



ISRAEL

**REVIEW OF THE FINANCIAL
SYSTEM**



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

This review of Israel by the Committee on Financial Markets (CMF) was prepared as part of the process of Israel's accession to OECD membership.

The OECD Council decided to open accession discussions with Israel on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Israel to become a Member of the Organisation on 10 May 2010. After completion of its internal procedures, Israel became an OECD Member on 7 September 2010.

The CMF was requested to review Israel's financial system, including its market and regulatory structure, to assess whether it is market-oriented and sufficiently open, efficient and sound, based on high standards of transparency, confidence and integrity, for Israel to be able to accept the requirements of membership in the area of financial markets. The present report was finalised on the basis of information available in September 2009. It is released on the responsibility of the Secretary General of the OECD.

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I. INTRODUCTION AND OVERVIEW^{1 2}

Israel is making solid progress in building a modern, competitive and open financial system. Through the mid-1980s, the government took a very active role in the allocation of resources, using direct government credits, capital grants and guarantees. Meanwhile, persistently high inflation contributed to financial repression and through the early 1990s nearly all financial assets were indexed to inflation or to foreign currencies, mainly the U.S. dollar. Exchange controls were pervasive and there was limited foreign presence in the financial system. The system was dominated by banks, while capital markets were rudimentary. Moreover, banking assets were highly concentrated, with the three largest institutions controlling 85% of assets, and most of the banks were eventually nationalised.

Since the mid-1980s, the country has undertaken significant deregulation and liberalisation while the role of market forces has expanded. Reserve requirements, which had been as high as 60%, were lowered significantly while much of the apparatus to distribute credit throughout the economy was dismantled. Capital controls were gradually relaxed. Banks were privatised and competition encouraged. A major programme to develop the capital market was launched. These reforms continued through the 1990s. Despite the growth of capital markets, however, a small number of banks continued to dominate all facets of financial intermediation with competition rather limited.

In recent years, the government has sought to lessen the domination of banks over financial intermediation and increase competition in the financial market. Following the recommendations of the Bachar Commission in 2005, measures were introduced to encourage intermediation through the capital markets and to encourage diversification in forms of wealth holding. Consequently, non-bank sources now account for a rising share of credit to the business sector while domestic bond and equity markets have expanded considerably. At the same time, gains in raising competition at the retail end of the market have been less impressive.

A. Macroeconomic Context and Trends in Financial Markets

Structural reforms in the financial sector have been accompanied by sustained efforts at stabilisation and improved macroeconomic performance. The government deficit was reduced sharply as a share of GDP during the 1980s. A reform program of 2003 further strengthened government finances. In recent years the budget has moved into surplus. However, government debt still stands at around 80 % of GDP, down from almost 160% in the mid-1980s. Inflation, which had reached triple digits in the 1980s, declined from about 20% annually in the early 1990s to about 5% by the year 2000 and has moved into line with world levels in later years. The inflation rate has fluctuated within the central bank's target range of 1-3 % since the year 2000.

¹ This document has been prepared by John K. Thompson on the basis of the responses of Israel to the CMF Accession Questionnaire and selected outside sources.

² This review is not intended to cover the territories known as the Golan Heights, the Gaza Strip or the West Bank. However, for technical reasons, this review uses Israel's official statistics, which include data relating to the Golan Heights, East Jerusalem and Israeli settlements in the West Bank.

Following a steep recession in 2001-2003, GDP growth exceeded 6 % on average in 2004-07. The unemployment rate peaked at 11 % in 2003.

Through the mid 1980s, the exchange rate for the shekel (NIS) was depreciated in line with the differential between Israeli and external inflation, first with respect to the US dollar and with respect to a basket of currencies after August 1986. In 1991, the country shifted to a “diagonal band” in which the exchange rate would be managed inside a predetermined range. The width of the band was widened through the 1990s. Since 1997, the currency has been floating freely.

The Israeli economy is very open, with both exports and imports amounting to over 40 % of GDP. There has been a surplus in the current account of the balance of payments in the past few years. Large capital inflows, both portfolio and direct investment, have been essentially matched by outflows of Israeli capital as domestic residents, corporations, and institutional investors diversify their portfolios. Thus there has been no serious appreciation pressure on the shekel despite the large gross capital inflows of recent years. However, the central bank has recently been buying foreign currency in order to build reserves.

B Real Economic Activity since the Beginning of the Global Financial Crisis.

Economic activity, which held up reasonably well during 2007 and the first half of 2008, has plummeted since August 2008. GDP declined 1.6 % in the fourth quarter of 2008 and 3.9 % in the first quarter of 2009 (quarter on quarter, annualised rates). Unemployment rate has increased from 5.9 percent in the last quarter of 2008 (a 20-year low) to 7.6 % in the first quarter of 2009 when real wages also started to decline.

The decrease in GDP is low compared with other advanced economies, especially the US and Europe. The reason is probably the good starting position of the Israeli economy including a) five consecutive years of high growth b) a positive net external investment position and a current account surplus c) a stable and conservative banking system d) a reasonably priced real-estate market, and e) credible and sustainable fiscal and monetary policy.

The decline in GDP mainly results from a sharp fall in aggregate demand, especially in the demand for Israeli exports, while supply side factors seem to have played only a minor role. The central bank (BOI)'s survey of companies showed that in all sectors the effective constraint on activity is the low level of demand.

While monthly indicators for the first quarter of 2009 indicate that exports and private consumption have stabilised, other indicators suggest that economic activity is still decreasing, but at a lower rate than in the previous quarter.

C. Trends in Financial Markets since the Crisis

Since 2003, expectations that the favourable macroeconomic conditions and structural reforms of recent years would continue have underpinned continued growth and diversification of the financial system. Some manifestations of this improved climate were declines in the real interest rate and risk margins resulting in a lower cost of capital for firms. The basic trend in the financial system remained positive through the first half of 2007. Share and bond prices continued rising, concurrent with a further increase in liquidity and trading. Risk premiums remained at historically low levels, while business-sector share and bond issues surged, and the profitability of the banks and institutional investors remained high.

In the second half of 2007, the pattern of unbroken gains ceased, mainly owing to the global crisis, which began in the US subprime sector (hereafter: “the global crisis”). After July 2007 the system was characterised by increased volatility and rising risk margins as well as by a correction in asset prices (see Table 1). While the impact of the global crisis on Israel has been less painful than in most developed countries, pressures have been mounting as the crisis has spread globally.

Through mid-2009 financial institutions, including the banks, continued to exhibit resilience and bank credit to the public continued to grow. The banks continue to be profitable (ROE 5.8 percent), well-provisioned and well-capitalised (11.5 percent). While NPLs increased moderately, their share of total loans is only 1.2 percent.

D Measures taken in reaction to the crisis

The global financial crisis affected the availability of credit, and most of the measures introduced were aimed at alleviating that problem. The main steps taken were:

1. The Ministry of Finance made NIS 6 billion of state guarantees available to the banks as guarantees for the issue of subordinated notes to increase their Tier 2 capital. These guarantees would enable banks to raise capital at reduced cost, thus enhancing the ability of banks to increase the supply of credit to the business sector and the general public. However, thus far no bank found it necessary had to use this guarantee.
2. Against the background of the world financial market crisis, there was concern that the unprecedented amounts of corporate debt maturing in 2009 and 2010 would swamp the Israeli corporate bond market at a time when investors were turning more cautious. Since there was no lack of liquidity in the Israeli capital markets, the Government felt that the most appropriate way to tackle this problem was through the creation of “value multipliers” and through risk sharing with the private sector. Investment funds (“leverage funds”) were established to increase credit from non-bank sources. The Ministry of Finance together with the long-term institutional investors (provident, pension and insurance funds) provided capital to establish “investment funds” to grant loans to corporations that carry out more than half of their activity in Israel. The government bears the initial risk of the investment up to a stipulated amount and receives part of any profit. So far three funds have been set up, with a total volume of NIS 4.5 billion with a total government commitment of 1.1 NIS billion. (Long-term institutional investors have contributed three times as much as the government's investment in the funds.)

Since the announcement of this program at the end of 2008, the Tel-Bond 60 broad index of corporate bonds has gained more than 15 percent, taking it back to its pre-crisis level. Risk premiums have narrowed, and activity in the primary market has picked up: Issuance in the first half of 2009 amounts to 16 billion NIS, as compared to 22 billion NIS for all of 2008.

3. The sharp falls in the domestic security markets caused heavy losses in the public's savings, including pension savings. To address the loss in the value of the savings of those close to retirement, the government activated a two-stage program to protect the savings of senior members of pension funds: 1) As a long-term solution the Ministry of Finance is preparing a comprehensive regulatory reform which will incorporate age-related investment channels, so that by increasing the share of low-risk assets in the portfolio the risk in savers' investment portfolios declines as the saver approaches retirement age; 2) As a solution to the immediate problem, the government established a “safety net” in order to ensure a basic pension for those close to retirement (more than 57 years or older) whose pension savings are significantly exposed to the capital market.

4. Against the background of the reduced availability of credit and the difficulty faced by small³ and medium-sized enterprises⁴ (SMEs) in obtaining bank credit, the government established special funds. The sum allocated to the small enterprise fund is NIS 180 million while NIS 260 million was allocated to the medium-sized enterprises fund. It was also decided to ease conditions for obtaining loans from the existing "sole exporter" fund, and to increase the sum allocated to this fund to NIS 80 million. In addition to these amounts provided directly by the government, banks that were successful in the tender agreed to make further sums available from their sources. The total amount provided by the government to the business sector from the funds is around 1 billion NIS, while the sources available under the funds total NIS 2 billion.

Table 1. Main Indicators of Developments in the Financial Markets during 2007

	2007	2008	Sep-09
Prices (change during period, percent)			
General share price index	23	-46	55
"Yeter-50" price index ¹⁾	-4.9	-73.0	142.5
Index of fixed-interest unindexed government bonds	2.4	12.5	1.5
Private bonds index	3.5	-14.0	27.3
Total during period, NIS billion			
Gross private sector issuing in Israel	20.1	17.9	1.557 ²⁾
Accumulation in mutual funds	8	-21.4	22.3
Risk indices (period averages, percent)			
CDS premium	22.5	97.2	177.2
Standard deviation of changes in NIS/\$ exchange rate ³⁾	7	15	13
Standard deviation of general share price index ³⁾	14.4	24.3	21.4
Standard deviation of unindexed government bond prices ³⁾	3.2	3.8	4.9
Probability of sharp depreciation of shekel against the dollar ²⁾	3.7	14.0	12.6
Implied volatility of NIS/\$ options ²⁾	9.8	15.1	14.9

¹⁾ The Yeter ("other") index consist of the main market stocks that are not included in the TA-100 index

²⁾ January-August 2009

³⁾ 10-day rolling period

Source: Based on Tel Aviv Stock Exchange data.

The relatively moderate impact of the crisis on the local markets and the continued improvement in the resilience of financial institutions in Israel reflected a) Israeli financial institutions' limited exposure to the subprime market--and international mortgage markets generally, b) the low reliance on bond finance in the domestic mortgage market, and c) the local banking system's low dependence on credit from abroad. The lack of advanced money markets and limited securitisation cushioned the impact of the global crisis on Israel, although the undeveloped state of these markets adversely affects the development of the financial system and the diversification of the risks within it. By most measures, the financial system's ability to absorb shocks increased in 2007. Banks' credit risks declined while their capital adequacy was maintained.

³ Business with no more than 70 employees, and whose last annual turnover did not exceed NIS 22 million.

⁴ Businesses whose annual turnover is between NIS 22 million and NIS 100 million.

While the banks have fared rather well, especially in comparison with those in advanced countries, capital markets and non bank financial institutions have come under strain.

E. Summary

The country has made substantial strides in introducing a market-based financial system and in achieving integration into the world financial system. However, partly owing to the legacy of inflation and heavy intervention, the financial system is still less advanced than in most OECD countries in several respects. Thus, financial intermediation is still dominated by a small number of banks and their affiliates. Inflation-indexed assets and assets denominated in foreign currency still represent a sizable share of the total financial market. Although indexed assets' share in the total system declined sharply during the period of stabilisation in the 1990s, inflation indexed assets still account for about 40% of the total and foreign currency indexed assets for another 20% (see Table 2).

Table 2. The Financial Asset Portfolio of the Public⁵, by Indexation, 2004–08

The Financial Asset Portfolio of the Public, 2005–08								
	Balance (NIS billion)				Composition (percent)			
	2005	2006	2007	2008	2005	2006	2007	2008
Total assets	1,648.5	1,837.0	2,057.9	1,884.6	100.0	100.0	100.0	100.0
Nominal change on previous year (%) ^a	16.0	11.4	12.0	-12.1				
Tradable assets in the portfolio (%)	47.4	50.2	52.6	42.1				
Assets by indexation								
Unindexed assets	501.5	542.8	567.6	668.8	30.4	29.5	27.6	35.5
CPI-indexed assets	521.7	547.7	609.2	660.9	31.6	29.8	29.6	35.1
Assets in or indexed to foreign currency	258.5	280.0	307.2	290.6	15.7	15.2	14.9	15.4
Shares in Israel	310.7	392.9	492.6	211.9	18.8	21.4	23.9	11.2
Shares abroad	56.1	73.5	81.4	52.4	3.4	4.0	4.0	2.8
Total assets, by indexation (excluding shares and the government's undertaking to help the old pension funds)								
	1,281.8	1,370.5	1,484.0	1,543.5	100.0	100.0	100.0	100.0
Unindexed assets	501.5	542.8	567.6	668.8	39.1	39.6	38.2	43.3
CPI-indexed assets	521.7	547.7	609.2	584.2	40.7	40.0	41.0	37.8
Assets in or indexed to foreign currency	258.5	280.0	307.2	290.6	20.2	20.4	20.7	18.8

The rate of change in 2008 is calculated after deducting the governments undertaking to help the old pension funds

Source: Based on banks' financial statements, and data from the Tel Aviv Stock Exchange and the Ministry of Finance.

