fixed assets and real estate for investment.