Along with its structural reforms, Israel has been strengthening its capacity to provide effective financial supervision. The IMF and World Bank conducted a Financial Stability Assessment Program (FSAP) of Israel in September 2000. Subsequently, a report on the adequacy of Israel's financial supervision and compliance with international codes and standards (ROSC) was conducted. A follow-up report was issued in 2002. Generally, Israel's practices were found to be of good quality, but certain deficiencies were cited, most of which have been subsequently rectified. At the same time, a few recommendations have not been fully implemented. For example, revised central bank legislation has not been approved and formal deposit insurance has not yet been introduced. The IMF Article IV Consultation of February 2009 generally found that Israel was making continued progress in

⁵ Cash and deposits in banks, financial instruments (short term and long term bonds), long term saving vehicles including pensions and investments in stocks.

strengthening its financial system and its regime for financial supervision. The report urged Israel to continue its reform programme while adjusting specific measures to lessen the impact of the current global financial crisis on the domestic financial system. For example it was noted that the long term objective of introducing a system of limited deposit insurance should be balanced against the need to maintain confidence during the present crisis.

Finally, despite official policies favouring increased foreign participation in the financial system, actual foreign participation is low in comparison with countries of similar levels of advancement.

Despite the improved capacity of the supervisors to exercise effective oversight and of the banks to control their risks, other factors have been working to increase risk, such as a slowing of growth and the risk of contagion from the global crisis. Deregulation of markets, including deregulation of investments of institutional investors, has led to a proliferation of exotic investment instruments that often lack transparency and liquidity. The risk to the system has also increased as a result of the rapid expansion of intermediation by institutional investors, which have less experience in managing risks and are still subject to a less rigorous supervision than the banks.

The tendency of banks to move into new activities as a result of the continual pressures of competition and the resulting erosion of profit margins in traditional activities constitutes an additional challenge. The authorities consider it to be a high priority to make sure that banks understand the new risks they are taking and that activities not migrating to sectors where supervisory standards are less rigorous than in banking. In order to meet these challenges the supervisory authorities must increase their own skills so as to be able to operate in an environment of innovation and mobile capital.

The authorities recognise the need to accelerate modernisation of the financial system. Reforms to encourage competition and reduce concentration are important priorities as is the privatisation of Bank Leumi. The authorities indicate that they would welcome increased foreign involvement in order to inject more competition into the system. However, foreign presence in the financial system is relatively modest for a country's at Israel's relatively advanced level of development. Only four foreign banks are established in the country.

In addition to encouraging more competition, important measures to strengthen the legal and regulatory framework are under consideration. Among the concrete legislative and regulatory reforms planned for the near term are the following:

1. In order to build the capacity of the system to respond to crisis, legislation is under consideration that would heighten the independence of the central bank and provide a clearer mandate for central bank supervision of the payments and settlement systems.
2. Supervisory authority for insurance, provident funds (i.e. long-term saving vehicles) and pensions will be transferred from the Ministry of Finance to an independent entity.
3. A system of formal deposit insurance is examined.

In order to deal with future crises, clearer delineation of responsibility will be made among the central bank, the Finance Ministry and the supervisory authorities, while provisions will be made for increased coordination, cooperation and information sharing among these entities in preparing for financial crises.

In addition to these areas in which an objective of modifying laws and regulations has already been established, there are some areas in which the authorities have not yet decided upon an optimal approach. In this context, two important issues that will necessitate in-depth examination in the

coming years are: (1) the optimal institutional structure for the financial system, including a delimitation of areas of activity of financial institutions (banks, insurance companies and investment management companies), and the desired manner for integrating these institutions within financial groups. In the view of the authorities, in order to have competition in the financial services market it is essential to maintain a separation between the areas of activity of the banks and the insurance companies, and to prohibit the insurance companies from marketing plans with a guaranteed-yield component similar to deposits at banks; (2) the best institutional structure for financial supervision, including the relationship between the supervisors and the central bank.

As in other countries, Israel's policies to strengthen the institutional and supervisory infrastructure in order to enhance financial stability will in all probability be re-assessed in the light of the country's experience, as well as that of other countries, in confronting the present crisis.

II. THE ISRAELI FINANCIAL SYSTEM IN LONG-TERM PERSPECTIVE

Between the foundation of the state of Israel in the late 1940s and the mid-1980s, the financial system was characterised by a very high degree of government intervention and control. This reflected a broader policy of widespread government intervention in the economy for the purposes of resource allocation and income distribution. The government took a very active role in the allocation of resources, using direct government credits, capital grants and guarantees, particularly to support the exporting and manufacturing sectors. At the same time, persistently high inflation contributed to financial repression while indexing of certain financial assets to inflation was common practice.

The authorities pursued many policies that stifled the development of a dynamic financial market. The range of authorised financial instruments was relatively narrow. The government issued non-tradable inflation-indexed bonds to pension funds, provident funds insurance companies and banks at attractive real rates of interest, with most of the public's savings channelled through these instruments. Outside these privileged channels, there was limited development of institutional savings and limited flexibility in the investments of institutional investors. Pension funds were under the control of trade unions. Individual tax-advantaged savings instruments (provident funds), which were offered through bank subsidiaries, were subject to strict controls on investment. In effect, 78% of their portfolios had to be invested in indexed government bonds. In 1985, an estimated 90% of government bonds were "earmarked:" i.e. inflation indexed and non-tradable.

While raising large sums through debt issues, the government either lent these funds to the business sector or used the funds to finance its deficits, which were still very large at the time. Because the return on indexed bonds was so attractive only a small amount of savings was intermediated through the private market. Consequently there was little demand for even traditional long term investment assets such as equities and corporate bonds.

The system was dominated by banks with rudimentary development of capital markets. Most credit to the private sector was directed under various government programmes. Bank assets were highly concentrated with the three largest banking institutions controlling 85% of assets. The banks engaged in a very broad spectrum of activities, such as managing collective investment schemes (CIS), i.e. mutual funds, unit trusts and similar instruments, and provident funds, while also controlling subsidiaries that provided other financial services such as mortgage finance. Exchange controls were pervasive and there was limited foreign presence in the financial system.

Another important development in the 1980s was the collapse of most major banking groups. In 1983, the share prices of several large banking institutions listed on the Tel Aviv Stock Exchange (TASE) collapsed, resulting in nationalisation of most banks (See next section). Between 1973 and 1985, the economy suffered a widespread deterioration in performance, including a serious loss of control over fiscal expenditure. The growth rate declined, foreign debt increased sharply, and inflation soared to annual rates of several hundred percent.

A visual representation of reforms in the financial markets is presented in Figure 1. After 1985, a reform process began under which the country began to move away from its pattern of heavy government intervention and high inflation. The policy of channelling most funds in keeping with

government guidelines was gradually eased, with market forces assuming a growing role in resource allocation. Government subsidies to industry were cut back drastically. With liberalisation of exchange controls, firms had better access to foreign capital, which provided some additional competition. At the same time only modest progress was initially made in modernising the domestic financial system. Controls on product innovation were relatively strict while indexing was still prevalent.

On balance, the reforms of the mid-1980s strengthened the position of banks inasmuch as government intervention receded, leaving banks with increased discretion in credit decisions. Banks controlled much of the equity of non-financial firms either directly or through their affiliated CIS. While the capital markets expanded somewhat after the reforms of the mid 1980s, the banks maintained their dominance, as they also controlled capital market subsidiaries and most institutional savings through provident funds and CIS.

Beginning in 1993, the government began a major effort to accelerate the development and deregulation of the capital market. A series of measures designed to promote the development of the capital markets was implemented in 1993 and in 1995 a reform of the pension regime and a deregulation of provident fund investments gave institutional investors more flexibility in their portfolio allocations. Privatisation occurred on a significant scale and the private sector began to issue more equity. With the lifting of restrictions on access to foreign capital many Israeli firms began to issue abroad. In particular, many high-tech firms, where Israel is very competitive, have listed their shares on foreign exchanges, especially NASDAQ. As part of the liberalisation of capital markets, the government relisted the shares of most banks on the TASE over the period 1993-1998. As part of its privatisation policy, the government began divesting itself of ownership of banks, mostly through sales to controlling groups.

Despite the progress in developing the capital markets, many observers and policy makers became concerned about the still-dominant position of the banks and the conflicts of interest in the system, where banks were alleged to use their control over CIS and provident funds to channel resources to affiliated firms. Analysts also noted the high fees charged by funds as well as the low level of services offered by banks to retail clients. In order to address these concerns, the Government formed a Commission, headed by Dr. Bachar of the Ministry of Finance, to examine the financial system and propose reforms that would further reduce government involvement in the financial markets and promote competition by loosening the grip of the banking industry on all parts of the markets.

The Commission concluded that a competitive capital market should be based on three main processes:

- Enhancing competition in the management of the public's financial assets by developing alternative investment vehicles to those offered by the banks and by decentralising the management of existing investment vehicles.
- Enhancing competition in credit provision by developing non-banking credit instruments.
- Enhancing competition vis-à-vis the household sector by exposing households to alternative systems of credit suppliers and by considering measures that would make it easier to switch from one bank to another.

As a result, in 2005, the Bachar Commission proposed a series of reforms to mitigate conflicts of interest and to introduce a higher degree of competition into the system. With regard to the institutional savings market, the major recommendations of the report were:

1. Banks should not be permitted to control CIS or pension funds. In implementing this recommendation the banks were required to divest ownership of companies that managed from provident funds and CIS (mutual funds); however, banks were permitted to distribute CIS.
2. An underwriter should not serve in a price setting capacity for a firm of which it is a major creditor;
3. An underwriter should not be allowed to sell 5 % or more of the value of securities offered in an issue to itself and the totality of institutional entities in its group;
4. Limits on total control of markets by individual CIS were proposed;
5. Investment counselling and the marketing of "financial products" (including Securities and CIS) and "pension products" (provident funds, life insurance and pensions) should require licensing; and
6. Banks were to be permitted to engage in pension consulting and marketing of pension products.

Additional recommendations concerned the introduction of new instruments. Following these recommendations, regulations authorising commercial paper and repurchase agreements (repos) were introduced. Money market funds were authorised at the end of 2007. However, legislative reforms that would make possible the issuance of mortgage-backed and asset-backed securities (MBS and ABS) have not been implemented. Similarly, the Commission also recommended that institutions that are not members of the TASE be permitted to distribute CIS, but this recommendation has also not yet been implemented.

On balance the Commission's recommendations as well as continued competition from foreign suppliers of financial services especially in investment and capital markets services, have made conditions more competitive. Thus, the corporate bond market and other non-bank sources of credit to the corporate sector have been gaining ground in recent years. In recent years, the bond market emerged as alternative to bank finance and in recent years has been providing nearly 40% of total corporate funding. At the same time, stronger competition has mostly benefited the corporate sector. Gains in competition have been far less evident in the retail sector. Indeed, by some measures concentration in banking appears to be growing.

III. FINANCIAL INFRASTRUCTURE

A. Central Bank and Monetary Policy Framework

The Bank of Israel (BoI) was established in 1954, as the nation's central bank⁶. The law states that the BoI's functions are to administer, regulate and direct the currency system, and to regulate and direct the credit and banking system with a view to promoting (1) the internal and external stabilisation of the value of the currency and (2) high levels of domestic production, employment, national income and capital investment.

The Governor of the Bank is appointed by the President of the State on the recommendation of the government. The government, in consultation with the Governor, appoints one or two Deputy Governors. The appointments of the Governor and Deputy Governors are for five years, with possibility of reappointment. (However, the first appointment of a Deputy Governor is for four years.) The Law enumerates specific causes and breaches of conduct for which the appointments of the Governor and Deputy Governors may be terminated and also provides for termination due to policy disagreements with the government.

Similarly, the government appoints an Advisory Council to which the Governor must report on the formulation of monetary policy and all important steps to be taken to implement monetary policy.

The Governor also appoints an Advisory Committee to advise him on matters related to banking business. The members of this Advisory Committee come from banks, private sector, academic settings, the accounting profession, the Ministry of Finance, the Israeli Security Authority (ISA) and the public. Five members of that Advisory Committee, who may not be related to banks, serve as members of the Licenses Committee, which advises the Governor on the issuing of various licenses and permits.

The Chairman and the Vice-Chairman of the Advisory Committee also serve as the Chairman and Vice-Chairman of the Council, respectively. At least ten of the members of the Council must not be employees of a banking institution. Members of the Advisory Committee and the Advisory Council are appointed for two years and may be re-appointed.

There is a certain incongruity between the legal status of the BoI and actual practice. Since 1997 the BoI has been pursuing an inflation-targeting policy. However, the BoI still operates under the 1954 statute, which requires the central bank to pursue domestic and international stability of the currency as well as domestic growth, employment and investment. Currently the main goal of monetary policy is to achieve the inflation target set by the Government as the range of 1 – 3 % measured over the prior 12 months.

⁶ The Bank of Israel ("BoI") was established by the Bank of Israel Law, 5714-1954. The BoI is a statutory body, essentially independent of the Government, with defined powers and functions under the Law. See: http://www.bankisrael.gov.il/deptdata/pikuah/bank_hakika/eng/102.pdf.

Proposals to revise the central bank law have been under consideration for a decade. In the preparation of the new Bank of Israel Law, the focus has been, on the one hand, on assuring the Bank's independence in operating its policy instruments while on the other hand establishing mechanisms for public and internal controls to ensure that the central bank's independence goes together with responsibility, accountability and transparency vis-à-vis the executive, the legislature and the public.

According to the draft Law, a Monetary Committee will be appointed, which will determine monetary policy, monitor its implementation, and decide on the measures to be taken to achieve the Bank's objectives. The Monetary Committee will consist of six members: the Governor, who will serve as the chair, the Deputy Governor, a member of the Bank of Israel staff, to be appointed by the Governor, and three external members, with appropriate qualifications, to be appointed by the government on the recommendation of an ad hoc public committee. The draft Law states that a detailed summary of the Committee's deliberations and decisions, including the arguments put forward and the numerical result of the vote (without names), shall be submitted to the government and published. The obligation to publish is not restricted to the Committee's deliberations on the interest rate, but applies generally to all its discussions, unless the Committee believes the publication may jeopardise the status of the Bank or of the State abroad or the Bank's relations with financial entities abroad.

An Administrative Council will also be appointed which will discuss and approve administrative issues related to the Bank. The Council will consist of seven members: the Governor, the Deputy Governor, and five external members with the appropriate qualifications, who will be appointed by the government on the recommendation of an ad hoc public committee. The Council will appoint three of its external members (not the chair) as an audit committee. The role of the audit committee is to discuss problems discovered in the management of the Bank and to suggest methods to rectify them, in consultation with the Bank's Internal Auditor and Ombudsperson or its accountant.

The new Law will impose new more formal obligations governing publication of data, transparency and accountability. The Monetary Committee will report to the Minister of Finance every half year on the management of the foreign exchange reserves, and once a year will publish details of the main currencies and securities in which the reserves are invested, in such a way that will not adversely affect the proper management of the reserves.

The draft specifies that the Bank must publish a quarterly report intended to present to the government, the Finance Committee of the Knesset and the public the information, assessments and analyses relative the maintenance of price stability and the policies needed to achieve that objective. In addition, the Governor will appear before the Finance Committee of the Knesset every half year and report on inflation developments, and the Bank will present to the government and the Finance Committee, whenever they so require, reports on any matter relevant to the activity of the Bank.

Although legislative discussion of the proposed new central bank Law has been prolonged, there has recently been considerable progress toward enactment of the new Bank of Israel Law (the BOI Law) to replace the law of 1954. In accordance with the government resolution of July 5, 2009, the Ministry of Finance, in coordination with the BOI, will circulate a memorandum on the BOI Law to other government ministries, relevant bodies and the public, for comments. The comments will be incorporated by the Ministry of Finance into the draft law and the formulation will be coordinated with the BOI and the Prime Minister's Office, and subject to their agreement. The draft law is expected to be submitted for approval to the Ministerial Committee on Legislation no later than mid-September 2009.

The main instrument of monetary policy is the policy interest rate of the BoI, the rate charged for key transactions between the BoI and the commercial banks. The BoI announces a target value for this rate at the end of each month for the coming month. The targeted rate determines the level of the monetary base consistent with the announced target. The means of execution of this policy is through a daily auction of either loans (base expanding) or deposits (base contracting), depending on the banks' basic liquidity situation.

Beyond the auctions described in the preceding paragraph, which are closely linked to the conduct of monetary policy, the BoI provides a standing facility to the commercial banks that constitutes a liquidity "corridor" similar to the ECB, i.e., a deposit facility paying 1 % below the key policy rate and a collateralised loan facility, charging 1 % above the key policy rate. The BoI also provides a collateralised, real time intra-day credit facility to commercial banks to support smooth functioning of the Real Time Gross Settlement (RTGS) payment system (introduced August 2007) and will be providing liquidity support for operations in the CLS international payment system. (See next Section.) The BoI is also promoting the development of a repo market by offering one-week liquidity providing repo transactions, as appropriate. Recently, the BoI has begun to operate directly in the foreign exchange market after an absence of more than a decade. Currently, it is purchasing foreign currency in small amounts on a daily basis in order to add to Israel's level of reserves.

One noteworthy feature of the BoI balance sheet is the BoI's negative net worth, the result of large-scale foreign exchange sterilised intervention in the mid-1990s. This situation does not appear to have compromised the BoI's capacity to conduct effective monetary policy in any way.

B. Present Monetary Policy

The Bank of Israel (BoI) is now conducting monetary policy using three principal instruments 1) the BoI's interest rate, 2) foreign currency purchases and 3) purchases of government bonds in the secondary market. Since April 2009 the BoI's interest rate has been at its lowest rate ever (0.5 percent). Purchases of foreign currency started on March 2008 with the daily average volume of purchases increasing from \$25 million to \$100 million. In August 2009, the BoI announced that it will act in the foreign exchange market in the event of unusual movements. Following the adoption of this new operating policy, it discontinued its program of daily purchases of \$ 100 million. Since mid-February 2009 the BoI purchases government bonds (both nominal and CPI-indexed) in the secondary market, now at a daily average of NIS 200 million (USD50 million equivalent). As the purchases of bonds helped the capital markets to return to more normal functioning, particularly to the renewal of issues and raising of capital by the business sector, the BoI stopped in August 2009 buying bonds.

The excess liquidity that results from foreign currency and bond purchases is absorbed by the BoI so that the interest rate on the commercial banks' deposits at the Bank does not decline below 0.5 percent. In the past the major tool with which liquidity was absorbed was by issuing MAKAM (1-year nominal T-bills) so that the monetary base remained unchanged and the public's portfolio shifted from long- and medium-term bonds or foreign currency to short term T-bills, with the resulting change in relative yields. This procedure implies that the as long as the BoI absorbed excess liquidity using MAKAM it did not perform quantitative easing in the sense of increasing the monetary base, but its actions may be better described as "operation twist" i.e. of changing the slope of the yield curve without effecting the money base.

In April 2009, the BoI reduced the MAKAM issues and since that time excess liquidity is absorbed primarily by allowing the commercial banks to increase their deposits at the BoI (which are not considered part of the money base). This means that the public's portfolio shifts from foreign currency and/or bonds to currency or deposits. Public deposits provide most of the liquidity in the

commercial banks, and the banks do not use all the additional liquidity to offer loans – this liquidity (excluding a small fraction they are required to hold as reserves) is absorbed by the BoI as commercial banks deposits at the prevailing rate (0.5 percent). Consequently, the base expands only by a small amount while M1 expands considerably due to the very low interest rates.

It is worth mentioning that the BoI did not at any time purchase any corporate bonds or any other commercial paper. The Bank was only active in the government bond market and the foreign exchange market.

C. Payments System.

Over the last four years, the Bank of Israel has been leading a comprehensive reform of the payment and settlement systems. The centrepiece of the reform is the establishment of the Zahav system, which began functioning in the second half of 2007. The Zahav system allows the immediate and final settlement of large payments. The Zahav system is also the final clearer of all previously existing settlement systems, specifically the (a) paper-based clearing house (checks), (b) the automatic clearing house (Masav) system and (c) the Stock Exchange clearing houses. These clearing houses, with the exception of the Zahav system, transfer net data to the Zahav system at different times, with the net settlement being final.

The banks' clearing house is made up of the paper-based (checks) clearing house and the automatic clearing house (Masav). The clearing house operates according to an agreement between its members - the commercial banks, the Postal Bank, and the BoI. The banks' clearing house is managed by the Clearing House Committee, which acts according to the clearing house regulations determined by the Committee. This reform covers a number of aspects, such as the abolition of retroactive entries, extending the banking business day, and improving the process of clearing checks. In addition, check truncation planning has continued. At the same time, preparations are being carried out for the operation of check imaging and image transfer, before check truncation comes into effect. The paper-based clearing house is operated by Bank of Israel. Paper-based transmissions presented in the clearing house by the banks consist mainly of checks presented electronically. In addition, non-magnetic, i.e., manual, instruments are presented, as well as returns of checks.

The automated banks' clearing house (Masav), which is operated by the domestic banks, settles automated inter-bank automatic transactions that are not paper or cash. In addition, charges and credits are transmitted on to Masav directly by non-bank institutions.

The Tel Aviv Stock Exchange (TASE) clearing system calculates the net value of each bank's transactions and transfers the net results to the Zahav system for settlement. The clearing house settles all securities-related transactions and provides additional services such as interest, dividend and debenture redemption payments. In addition, the Stock Exchange clearing house settles payments in the Maof (options and derivatives) clearing house deriving from the purchase and expiry of derivatives. In recent years, the TASE has acted to receive delivery versus payment (DVP), in order to reduce risks. Since the introduction of the Zahav system, the transfer of the payment is simultaneous with the transfer of the security DVP. As part of the Zahav system, the TASE clearing house operates an intraday credit system (ICS), which provides the Bank of Israel with collateral for the intraday credit advanced to participants in the system.

While these earlier systems continue to function, the new large value payments system (Zahav) now links all of these systems. At the end of the current process of improving the payments system, it will comply with the international standards for payments systems set by the Bank for International Settlement (BIS). Each component of the system has its own features to insure minimisation of

operational risk while collateral for BoI lending insures stability. The reform process has not had any significant technical or conceptual problems.

As is accepted in other countries and in accordance with international standards, a Payment Systems Law⁷ was passed in order to provide is a strong legal basis for the activities of the Israeli payment system. Among other things, the Law determines the finality of payments settled in certain payment systems, establishes the Bank of Israel's authority for various important payment systems, and deals with the eventuality of a participant's bankruptcy. In order to permit the operation of the Zahav system, rules and agreements among the system's participants were defined. The system's rules cover all issues pertaining to its operation, including the finality of payment. The Zahav (RTGS) system enables the final and immediate settlement of bilateral transactions, and of net settlement of multilateral transactions of the clearing houses. The settlement is safe, and it is carried out by the Swift system.

Establishing the Zahav system helps to reduce the various risks existing in other settlement systems, especially systematic risk, settlement risk and credit risks. The system settles bank payments immediately and finally, so that, at any moment each participant's balance is final.

As planned, the Bank of Israel joined the Continuous Linked Settlement (CLS) in May 2008. As part of the process of joining the CLS, two Israeli commercial banks (Bank Hapoalim and Bank Leumi, with First International Bank of Israel as backup) became members of the CLS. Membership in the CLS allows an upgrade in payments in Israel in shekel and in foreign currency, permitting immediate and final payments in almost any currency.

⁷ Law 5768–2008.

IV. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: BANKING SYSTEM

At the end of 2008, there were twenty-four banking corporations, including fifteen commercial banks, two mortgage banks, one financial institution, two joint-service companies and four foreign banks.

Patterns of ownership of Israeli banks have been changing over time. In 1983 the share prices of several large banking institutions collapsed, partly as a result of manipulation of share prices by the bank's controlling shareholders. The government entered into an arrangement (the "Bank Shares Arrangement") under which the State gained controlling stakes in four of the five largest Israeli banks. (However, the State did not exercise direct management control over these banks). The shares of these four banks were delisted from trading on the TASE, with non controlling shareholders receiving government bonds in exchange for their shares. Among the five largest banks, the exception was the First International Bank which did not participate in the manipulation of its share prices and therefore did not suffer from the crisis. Its shares traded continuously with no interruption.

As part of the liberalisation program for capital markets, the government relisted the shares of the banks for trading during the period 1993-1998. As part of its privatisation policy, the government began to sell its shares in banks to the public (mostly to controlling groups); this process is continuing to the present. All banks, other than Bank Leumi, which amounts to about 30 % of the banking sector, have now been privatised. The Government plans to privatise Bank Leumi in the near future and it currently is searching for potential buyers (see Table 3).

Table 3. Privatisation of Major Nationalised Banks

Dates of Privatisation	Dates of relisting	December 1992	June 2009		
		Government	Govt	Significant Holders	Public
Bank Hapoalim 10/97	06/93	99.9	----	25.74	74.26
Bank Leumi In the process	09/93	95.0	11.46	9.59	78.95
Israel Discount Bank 01/2005	03/96	87.0	25.0	26.0	49.0
Mizrahi Tefahot Bank 10/94	06/98	97.0	----	45.66	54.34
First International Bank -----	01/93	-----	----	80.86	19.14

Source: Banking Supervision Department. Bank of Israel

The five largest banking groups⁸ account for approximately 95% of the banking market. A very large share of bank activities are denominated in foreign currency, about 38% of total assets and a

⁸ Bank Hapoalim, Bank Leumi Le-Israel, Israel Discount Bank, Mizrahi-Tefahot Bank and the First International Bank of Israel.

similar share of liabilities at the end of 2007 (see Table 4). These percentages have remained relatively stable in the past five years.

Table 4. Assets, Liabilities and Equity Capital of the Five Major Banking Groups (in millions of NIS)¹

	For Year Ending December 31,						
	2002 ⁽²⁾	2003 ⁽²⁾	2004 ⁽²⁾	2005	2006	2007	2008
Assets							
In local currency ⁽³⁾	463,542	475,377	478,557	511,926	534,529	596,811	677,247
In foreign currency	328,134	326,752	350,726	363,791	377,448	364,974	335,574
Total assets	791,676	802,129	829,283	875,717	911,977	961,785	1,012,821
Liabilities & Equity Capital							
In local currency ⁽⁴⁾	486,520	498,090	505,361	531,795	562,971	602,946	667,900
In foreign currency	305,156	304,039	323,922	343,922	349,006	358,839	344,921
Total liabilities & equity capital	791,676	802,129	829,283	875,717	911,977	961,785	1,012,821
Equity capital	37,959	41,793	44,364	47,812	53,490	58,574	57,707

(1) The five major banking groups are the Bank Hapoalim group, the Bank Leumi group, the Discount Bank group, the First International Bank of Israel group and the Mizrahi-Tefahot Bank group.

(2) The division into local and foreign currency for 2001, 2002 and 2003 was adjusted according to the published financial statements for those years.

(3) Including non-financial items.

(4) Including non-financial items, minority interests and equity.

Sources: Bank of Israel, Supervisor of Banks.

The number of domestic bank branches increased from 1,003 in 2006 to 1286 at the end of 2008. The gradual decrease in the number of commercial banks in recent years (from 22 at year-end 2002 to 15 at year-end 2008) is a result of the voluntary closing of very small banks and the amalgamation of several banks (including mortgage banks) into bank-led groups. The recent reduction in the number of very small banks is a result of the explicit policy of the BoI to encourage these banks to merge with larger ones or to exit. The official view was that the small capital base of these banks was hindering their ability to develop and maintain necessary managerial infrastructure, technology and controls.

In addition to commercial banking (including mortgage activity), the large banks also operate, via subsidiaries, in areas that complement their commercial banking activities such as credit cards. Banks are also the main players in capital market operations, where they mainly operate through subsidiaries. The banks also have holdings in non-financial companies, but investments in non-financial companies (including insurance companies) are restricted to 20 % of the shares of the each company without assuming any control. The total investment of a bank corporation in a non-financial company must not exceed 15% of the equity of the bank, but in exceptional circumstances this proportion may be increased to 25%.

As discussed above, the market power of the banks and the high concentration of banking assets in a small number of institutions have long been areas of concern for policy makers. Accordingly, in 2005 amendments to the banking laws restricted the activities of banks in capital markets as

recommended by the Bachar Commission. Banks were required to divest their holdings and management of provident and mutual funds. At the same time, banks were permitted to expand some non-banking activities such as 1) the provision of investment advisory services pertaining to pensions and 2) the purchase of insurance agencies that engage solely in providing life insurance and residential property policies.

Israel has no banks that specialise in retail services, other than mortgage banks. All commercial banks engage in retail activities via branches and serve small and medium-sized enterprises. Banks engage in mortgage lending either directly or via their specialised subsidiaries. One insurance company (CLAL) operates on the mortgage lending sector, and is the only non-bank mortgage lending entity in the country. “CLAL” has been operating in this sector since 1989 via three branches – in Jerusalem, Tel-Aviv, and Haifa.

Banks are also active in dealing with the corporate sector. Corporate banking is a main line of business for commercial banks. Bond and equity underwriting of securities is typically done by underwriting companies, which usually are bank subsidiaries. The majority of leasing operations is conducted by banks and their subsidiaries.

The concentration of banking assets as well as the relatively ineffective competition from non-bank and foreign institutions has meant that a small number of banking entities have exercised considerable power in the market. Comparison with other countries also shows that concentration in the Israeli banking system is higher than in most Western countries. In fact, as can be seen in Figure 2 an increase in concentration appears to have been occurring since the late 1990s, as measured by two commonly used measures of bank concentration – the Herfindahl-Hirschman index (the H index) and the Market Segment Index (CR2)⁹.

The resurgence of the market power of banks came after many years when their market power had weakened owing to the liberalisation measures in the money and capital markets. The grip that banks were able to exercise over all aspects of financial intermediation was the major factor that led the Bachar Commission to recommend special reforms designed to curb the power of banks. As observed in other countries, the market power that banks exercise over households is greater than their power over business firms.

The concentration in the banking system has had a positive effect on the banking system's profitability. Banks have been performing well in terms of profitability and asset quality in recent years. In 2007, credit extended to the public increased 9.0% (1.9% in 2006.) However, net-income increased by a mere 0.8% due to the sharp decline in non-recurring profit that amounted to NIS 1.7 billion in 2007 (compared to NIS 3.7 billion in 2006. Net income adjusted for non-recurring profits rose 45%. (In 2006, net income had been swollen by revenue from forced divestiture of the banks of mutual and provident funds following amendments to Israeli banking laws). The net return on equity (ROE) slightly dropped to 16.0% in 2007 (from 17.5% in 2006). However, after adjusting for non-recurring profit, the after-tax ROE on ordinary activity increased to 13% in 2007 from 10.3% in 2006.

⁹ The H index is defined as follows: $\frac{1}{n} \leq H = \sum_{i=1}^n S_i^2 = \sum_{i=1}^n (S_i - \bar{S})^2 + \frac{1}{n} = n\sigma^2 + \frac{1}{n} \leq 1$, where, S_i is the market share of bank or banking group i and n is the number of banks or banking groups in the banking system.

CR2 measures the dominance of the market share of Israel's two largest banks (Bank Hapoalim and Bank Leumi) in the non-indexed credit to the public (local currency) in relation to the total credit in the banking system.

The market power of the large Israeli banks has led to several anti-trust actions by the government as well as class action lawsuits. The Anti-Trust Authority conducted an investigation regarding “coordination” among banks of fees they charge their clients. At the end of the investigation it was decided to employ only civil measures and issue a "ruling" that the banks had unlawfully shared among themselves information regarding fees. This ruling may be used as evidence in a civil trial. The banks requested the Anti-Trust Authority to consider replacing the "ruling" with a consent order, and the Authority offered its agreement, subject to the imposition of heavy fines. The banks rejected this offer. Some banks are also involved in a separate class action regarding the “coordination” among them of credit interest rates. A court decision has been rendered, approving the submission of a class action against the banks, and they have appealed this decision to the Supreme Court.

Although Israeli banks have withstood the international financial crisis reasonably well, the impact of the crisis was not negligible. The five largest banks increased their expenses for loan-loss provision considerably, with expenses for loan provisions rising 186% - from NIS 1.78 billion in 2007 to 5.08 billion, in 2008. The ratio of this expense to total loans amounted to 0.72% in 2008 compared with a mere 0.28% in 2007. Most of the increase in this expense is attributed to lending to the construction and real estate, manufacturing and to the financial sectors. (see next paragraph).

Nevertheless, mortgage lending has held up fairly well and problem loans to all household lending (all consumer loans to individuals) increased by only 3.2%. The sum total (including mortgages) of non-accrual loans amounted to NIS 10.3 billion in 2008 an increase of 10.8% from the preceding year. However, the ratio of non-accrual loans to total loans remained steady during 2008, approximately 1.5%.

Israeli banks incurred losses due to the depressed asset prices in the capital markets which caused a decline in the income generated from the bond portfolio. This was a major factor underlying the 21.7% decrease in the net interest income (before loan-loss provision expense) that amounted to NIS 17.9 billion in 2008 (down from NIS 22.9 billion in 2007). A significant portion of this possibly resulted from the investment by a single large bank in the structured product market, particularly in “private label” mortgage-backed securities. This resulted in a NIS 3.9 billion loss during 2008 (NIS 1.2 billion loss recorded in 2007) which was reflected in the lower net interest income item.

The capital of the Israeli banks decreased by 1%, the first decline since the 2001-2 recession. The decrease was caused by the negative charge to the capital account of some NIS 5 billion attributed to provisions of a temporary nature due to adjustments made in the market value of securities (primarily mortgage backed related securities that are guaranteed by US government and federal agencies). Dividend distribution was very sparse and only two large banks disbursed for the first half of 2008.

Conversely, the total risk-based capital ratio of the five large banks reached 11.2% at year-end 2008 (Tier I ratio 7.5%) up from 11.0% (Tier I ratio 7.6%) at year-end 2007. The composition of Tier I capital of Israeli banks is of high quality grade inasmuch the Tangible Common Equity Ratio has been at more than 6% in the last two years. Israeli banks have issued only small amounts of preferred shares and innovative instruments.

Domestic activity of the five large banks increased 13.5% in local currency in 2008 credit to the public increased by 10.4%. On balance Israeli credit markets have continued to operate fairly well in contrast to the credit crunch that can be observed in most developed economies. This increase is partially due to the return of clients from the non-bank credit markets, which have been contracting.

Due primarily to the increase in expenses for loan-loss provisioning and the decrease in net interest income, the net income of the Israeli banks amounted to only NIS 205 million in 2008 down

sharply from NIS 8.9 billion in 2007. In 2008, net profit from non-recurring items was NIS 815 million, only half of 2007's non-recurring items. Overall, net operating profit was a negative NIS 610 million in 2008.

In light of the global financial crisis, the Supervisor of Banks undertook the following measures in order to maintain confidence in the banking markets and to enhance responsiveness to counter the adverse impact of this crisis.

- a) The Israeli banking groups are now expected to reach a total risk-based capital ratio of 12 percent by year-end 2009. This is targeted to coincide with the implementation of the Basel II regime in Israel. The Supervisor of Banks urges the continuous upgrading of the Israeli bank's risk management systems within the Basel II framework.
- b) The Banking Supervisor established ad-hoc task force teams to scrutinise the bank's risk exposures and to monitor their operations and liquidity positions. In addition, banks were required to meet several guidelines and to enhance transparency of financial reporting. The Banking Supervisor is taking a proactive approach in dealing with this crisis and conducts reviews via the supervisory functions in the Banking Supervision Department.

The Supervisor of Banks at the Bank of Israel announced that Israel will adopt the Basel II regime by the end of 2009. It is anticipated that at the preliminary phase of the Basel II regime, banks will implement the Standardised Approach to credit risk and the Basic Indicator Approach or the Standardised Approach to operational risk. The Banking Supervisor promulgated temporary directives regarding the Basel II framework incorporating the national practices, which incorporate the advanced methods for credit risk but not the advanced method for operational risk).

The banks participated in a quantitative impact study (QIS) in which the capability of the banks to operate under the Standardised Approach to credit risk was tested. The banking supervisors are now analyzing results of this test.

While the soundness of the banking system has been improving, the need to make further gains in the resilience of the system is acknowledged. In this context, in 2007 the Financial Stability Area of the BoI conducted a comparison of Israel to selected OECD countries, using the financial soundness indicators (FSI) of the International Monetary Fund (IMF). This international comparison was made possible for the first time by a new database set up by the IMF, as part of a project in which 60 countries have taken part. The database¹⁰ contains end-of-2005 data for various countries, based on a list of financial soundness indicators compiled by the IMF. The list includes some 40 indicators referring to the financial soundness of each of the components of the financial system: banks, non-bank financial institutions, capital markets, real estate market, business sector and households. The database also contains metadata on definitions and methods of calculation used by each country in compiling its data, which may not necessarily be the same from country to country.

The comparison using 2005 data shows that the banking system in Israel needs to improve in order to reach the average among OECD countries in the two most important fields of banking stability: capital adequacy and nonperforming loans (see Table 5). The leading indicator of capital adequacy—regulatory capital to risk-weighted assets—which measures the banks' ability to absorb losses at a time of realising credit risks, stood at only 10.7 % in Israel compared to 12.2 % on average among OECD countries. With respect to indicators of credit quality, the ratio of non-accruing credit to credit in Israel stands at a similar level to that of the average among OECD countries (2.3 %).

¹⁰. See www.imf.org/external/np/sta/fsi/datarisl.htm.

However this ratio deteriorates when nonperforming loans (NPLs) are defined more widely. If the definition includes debts in arrears, then the indicator reaches 3.1 %, and if the definition includes all problem loans, according to the definition of the Banking Supervision Department, then the indicator reaches 9.5 %. It should be noted that, during 2006-07, the ratio of regulatory capital to risk-weighted assets rose slightly and the rate of nonperforming loans, by most definitions, fell.

Table 5. Comparison of Israeli and OECD Banks, using IMF Indicators of Financial Stability

Indicator	2006	2005	
	Israel	Israel	OECD average
Regulatory capital to risk weighted assets	10.8	10.7	12.2
Nonperforming loans to total gross loans ^a	1.9	2.3	2.3
Net open position in foreign exchange to capital	1.8	- 0.5	19.5

^a Israel's figure is based only on problem credit not accruing income. Adding debts in arrears raises the figure to 3.1 percent, and adding all other problem loans raises the figure to 9.5 percent of total gross loans in 2005. For 2006 the figures are 2.6 percent and 8.4 percent respectively.

Source: Based on data from the International Monetary Fund and Banking Supervision, Bank of Israel.

The comparison showed that the banking system in Israel ranked differently on each of the financial soundness indicators of the IMF in comparison to OECD countries. For example, in terms of regulatory capital to risk-weighted assets, Israel's banking system was ranked 19th out of 23 OECD countries in 2005 (See Figure 3). In terms of NPL ratios Israel ranked 14th out of 22 OECD countries. In terms of net open position in foreign exchange to capital, Israel, with negligible net foreign currency exposure, ranked fourth out of 20 countries.

On balance the relative position of Israel (measured with respect to most OECD countries) has probably improved in the past few years, due in large part to the sharp deterioration in many major financial systems.

Comparison of various ratios involving non performing loans (NPLs) in Israel with those of other countries is complicated by the fact that Israel has no formal definition of non performing loans. Loans are categorised in accordance with BoI Banking Directives ¹¹ problem debts are assigned to different categories a) doubtful debt, b) debt not accruing income, c) restructured debt, d) debts in arrears, e) debts in temporary arrears and f) debts under special supervision.

The Bank of Israel defines non-performing loans as all indebtedness in the following categories as defined in the above directive:

1. "Debt not accruing income" – defined as: A debt, the interest on which is not credited to the profit and loss statement, a debt that was restructured and the indebtedness balance (including the accrued interest) prior to the new arrangement exceeds the expected receipts according to the arrangement, a debt in arrears¹², or any other debt the accrued interest on

¹¹ BoI Banking Directives: "Proper Conduct of Banking Business." Directive No. 314 – "Dealing with Problem Debts".

¹² Debt in arrears is defined as "The full amount of a debt if part of it has not been repaid within 90 days of its due date, with the exception of a debt which is temporarily in arrears. For this purpose, a debt in a

which is not regarded as likely to be collected even though the debt itself has not been defined as doubtful.

2. "Temporary arrears"- defined as: A debt in arrears, which the banking corporation's management regards as temporary and which does not indicate expected credit loss.

The loan portfolio shown on banks' financial statements are net of specific provisions. It is planned that from 2010 banks' financial statements will incorporate the US GAAP concerning impaired loans.

There is no formal deposit insurance scheme, however, the law specifies that (a) the Governor may decide to guarantee in whole or in part (1) deposits of a bank in which the BoI has intervened or (2) other classes of bank liabilities. The guarantee may be for a limited or unlimited time, subject to conditions or unconditional. The implicit government guarantee is a result of the precedent established in 1983 when the government saved the major Israeli banks by nationalising them. The authorities strengthened this precedent by guaranteeing the deposits of two small banks which failed in 1985 and in 2002. The Governor of the Bank of Israel is empowered to guarantee deposits upon receiving the Government's approval. In fact, the authorities have never permitted bank depositors to lose money and market participants believe that the government has an implicit guarantee for all bank deposits.

Foreign banks which operated in Israel in 1983, whether through subsidiaries or branches, did not need government intervention; nor did a few local banks. In a recent pronouncement on this subject, the authorities indicated that there would be no discrimination between local and foreign banks. Also the reform proposals that are currently being considered would include the deposits in subsidiaries or branches of foreign banks. The authorities indicate that if a formal deposit insurance scheme were to be established, there would be equal treatment of local banks and foreign banks' subsidiaries and branches.

checking account in excess of the authorised credit lines will be regarded as being in arrears if not repaid within 90 days, or if that account is not credited with sums sufficient to cover the debt under the credit lines within the period determined by the banking corporation. When a debt in a checking account is considered as being in arrears and it is possible to identify the specific debt which created the arrears, such debt will also be defined as a debt in arrears. When it is not possible to identify the debt that caused the arrears, all of the customer's indebtedness will be defined as a debt in arrears. Despite the foregoing, other debt of the customer (excluding the debt in a checking account) will not be considered as debt in arrears if:

- (a) It is possible to specifically identify repayments of the debt; or
- (b) It is not possible to identify such payments, but after the checking account was charged with the payment, the balance in the account was lower than the balance before the payment was made."

V. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: CAPITAL MARKETS

A. Capital Market Intermediaries

As mentioned in the preceding section, banks are major players in the capital markets, through their specialised subsidiaries. Several categories of non-bank intermediaries (i.e. securities companies) are also active in the capital market, including brokers (i.e. members of the Tel Aviv Stock Exchange or TASE), market makers, investment advisors, portfolio managers, CIS and securities underwriters. The retail end of the market is very much dominated by the local banks through their branch networks, and increasingly online. Retail activity usually focuses on the simpler transaction services (both for TASE and foreign securities).

The client base of the securities companies is mainly institutional clients, corporates and to some extent high net worth individuals; and, their operations tend to be more sophisticated. There are currently eleven non-bank members of TASE. Non-deposit taking intermediaries tend to offer a wide array of investment services under a single brand. In addition to traditional brokerage, these services typically include the management of mutual funds, pension and provident funds, structured products, exchange-traded basket certificates (usually synthetic index trackers packaged as notes) and underwriting services as well as many investment banking services such as advising on and arranging mergers, acquisitions, restructurings, spin-offs, follow-on offerings, and private placements. In most cases a group of closely affiliated companies using the group brand offers services to clients through the various companies making up the group. These intermediaries frequently offer services for securities traded outside Israel as well as domestic securities. International activity may be a result of their status as remote members of foreign exchanges or they may simply transmit orders to brokers abroad.

Most securities companies engage in most or all of the following activities:

1. Bonds and equities. The traditional activities are primary and secondary trading, market making and distribution, but more sophisticated services are offered as well;
3. Derivatives. Intermediaries trade in contracts on the derivatives exchange (Maof). The underlying assets covered by these contracts include equity index products (TA-25 index, bank index etc) and currency derivatives (Shekel-Dollar and Shekel-Euro.) Related activities include hedging of client's positions, financing transactions by way of options and pricing of non-traded options;
4. International activities include trading in foreign securities and products that are available on foreign exchanges as well as foreign exchange forwards, futures and swaps; and
5. Research. Securities companies produce both micro and macro research on of Israeli and foreign markets. Related activities are valuations, analyses and investment ratings and recommendations.

Domestic investors have access to wide variety of investment products, including over 1,000 Israeli registered mutual funds and a wide array of traded instruments, ranging from equity to complex certificates.

B. Fixed-Income Market

The government bond market is now well developed and government bonds account for the majority of publicly issued debt securities. Israel has suffered from severe bouts of inflation during the past few decades. Double digit inflation prevailed throughout 1970s, culminating in inflation of more than 300% in 1979. The beginning of the 1980s witnessed stagflation. In an effort to combat endemic inflation, Israel created an economy-wide phenomenon of CPI-linked debt. Despite the reduction of inflation, indexation and denomination in foreign currency are salient features of the fixed-income market. Indexed debt comprises, over 60% of the government's shekel debt as well as 60% of mortgages and 90% of corporate debt.

Before the reform, the government was the major borrower as well as a major creditor, effectively setting the rate of return on capital by issuing bonds that bore interest rates above market-clearing rates. The government issued these bonds to pension funds and provident funds, which together represent much of total long-term savings in Israel, as well as to insurance companies, while also offering some subsidised bonds to banks. Provident funds were obliged to hold 78% of their assets in indexed government bonds. Because the return on indexed bonds was so attractive only a small amount of savings was intermediated through the private market. Furthermore, there were several categories of debt issued without adequate coordination. Partly as a result, the market was not very liquid despite its large size.

The reform of public debt management has taken place against the background of a strengthening fiscal position. Israel's public debt/GDP ratio, which had been as high as 160% in the mid 1980s, stood at 102 % in 2003. It has been on a downward path since then, reaching 79 % at the end of 2007. The improvement reflected the reduction in the budget deficit, together with the economy's high rates of growth. At the end of 2007 total government debt amounted to NIS 524.4 billion (\$ 136.3 billion equivalent) of which 77% was domestic debt and 23% external debt. About 1/3 of domestic debt consisted of non tradable bonds at attractive rates that were distributed to domestic investors, such as pension funds and insurance companies for inclusion in special government sponsored instruments to provide income on favourable terms (See Figure 4).

During the past six years, the government has been striving to move to develop a market-based system of debt management as part of a broader effort to liberalise and modernise the financial system. In 2002, all departments that had responsibility for debt issuance and management were consolidated into the Government Debt Management Unit in the Ministry of Finance. This Unit has been spearheading the program to introduce market-based techniques of debt management.

At present, there are four categories of publicly traded government bonds:

- Shahaar. Non-indexed fixed-rate bonds;
- Gilon. Non-indexed floating-rate bonds. The floating rate is determined according to a weighted average of yields to maturity of Makams (Israeli T-Bills) at 3-12 months to maturity;
- Galil. CPI-linked fixed-rate bonds; and
- Gilboa. US Dollar-linked bonds.

In addition, a short-term Treasury bill was recently introduced. The Makam (Israeli Treasury Bill) is a short-term loan issued by the Bank of Israel and backed by the Israeli government with a maturity of less than one year. T-Bills are zero-coupon bonds issued at a discount to face value.

Reform of Government Debt Management after 2006

In 2006, the reform accelerated with a series of measures designed to bring Israeli debt management practices into line with best international practices, including the appointment of primary dealers and several other measures to deepen the market. As explained in the next few sections this reform has helped to increase the liquidity and transparency of the capital market while encouraging the entry of international investors into the market.

Primary Dealers Reform

In 2006, the Government Debt Management Unit launched the Primary Dealers reform. The Unit appointed 17 local and foreign Primary Dealers who accepted a commitment to quote bid and ask prices for government bonds in a new trading system for several hours daily at predetermined spreads. Primary Dealers also committed to maintain a minimum volume of purchases in government bond auctions over the year. In return, Primary Dealers enjoy access to designated bond auctions. Further, they enjoy the option of an additional allocation at the average price of the auction ("green shoe") on the day following the auction, access to the repo facility established by the Ministry of Finance in order to help them comply with their quoting commitments and exclusive access to the new designated inter-dealer trading system.

The reform brought about a significant increase in turnover of government bonds. The average daily turnover rose from 1.1 billion NIS in 2005 to 1.7 billion in 2006 NIS and 3.2 billion NIS in 2007. Further, this reform reduced the liquidity premium, attracted new investors to the market, reduced the Government's funding costs, caused a reduction in concentration in the Israeli capital market and promoted an expansion of activity by foreign banks in the Israeli capital market.

Reform of Trading Systems

Another important element of the reform is the change in trading methods in government bonds. Until the introduction of the system of market makers, government bonds were traded only on the Tel Aviv Stock Exchange (TASE) by the same electronic order-driven system used for trading equities and derivatives. Households as well as the large financial institutions used this method, which meant there was in effect no over-the-counter (OTC) market. Today, bonds are traded on three platforms: 1) the Stock Exchange, which still concentrates the highest trading volumes; 2) the MTS arena, which is designated for Primary Dealers; and 3) the OTC market that has developed significantly since the Primary Dealers reform was launched.

Government Cash Management Reform

The Government Debt Management Unit has been implementing a reform in the government cash flow management system designed to reduce borrowing costs and to support the development of an active market in government debt instruments. This reform includes steps that were taken to reduce the government's cash balances to the minimum necessary and to reduce funding amounts, in order to improve efficiency in cash flow management and to reduce interest payments on the government debt.

One important recent advance in cash management was the launch of short-term T-bills. The use of short-term T-bills is expected to permit the government to deal with short periods of lack of cash. During these periods Government borrowing will no longer take the form of long-term debt, but short-term debt (2-4 months), which is usually significantly cheaper. Prior to the launching of T-bills, the Ministry of Finance and the Bank of Israel agreed on measures to coordinate the implementation of

this step. Coordination is necessary in this case because the Bank of Israel issues its own short-term T-bills for monetary policy purposes.

Development of an Advanced Repurchase Market

In 2006, the Law of Special Transactions in Securities, dealing with repurchase facility (repo) transactions, was passed. The Repo facility will further advance the capability of the Government Debt Management Unit to manage the government's cash flow while reducing its borrowing costs and lowering the level of risk. Furthermore, a liquid repo market is expected to assist in the development of a non-bank credit market, thereby lowering financing costs in the business sector. The law opens the possibility of netting between offsetting transactions, defines the legal status of the asset and clarifies the issue of its ownership in the event that one of the parties enters a process of liquidation or bankruptcy during the transaction. Corporations also benefit in their short-term liquidity management due to the purchasing and repurchasing of government bonds that are tradeable on the market. This adds to the liquidity supply furnished by the purchaser, which in turn, increases the liquidity stock and reduces cost.

In 2007 additional progress was made in developing an active repo market. The Bank of Israel in cooperation with the Finance Ministry, and the Israel Securities Authority (ISA) and the Tel Aviv Stock Exchange stepped up their efforts to remove additional barriers and to complete the infrastructure necessary for the repo market, and to increase the awareness of its importance. The following measures were applied:

1. The Bank of Israel began to hold reverse repo auctions (in which it lends resources to the financial system) for monetary management purposes and in order to promote the development of the market;
2. In order to make it easier for the parties involved to conduct a repo transaction, the Bank of Israel compiled a draft framework agreement whereby such a transaction can be conducted between the parties. The agreement matches the generally accepted worldwide framework;
3. In cooperation with the Tax Authority; a team is examining the legislative measures necessary to provide regulatory coverage for the taxation aspects of repo transactions. The Tax Authority has already given initial authorisation for Bank of Israel repo transactions to be classified as a credit transaction; and
4. The Tel Aviv Stock Exchange is promoting the establishment of a central settlement system that will greatly facilitate trading in repo contracts. This system began operating in mid-2008.

Deepening of the Market for Non-indexed Bonds

As mentioned previously in this report Israel has a long history of wide-ranging indexation, which also included the government debt market. Since the middle of the 1990s a market for non-indexed, fixed-interest bonds has arisen. Long-term trends in debt issuance can be seen in Figure 5. In the early 1990s about 80% of government debt was indexed. As can be seen, the trend is clearly in the direction of diminishing issues indexed to foreign currencies, which have virtually disappeared, and inflation Indexed debt, which now only accounts for about ¼ of total new issues. Meanwhile, the average maturity has lengthened from two years at the beginning of the process to ten years in 2001, and twenty years in 2006.

Concurrent with the development of the non-indexed bond market, the issuance of foreign-currency-indexed bonds and non-indexed floating-rate bonds ceased. Currently, in addition to non-indexed bonds CPI-indexed, mostly long-term (30-year) bonds, are also issued.

Since 1995 the fraction of indexed debt in the total government debt market has decreased from 68 percent to 47 percent, and the Government's long-term goal is to decrease the share of indexed debt further. This policy is reflected in a downward trend over the past several years in the fraction of new issuance that is indexed. However, full nominalisation will be difficult to achieve in the near future, as there is still a demand for CPI-linked debt, and as the maturity and the duration of the existing indexed portfolio is long. Additionally it should be noted that the trend in the developed world is in the direction of governments increasing the share of inflation-linked debt in their debt portfolios. Thus it seems unlikely that Israel will eliminate CPI-linked government bonds entirely.

Consolidation of Bond Series Issuance

In order to improve the level of tradability and liquidity of the secondary market and to reduce government funding costs, authorities have continued to reduce the number of series of government bonds, and the focus has switched to a small number of large benchmark series. The number of series went down from 265 at the beginning of the 1990s to 120 in 2000 and to 46 in 2007, while the average size of a series rose from \$150 million equivalent in 1990 to \$300 million equivalent in 2000 and to \$1.5 billion equivalent in 2007.

Introduction of switch auctions and buy-back auctions

In 2007, an additional step in the reform was taken when switch auctions and buy-back auctions were instituted. These auctions are to be used by the Government Debt Management Unit in order to achieve the following aims:

1. To increase liquidity in the secondary market by diminishing the volume of debt in small series that are close to maturity. *The "series" of any given bond is defined only by its time to maturity, its coupon, whether it is fixed-rate or floating rate and whether it is linked or non-linked to the CPI.*
2. To improve government debt structure by replacing bonds that are not compatible with the aims of the Government Debt Management Unit with bonds that are compatible with these aims.
3. To flatten the maturities curve. Switch auctions and buy-back auctions enable the government to decrease maturity payments in periods of high payments and to increase them in other periods. As a result, the government will not have to accumulate large amounts of financial resources before maturity dates.

Policies to Enlarge Foreign Participation in the Market

The Government Debt Management Unit's policy is to enlarge foreigners' involvement in the government bond market, both the primary market and the secondary market, and to increase their share of holdings of government debt. In order to achieve this goal, during recent years the unit has been adopting instruments and procedures that are more closely aligned with international practice.

In 2006, the Unit replaced local trading systems with systems that are used by financial institutions worldwide. The bond auctions and the switch auctions are carried by the Bloomberg system that contains modules which are compatible with Israel's auctions method. The Primary

Dealers trading platform is operated by MTS Europe, which operates a large number of government bond platforms in Europe. As a result, both the primary market and the secondary market of Israel government bonds are now easily accessible to financial institutions worldwide. Further, tax-exemption for interest and capital gains on foreign investments in government bonds (and other Israeli bonds) was enacted. However, one important issue that is seen as impeding greater foreign activity in bond trading in Israel is the fact that tax on interest payments is deducted at source. This means that foreign investors must go through a tax reclaim process in order to receive the tax. The TASE is in contact with the Tax Authorities in Israel and is trying to resolve this problem.

In response to these reforms, foreigners' share in outstanding debt, which was negligible only six years ago, increased to a share of 4.7% of the total tradable debt at the end of 2006. The breakdown of government debt holdings by category of investor is shown in Table 6. Currently, foreigners' involvement is high both in the primary market, where they are responsible for more than 50% of the purchases, and in the secondary market, where in the first quarter of 2008 more than 30% of the transactions volume at the PD's trading system was executed by foreign intermediaries. Six of the 17 Primary Dealers in the bond market are foreigners¹³.

**Table 6. Holdings of Government Debt Traded on TASE by Category of Investor
(Percent of total)**

Year	Bank Israel	Foreign Investors	Insurance Companies	Pensions Funds	Provident Funds ¹⁴	Mutual Funds ¹⁵	Banks	Public
2003	2.4	0.4	12.7	1.9	34.0	13.9	16.3	18.4
2004	1.9	0.6	12.5	5.0	31.8	11.1	17.9	19.2
2005	1.3	1.3	10.1	9.8	28.0	15.9	17.0	16.7
2006	1.2	4.7	9.7	10.7	24.1	12.4	18.1	19.2
2007	1.1	3.8	8.9	11.0	18.4	14.2	18.6	24.1
2008	0.8	1.6	10.2	12.8	20.5	11.5	14.6	28.0

Source: Ministry of Finance

Risk Management

Examination of the distribution of risks related to debt management, identification of measures to reduce the costs of debt and analysis of the risks in the government's liabilities portfolio are deemed essential tools to assist the government in meeting its financing needs at the minimum possible cost, while minimising risks.

Funding Plan. Towards the middle of the budget year, the annual funding plan for the subsequent budget year is formulated, mainly based on strategic debt management models, whose output is the volume of funding of different instruments on an annual level. As a complement to those models, a lower-resolution analysis is performed, which takes into account cash flow management during the

¹³ Citi, Deutsche Bank, Goldman Sachs, Lehman Brothers, Morgan Stanley and UBS.

¹⁴ Provident funds are long-term saving vehicles while mutual funds are collective investment schemes. A provident fund is a long-term investment vehicle intended mainly for the payment of pensions, savings and severance pay.

¹⁵ Mutual funds collect funds from the investment money in return for the issuance of shares and invest it in an identifiable pool of assets. An investment in a mutual fund has no minimal maturity.

budget year and the timing of opening new series and their effect on future maturities of cash flows. This comprehensive exercise balances various strategic goals and tactical considerations.

The Benchmark Model. The optimisation model is based on a dynamic Monte Carlo simulation. Since the Unit manages the liabilities portfolio only (without the assets portfolio), there is no natural risk-free position. To solve this issue, a target portfolio (a benchmark) must be defined to serve as a proxy for the risk-free position. The benchmark serves as an indicator of the point (or range) for which the debt manager should aim and is defined by the currency mix of external debt, the interest rate mix (fixed vs. floating) and maturity (duration) of the debt.

The Issuance Model. A strategic model deals with long-term planning of domestic funding and of external funding, through dynamic optimisation. According to the theoretical principle at the basis of the model, there is a debt structure which can be held constant over time through a fixed, stable funding policy applied over the years.

These models serve various purposes in the construction of the portfolio. The Benchmark Model is aimed at optimising the debt portfolio structure with respect to the trade-off between volatility and cost of financing. In the same way the CAPM model serves as a benchmark for the asset-allocation of an investment portfolio; this model serves as benchmark for the design of the issuance program in terms of currency mix, interest rate mix (fixed vs. floating) and duration. The Issuance Model is aimed at optimising the maturity structure of the debt portfolio. This model serves as benchmark for the design of the issuance program in term of maturities in order to reduce refinancing risk in the future.

Pricing. The Risk Management Department is responsible for the pricing of financial transactions. For this purpose, the Department has developed in-house pricing capabilities of financial instruments, such as callable bonds, basis swaps, currency swaps, interest rate swaps and more.

External Government Debt

In addition to its domestic operations, the Government Debt Management Unit executes each year a sovereign (unguaranteed) issue in the American market or in the Euro market. In 2006, a \$1 billion issue was executed and a €1 billion issue for the fourth quarter of 2007 was planned but was postponed due to the bad conditions in the markets (global crisis) and is rescheduled for 2008.

For strategic reasons sovereign issues are executed even in periods when foreign currency finance is not required. These strategic reasons include:

1. To open new financial markets to the Israeli economy.
2. To familiarise foreign investors with the Israeli economy. A "road show" is performed as part of the issuance process. Additional means are also used during funding, such as advertising and public relations. These methods expose the Israeli economy to foreign investors.
3. To establish new sources of government foreign currency funding, which increases flexibility in selecting funding sources.
4. To create a benchmark for Israeli companies wishing to issue abroad. *However, sovereign issues make up less than 3.5% of the total debt portfolio. Thus, their current impact on the total costs and risks is marginal.*

In order to reduce the government's foreign currency risk on its debt, the Government Debt Management Unit executed a series of swap transactions in order to replace US\$ exposure with € or

NIS exposure. Furthermore, the Government performed a unique move that included a Real (Brazilian currency)-linked debt issue and a swap transaction that replaced the Real exposure with NIS exposure.

The outlook for Israel's debt in the international markets is difficult to predict, as it will be mainly determined by the general level of demand for sovereign debt and by global market conditions. However, it is worth mentioning that Israel's most recent external issue, in March 2009, was heavily oversubscribed. Customer demand was for over US \$10 billion, while only US \$1.5 billion of bonds were allocated to investors. No doubt, global investors view Israel's US guarantee as providing support for Israel's international refinancing capabilities. Thus, it is reasonable to assume it has some positive effect on the price of Israel's non-guaranteed debt.

Corporate Bond Market

The corporate bond market has enjoyed a number of good years reflecting favourable market conditions. The TASE trading system TACT-Bond has proved a popular addition to the market as has TACT-Institutional amongst institutional investors for whom it is designed.

There has also been a steadily increasing trend among corporates to look to the bond market as a source of credit in place of banks. Bank credit to the business sector has remained fairly flat between 2002 and 2007. The 2002 annual peak of NIS 399 billion has not been reached since that year and bank credit decreased each year until 2007 when it rose for the first time since 2002 but at NIS 379 billion still remained short of the 2002 figure. In 2008 it continued to grow reaching NIS 408 billion. As Table 7, shows issuance of tradeable and non-tradeable bonds which comprise 35% of the distribution of credit to the business sector as of 2007.

The strong fiscal performance of the Government in 2007 indirectly benefited the bond market. The year ended with a balanced budget and no deficit. This compares to a planned budget deficit of NIS 18.7bn (2.9% of GDP) for all of 2007. The fact that the government came in under its expected deficit had a significant impact on the local capital market, and especially on the bond market. Because the Government did not need to raise large amounts of capital in order to finance its deficit, the already high liquidity was increased to the benefit of the corporate bond sector.

The financial crisis was felt acutely by the bond market during the second half of 2008. As the effect of the financial crisis on the real economy became increasingly clear, investors were concerned that reduced company earnings coupled with the continuing scarcity of liquidity could result in bond issuers failing to meet their payment obligations. As a result, prices dropped sharply from August to November of 2008. The Tel Bond 20 Index of leading bonds began 2008 at 207 and by the end of June had climbed to 225. However, this rise was completely reversed in the second half, with the index finishing the year at 201. The Tel Bond 40 followed a similar course, gaining in the first half from a start of 210 and then falling back to finish the year at 164. The particularly sharp drop in the Tel Bond 40 was partially caused by the real estate companies that form a significant portion of the index and which were especially hard hit.

Following a number of initiatives by the Treasury, Bank of Israel and the ISA, and as fears for the depth of the recession have eased somewhat, confidence appears to be returning to the bond market in 2009. The Tel Bond indices have been rising steadily from January and at the end of June 2009, the Tel Bond 20 was at 238 and the Tel Bond 40 was at 225, in both cases exceeding their previous highs.

Table 7. Changes in Credit to the Private Sector and the Business Sector,^a 2002 to 2008

	2003	2004	2005	2006	2007	2008
Balances	(NIS billion, at current prices)					
Total credit to the business sector^b	503	530	591	644	740	738
<i>of which</i> Domestic bank credit	362	353	358	357	379	408
Nonbank domestic credit	56	75	126	166	239	197
Credit from nonresidents	86	102	107	120	122	133
Distribution of credit to the business sector	(percent)					
By source						
Domestic bank credit	72	67	61	55	51	55
Nonbank domestic credit	11	14	21	26	32	27
Credit from nonresidents	17	19	18	19	16	18
By tradability						
Tradable bonds	8	10	14	18	24	23
Nontradable bonds	7	8	11	12	11	8
Loans	85	81	75	70	65	70
Annual change in credit to the business sector	(percent)					
Total credit to the business sector	-1.7	5.2	11.5	9.0	14.9	-0.3
<i>of which</i> Tradable bonds	6.7	31.5	48.5	42.8	53.0	-7.1
By source						
Domestic bank credit	-4.8	-2.4	1.5	-0.3	6.1	7.7
Nonbank domestic credit	35.4	35.5	66.4	32.3	43.9	-17.8
Credit from nonresidents	-5.8	18.0	5.4	12.5	1.1	9.4

^a Credit to the business sector includes loans and tradable and nontradable bonds, with loans shown at their adjusted price and tradable bonds at their market price. (For the definition of credit to the business sector, see the Bank of Israel website <http://boisite/deptdata/stability/indic/e03e.pdf>).

SOURCE: Based on Bank of Israel data and data from the Capital Market, Insurance and Savings Division of the Ministry of Finance.

The growth in corporate bonds traded on TASE between 2000 and the present is extremely marked. The CIS sector and retail investors have been the main purchasers of this new category of debt (see Table 8). Total market value of corporate bonds has risen from a meagre NIS 11.7 billion at the end of 2000 to NIS 265.7 billion at the end of 2007. This figure stood at NIS 296.5 billion at the end of February 2008 (but since then growth levelled off as market conditions became less favourable). In terms of the amount of corporate debt raised each year, the figure which was only NIS 0.3 billion in for 2000 rose to NIS 87 billion by 2007. In 2008 the financial crisis led to a reduction in new bond issues. The business sector raised approximately NIS 25 billion compared to NIS 87 billion in 2007. Of this NIS 25 billion, about 80% was issued during the first half of the year. During the first half of 2009, new corporate bond issues raised approximately NIS 17 billion, of which approximately NIS 13 billion was raised during the 2nd Quarter.

**Table 8. Relative holdings of non-Government debt traded on TASE
(Percent of total)**

Year	Foreign Investors	Insurance Companies	Pensions Funds	Provident Funds	Mutual Funds	Banks	Public
2003	0.3	16.7	5.7	36.8	7.7	5.3	27.5
2004	0.2	10.5	4.3	26.8	11.7	2.4	44.0
2005	0.3	10.0	5.2	23.9	14.5	2.9	43.2
2006	0.4	10.3	6.8	25.0	14.8	3.1	39.6
2007	0.2	9.5	6.9	26.9	13.7	2.2	40.5

Source: Bank of Israel

Since July 2007 the primary market in Israel has operated under the new underwriting law, and the volume of issues in it, mainly bond issues, reached a new record level of NIS 104 billion. As in previous years, the majority of issues (80 %) were floated by companies rated at A and above. In the second half of the year issue volumes decreased, especially among non-marketable bonds and non-rated bonds, reflecting the change in the public's preferences and its assessment of the risks resulting from the global crisis.

The authorities are studying the possibility of promoting securitisation, i.e. mortgage-backed securities (MBS) and asset-backed securities (ABS). This was one of the proposals put forth by the Bachar Commission. At this time the market in securitised assets is negligible.

Rating agencies

Domestically traded non-government debt is rated in Israel by two rating firms – Maalot (affiliated with S&P) and Midroog (affiliated with Moody's). Some debt is also rated by the major international rating agencies for international investors.

C. Equity Market

The Tel Aviv Stock Exchange (TASE)

Trading in Israeli publicly listed securities occurs exclusively on TASE, the only licensed stock exchange in the country (see Table 9). A broad range of financial instruments is traded on TASE, specifically:

- Equities and securities convertible into equities, such as warrants and convertible bonds and call options.
- Debt: Government bonds of various types (see above), Makams (T-bills) and corporate bonds.
- Index products: Several types of index products are traded on TASE. By far the most popular and successful are basket certificates but also available are commodity certificates, reverse certificates, covered warrants and complex certificates. The term “complex certificates” includes certificates that track multiple indices, leveraged certificates on a given index or index-linked notes tracking variable indices.
- Derivatives are traded on the Maof market, which is part of the TASE system, and cleared through the Maof Clearing House. Publicly traded derivatives include traded options on the

TA-25 Index, the Shekel-Dollar exchange rate, the Shekel-Euro exchange rate, and the TA-Banks Index, as well as futures on the three month interest rate and Shahar bonds.

The TASE operates under a fully automated order matching system comparable to those found in most European markets. Rules for trading on the exchange are set by the TASE acting as an SRO and by the Israel Securities Authority (ISA), the official body responsible for capital market oversight.

Table 9. Total Market Value of Securities Traded on the Tel Aviv Stock Exchange, 2003–08

	2004	2005	2006	2007	2008
	(NIS billion, at current prices)				
Total	667.6	834.7	981.2	1175.2	904.8
Percent of GDP	118.4	139.6	153.1	174.5	126.7
Shares and convertibles	284.7	379.6	472.3	591.4	301.4
Government bonds, total	252.9	261.4	265.1	269.4	312.9
<i>Makam</i>	75.4	87.2	96.9	77.5	72.0
Corporate bonds	29.4	58.0	84.8	152.2	134.7
Convertibles	6.0	11.1	9.7	8.4	3.9
Structured bonds and CDs	12.8	29.1	37.6	49.4	55.3
ETFs ^a	5.1	7.0	13.1	25.7	23.2
Futures contracts	1.4	1.4	1.7	1.3	1.4
Composition of government bonds by indexation base			(percent)		
CPI indexed	44.6	42.0	42.6	41.7	42.0
Foreign currency indexed	0.1	0.1	0.1	0.1	0.1
Unindexed fixed interest	32.7	36.0	38.9	39.5	42.8
Unindexed variable interest	22.6	22.0	18.4	18.7	15.2
Composition of corporate bonds by indexation base			(percent)		
CPI indexed	85.8	91.8	93.0	90.1	88.2
Foreign currency indexed	6.6	4.7	1.2	5.2	4.6
Unindexed	7.6	3.5	5.8	4.7	7.2

^a Exchange traded funds.

Source: Based on Tel Aviv Stock Exchange data.

Equity Ownership and Corporate Governance

Ownership of TASE listed companies remains very concentrated. Ten privately owned business groups own 30% of companies listed on TASE (See Figure 6). Twenty business groups, nearly all of them family-owned, control 160 publicly traded companies with 40% of the market. These are very high levels of concentration by the standards of Western economies.

While holdings of the business groups in Israel are generally diversified among sectors, concentration is important in the financial sector where half of the companies can be classified as affiliated to business groups. A recent report issued by the Bank of Israel found that companies affiliated to these business groups tended to be mature, exhibit lower growth and lower investment in R&D, and to have higher investment risk than unaffiliated companies. While it may prove to be the case that this investment risk will compare favourably with that of unaffiliated companies in the tougher market conditions expected during 2008, the ISA considers this situation to be undesirable because of the huge influence the ultimate owners of these groups have over the market.

Concentrated ownership and the consequent need to protect minority investors have been well recognised problems for many years and a sophisticated regime of law and regulation has grown up to counter its potential negative effects. Both the Companies Law and the Securities Law regulations have strict rules on transactions between listed companies and their owners and on protection of minority shareholder rights. The Securities Law imposes rigorous reporting requirements.

Alternative Trading Systems

Even though TASE is the only licensed exchange in Israel at this time, the presence of small alternative trading systems (often web based) are increasingly making themselves felt. The nature of these platforms remains primarily as “notice board” type systems where buyers and sellers make contact before closing transactions outside the systems and settling through TASE and the relevant clearing house. However some foreign exchanges and alternative trading platforms are already active in Israel, usually with the permission of the ISA.

While alternative platforms are not currently recognised by the securities law, an important amendment to the Law, which would change the definition of an exchange thereby bringing many types of trading systems under direct regulatory oversight, is being considered by the ISA. This proposal is based on the findings of an independent committee (the Prokatchia Committee) set up by the ISA to investigate and report on the growth of alternative trading platforms in Israel and the need for their regulation.

Venture Capital

Israel has one of the most advanced venture capital industries in the world. Israeli high-tech companies have been very successful in raising equity capital. In order to assist early stage Research and Development companies (R& D companies) raise capital publicly, TASE offers reduced listing thresholds to such companies. An “R&D company” is a company that has invested at least NIS 3 million in research and development over the last three years, including investments using funds received from the Office of the Chief Scientist (O.C.S.) at the Ministry of Industry and Trade. Confirmation of R&D investments is obtained from the Chief Scientist (whether or not the company has received funds from the Chief Scientist). The applicant company’s main area of activity must be research and development, or the production and marketing of products resulting from its own research and development.

R&D companies are not required to demonstrate a minimum period of activity or level of shareholders’ equity prior to their IPO. Shareholders’ equity after the IPO must reach only NIS 8 million, as opposed to NIS 25 million for most listed companies. The minimum public-float rate is relatively low, making it easier for R&D companies to raise capital on the TASE at an early stage in their life cycle, with relatively little dilution of the founders’ holdings. Maintenance Rules, which apply to illiquid TASE listed shares, do not apply to R&D companies during the first three years that they are listed on TASE.

Many Israeli high-tech companies are listed abroad, notably on NASDAQ, either in addition to their listing on TASE or without a domestic listing.

Multiple listings

The Dual Listing Law that took effect in October 2000 enables companies listed in United States or London to dual-list on the TASE with no additional regulatory requirements. As of December 31, 2006, 39 Israeli companies have dual-listed on the TASE in compliance with this framework.

Since 2002 companies incorporated in Israel and admitted to trading on certain foreign exchanges are permitted to carry out a secondary listing on TASE while continuing to comply with the foreign disclosure regulation only. In other words, such Israeli companies may submit to the ISA the reports submitted, which will be recognised as sufficient to meet local reporting requirements. At present the Securities Law recognises a limited number of exchanges: these are NASDAQ, the New York Stock Exchange, the American Stock Exchange and the London Stock Exchange Main Market.

Shelf prospectuses (known in Europe as base prospectuses) may be used in Israel to support a series of offerings to the public. Each shelf prospectus remains in force for two years. This innovation was facilitated by changes to the reporting requirements in annual reports. The expanded disclosure requirements brought annual and quarterly reports much more closely into line with prospectuses such that an investor looking at an offering under a shelf prospectus always has full up to date information at his disposal when considering investing in a shelf offer.

Trends in the Equity Market since 2000

The Equity market has passed through three phases in recent years. Around 2000, the market underwent a sharp correction as a result of the worldwide "dot com" crash which had a strong reverberation on the hi-tech sector, which is very important in Israel and on TASE where these companies are heavily represented.

After stagnating for three years, the market staged a strong recovery after 2003, which lasted through mid 2007. Activity in the local stock market in 2006 reflected the strength of the Israeli economy and confidence in continuation of economic reforms. The General Share Index registered a 5.9 % gain in 2006, following a jump of 33 % in 2005. An increase of 12.5 % was recorded for the TA-25 index of blue chip shares and 12 % for the TA-100 index of the 100 most actively traded shares. Considering the full year 2007 the TASE had a very successful year, with many market indicators rising to record levels. The loss of confidence in the wake of the financial crisis and recession was clear in 2008. The General Share Index fell 45.8% over the year, most of this drop being concentrated in the second half. The TA-25 suffered the same loss ending the year 45.6% down. In 2009, these reductions have been reversed. At the end of July the General Share Index was up 55.5% and the TA-25 was up 45.6%.

New money raised through the issuance of non-government bonds rose 81% from 2006. In 2007 share trading volumes increased to a daily average of over NIS 2 billion (55% increase compared with 2006). This rose slightly during 2008. At the end of July 2009, the daily average was NIS 1.4 billion. The daily average trading volume in bonds reached over NIS 3 billion (an increase of more than 100% over 2006) in 2007. In 2008, daily average trading volume in bonds was NIS 4.2 billion. The TASE continued in 2007 to serve as a central source of financing growth. Fifty six new companies raised more than NIS 9.6 billion (USD 2.5 billion) in IPO's this year, twenty of these were Hi-Tech R&D firms.

Significant diversification was made in the range of investment products traded on the TASE in 2007. The market in exchange traded funds continued to grow rapidly. One hundred and fifty ETFs were added during 2007, and at the end of 2007 237 ETFs are listed in Tel Aviv. By the end of 2008, this figure had risen to 333. At the end of July 2009 the figure was 344.

Trading volume in ETFs is equal to 18% of the trading volume in shares and 10% of the trading volume in non-government bonds (see Figure 7). The public's holdings in ETFs have reached over NIS 1.5 billion.

The Tel Bond-20 index was launched in 2007. At the end of the year the total value of index products on the Tel Bond-20 was well over NIS 3 billion. At the beginning of 2008 two further indices, the Tel Bond 40 and the Tel Bond 60 have been introduced.

In February, 2007, the State of Israel completed the full privatisation of the Haifa Oil Refineries through a NIS 6 billion IPO, the largest in the history of TASE. The company's privatisation reflects the Government's strategy of economic reform and its policy of gradually removing itself from the business sector.

Despite turbulence in world markets the TASE showed resilience over 2006 and 2007. The correction that took place in May-June 2006 was less acute in the case of the Tel Aviv Stock Exchange than in other emerging-market exchanges. For example, during the second half of May and the first half of June the Indian stock market plummeted 30 %, the equity markets in Thailand and South Korea fell 18%, and the equity markets in Eastern Europe registered price declines of 24% on average. Meanwhile, the leading share indexes in Israel, the TA-25 and the TA-75, fell 8% and 14%, respectively, in the same period. The other very clear indication of TASE's resilience and relative stability was the absence of any strong effect to the major military conflict in the summer of 2006. (See Para. 157 above regarding the impact of the financial crisis on TASE share indices and the subsequent recovery.)

The number of shares listed on TASE actually dipped quite significantly during the 2000-2007 period and only recently did it again approach the 2000 figure. The number of companies that had listed equity securities on TASE at the end of 2000 was 665. This figure declined to as low as 577 at the close of 2003 and only started to climb significantly in 2006 by the end of which 606 companies had listed equity. By the end of 2007 this had grown to 657. At the end of 2008 the number had dropped slightly to 642. At the end of July 2009 the figure was 633.

The total market capitalisation of TASE at the end of 2000 was NIS 529 billion. This figure had fallen to NIS 480.5 billion by the end of 2002 but from that point it rose steadily to NIS 1,556.6 billion by the end of 2007, before dropping back to NIS 1,473.1 billion in the first quarter of 2008. This had dropped to NIS 1,229 billion by the end of 2008. By July 2009 total market capitalisation had recovered to NIS 1,558 billion.

A similar pattern is visible in new capital raised by issues of shares and convertible securities, with steady activity after 2003 and favourable trends peaking in mid-2007. The 2000 figure of NIS 15.1 billion dropped to NIS 3.5 billion during 2003. However since 2003 there has been no clear trend. In 2004 the amount of new capital raised grew to NIS 17.1 billion. It then dropped to NIS 14.9 billion during 2005 but rose to NIS 44.6 billion during 2006. This figure then dropped to NIS 22.3 billion in 2007. In the first quarter of 2008, only NIS 1.8 billion was raised. In 2008, all issues of shares and convertibles including IPOs numbered 24 and they raised approximately NIS 19 billion. By end July 2009, approximately NIS 1.5 billion had been raised through 22 equity issues.

Active involvement of foreign investors in the TASE began in 1994. In 2006, international holdings increased to 11.6% of the total market capitalisation of the shares and convertible securities tradable on the TASE, compared to 11.4% in 2005 and 10.0% in 2004.

Exchange-Traded Derivatives

All exchange-traded derivatives are traded on the Maof exchange. By far the most heavily traded products on the Maof are options on the TA-25 (an Index of the 25 leading TASE companies). The average daily turnover (in terms of the underlying assets) in TA-25 options during 2000 was NIS 5.7

billion. This dropped to NIS 4.9 billion per day during 2003 but then rose to NIS 8.1 billion in 2004. By 2007, the daily average was NIS 41.9 billion and a high point was reached in January 2008 of NIS 51.4 billion. However, with the market slowdown the figure for March 2008 had dropped to NIS 34 billion. By the end of 2008 this had dropped significantly to NIS 16.6 billion. However, this figure has been rising steadily throughout 2009 and by the end of August had reached NIS 28 billion. The average number of transactions per day was between 80,000 to 90,000 throughout 2008 and the first half of 2009

The average daily turnover (in terms of the underlying assets) in 2000 for TA-25 futures (as opposed to options) was NIS 25.5 million. This dropped sharply until 2004 when the figure was NIS 1.9 million. It has risen quite strongly since then reaching NIS 8 - 10 million during 2006 and 2007. At the end of 2008, the figure was NIS 11.9 million and at the end of August 2009, NIS 10.9 million. This average is based on a very limited number of transactions (1, 2 or 3 transactions per day on average during 2009) and therefore fluctuates quite widely.

Futures and options are traded on the Shekel/USD exchange, as well as on the Shekel/Euro, but the latter in far lower volumes than the equity index derivatives. Traded options on the shekel/dollar rate exhibit a different pattern to the derivatives that have securities as underlying assets. The average daily turnover was USD 127 million in 2000. This rose to USD 463 million by 2002 before easing off moderately between 2003 and 2005 and then rose to USD 388 million during 2007. Activity continued to rise during the first quarter of 2008 and has been between USD 400 – 450 million per day during this period. The average daily turnover for the whole of 2008 was NIS 435 million, and has generally been between NIS 320 – 340 million during 2009.

Shekel/Euro options began trading in 2001. Average daily trading volumes were stable between 2001 and 2003 at around EUR 10 – 15 million a day. They rose in 2004 to EUR 25 million but dropped sharply in 2005 and 2006 (EUR 4.2 million in 2006), and rose in 2007 to EUR 30 million per day. During the first quarter of 2008, the daily average has been between at EUR 10-15 million and at 2008 year end the daily average turnover was NIS 16 million. This has reduced to approximately NIS 3.5 million during 2009.

Reform Measures Introduced during 2007

During 2007, the TASE took the important step of adapting its indexes to international standards. As a result a 25% public float is now a precondition for eligibility to join an index and the weight of each company within the relevant index is calculated according to the public float. However, as a result of the financial crisis and its effect on share ownership, during 2008 TASE reduced the threshold to 20%. This was an emergency measure and will remain in effect until the end of 2009.

During 2007, the TASE signed cooperation agreements or MoUs with the London Stock Exchange and with NASDAQ. The MoU with the London Stock Exchange formalises the existing strong ties between the two organisations. Under the agreement, the London Stock Exchange and the TASE will establish a series of regular meetings between senior executives and agreed to exchange information in order to facilitate orderly trading in companies admitted to both markets. During 2008 further cooperation agreements were signed with NYSE-Euronext and the Shanghai Stock Exchange.

During 2007 the ISA endorsed a resolution by the Tel Aviv Stock Exchange's Board of Directors to allow major international financing institutions to serve as remote members of the exchange, even if they do not maintain any physical representation in Israel. Until that time the TASE did not permit remote memberships. Eligibility for remote membership in the TASE is currently confined to international banks and investment houses that have at least ten years' membership in one of the

following exchanges: the London Stock Exchange, Euronext-NYSE, DTB (Frankfurt), Eurex (Germany), SWE (Switzerland), or the TSE (Tokyo). To be eligible for remote membership, the bank or firm must have shareholders' equity of at least USD 1 billion. It must also appoint a senior manager to be responsible for its activity on TASE. Prior to this important innovation, four international institutions with physical representation in Israel had become members of the exchange. These are UBS, Deutsche Bank, HSBC and Citibank. During 2008 TASE approved the application of Merrill Lynch International to become TASE's first remote member.

The decision was taken during 2007 that during 2008 the MAOF Clearing House will begin issuing options on the most liquid shares in the TASE. This was subsequently delayed until June 2009 since when options on individual shares have been available to trade on TASE. Options are currently available on four of Israel's leading corporations.

Collective investment schemes

Collective investment schemes or (CIS) are a well established form of institutional savings in Israel. However, their share of total institutional savings is small than in most other countries, due to the importance of other forms such as pension and provident funds, advanced study funds and insurance products. Israeli law only recognises the trust form of CIS¹⁶. Israeli CIS tend to invest more in fixed-income assets than in equities.

One of the main developments in patterns of asset holding resulted from the implementation of the Bachar Commission recommendations under which banks were prohibited from controlling CIS and certain other forms of institutional investment. As Table 10 shows, control of CIS by banks has been all but eliminated, with insurance companies and unaffiliated companies now in control of most CIS.

A number of new categories of CIS were recently authorised including:

- Funds of funds are a fairly new development. Following recent regulatory changes there are now two types of funds of funds that may be active in Israel: Foreign Fund of Funds in which are held only foreign funds and Israeli Fund of Funds in which are held only other funds managed by the same fund manager.
- Special Funds are mutual funds that may hold up to 30% of their assets in hedge funds. The goal of the regulator, the ISA, in permitting this type of fund was to allow the public to begin becoming exposed to hedge funds in a controlled way and relatively safe way. However to date no Special Funds have been established.
- Money market funds made a relatively recent appearance in Israel and have proved extremely popular with over NIS 32.5 billion being transferred into them by the end of 2008.

¹⁶ Under the Joint Investment Trust Law of 1994 the fund is established by an agreement between a corporation acting as the trustee – in whom ownership of the fund's assets are vested, and a corporation acting as the fund's manager – carrying out transactions in the fund's assets under a power of attorney granted to it by the trustee. A portfolio management company is prohibited from carrying on any business other than the management, provision investment advice and related activities. The fund itself is not a legal entity, but a portfolio of securities, cash and undertakings. The fund issues units to the public with each unit representing an equal relative portion of the funds assets. For a discussion of the various forms of CIS, see John K. Thompson and Sang-Mok Choi "Governance Systems for Collective Investment Schemes in OECD Countries," OECD. Financial Affairs Division. Directorate for Financial, and Enterprise Affairs Occasional Papers (no 1), (March 2001).

As market conditions have improved during 2009 investors have moved to CIS that focus on shares and particularly bonds and by the end of August 2009 the total value of assets in money market funds had dropped to approximately NIS 21 billion despite an overall increase of over 20% in the value of assets held by the CIS industry during 2009.

Israeli Capital Market Upgrade

An important development regarding the international perception of the Israeli market is that effective June 2008 the Israeli capital market was upgraded to "developed status" by the FTSE Group, a private market body that compiles various capital market indices and produces comparative data. The markets criteria for classifying a market as either developed or emerging are subdivided into four categories (a) market and regulatory environment, (b) custody and settlement (c) dealing landscape and (d) derivatives market. Since being included on the FTSE Watch List in 2006, Israel has met developed market standards in all these categories. It should be stated that almost as soon as the announcement was made it was met with mixed reactions from investment strategists and fund managers who cautioned that the move may not necessarily translate into the big investments in the local market that some people expect.

Authorities express little doubt that the upgrade is clear evidence of the health of the Israeli capital market and that following the upgrade Israel will become a potential investment destination to a far larger pool of funds internationally. It is possible that Israel's ranking with the world's leading economies will mean that a smaller percentage of those funds will be allocated to TASE than is currently the case. Israel's current weighting of 1.89% in the emerging-market index measure will shrink to 0.2% in the FTSE's developed-market index.

One important advantage that Israel had when in the emerging markets index is that the relative transparency of corporate reporting and corporate governance compared to other emerging countries had made Israel a low-risk investment choice for many global investors placing funds in emerging markets. This regulatory gap in Israel's favour will be reduced once Israel joins the developed market index.

MSCI reclassified the Israeli market to Developed Markets status on 15 June 2009. The change will take effect from May 2010.

Table 10. Estimate of the Changes in Control of Long-Term Savings^a and Mutual Funds Resulting from the Pensions Funds Reform and the Adoption of the Bachar Committee Proposals, 2003-08^b

	Total assets (NIS billion)	The largest five banking groups						The largest five insurance groups					(percent)	
		Total	Hapoalim	Leumi	Discount	Beinleumi	Mizrahi-Tefahot	Total	Migdal	Clal	Phoenix	Menorah	Harel	Other financial institutions
														Total ^b
Total long-term savings^a														
December 2003	260	52	22	14	10	3	4	21	7	5	3	2	3	27
December 2004	293	50	21	14	9	3	4	28	9	6	4	6	3	22
December 2005	355	45	19	12	8	3	2	30	10	7	4	7	3	25
December 2006	394	35	17	7	7	2	2	37	10	7	5	7	8	28
December 2007	424	11	9	1	1	0	0	54	14	15	9	8	8	35
September 2008	363	5	0	3	1	0	1	60	16	16	9	10	9	35
Mutual funds														
December 2004	101	84	34	29	13	4	5	2	1	1	0	0	0	14
December 2005	125	77	30	27	12	4	4	3	1	2	0	0	0	20
December 2006	111	1	0	0	0	1	0	41	8	14	2	4	12	58
December 2007	120	1	0	0	0	1	0	38	10	10	3	3	11	61
December 2008	98	2	0	0	1	1	0	36	7	11	3	4	11	62

^a Long-term savings include assets in provident funds, the new pension funds (including the central pension fund of the Israel Electric Corporation controlled by Clal), and with-profit life insurance schemes.

^b The two largest portfolio managers that are not banks or insurance companies are Psagot and Prisma. At the end of June 2008 Psagot held about 5 percent, and Prisma about 7 percent, of all long-term savings assets. At that time Psagot held about 23 percent of mutual funds' assets, and Prisma held about 12 percent.

SOURCE: Based on data of The Capital Markets, Insurance and Savings Division of the Ministry of Finance, and of the Securities Authority.

VI. FINANCIAL SUPERVISION AND REGULATION

A. Supervision of Markets and Intermediaries

Financial supervision in Israel is organised along institutional lines. The Bank of Israel, via the Supervisor of Banks, regulates and supervises the banking sector. The Ministry of Finance, via the Capital Market, Insurance & Savings Commissioner regulates insurance companies, pension funds and provident funds. The Israel Securities Authority (ISA) regulates Israeli public corporations that are listed on the Tel-Aviv Stock Exchange, as well as brokerages and security firms, mutual funds and investment advisors. The Israeli Anti-Trust Authority ensures that markets operate in an orderly and efficient manner to ensure a competitive marketplace.

Banking Supervision

The Supervisor of Banks (“the Supervisor”) has sole supervisory responsibility for the banking system and operates inside the Bank of Israel¹⁷. According to the law the objectives of banking supervision are (a) to ensure the safety and soundness of the banking system (b) to promote competition and efficiency and (c) to protect consumers. The Governor of the Bank of Israel appoints the Supervisor of Banks whose term of office is not limited by Law but generally does not exceed five years. The Supervisor of Banks is accountable to the Governor and works with the Governor on important issues. Statutorily, all powers vested with the Supervisor of Banks are vested with the Governor of the Bank of Israel. Upon being appointed the Supervisor becomes an employee of the Bank of Israel. The Supervisor has legal authority to obtain necessary information from banks.

The Supervisor has at his disposal a range of powers to ensure the banks’ safety and soundness of the banking system. Sanctions vary from corrective actions and administrative sanctions to dismissal

¹⁷ Banking Supervision is governed by the following legislation:

Bank of Israel Law, 5714-1954 – Section 3 delineates the role of the Bank of Israel and Section 9 specifies the regulation of the liquidity (monetary) of the banking organisation.

Banking Ordinance, 1941 – Specifies the authority, power and functions of the Supervisor of Banks. It empowers the Supervisor of Banks to promulgate the code of “Proper Conduct for Banking Business” to ensure the banks can meet their financial liabilities and includes an array of corrective measures and enforcement actions that can be imposed on the banks by the Supervisor of Banks without accountability to the Israeli government. The government’s role, in this context, is that in order to proceed with exit resolutions in the case of insolvency (Section 8D to the above Law), the Governor is mandated to receive the government’s approval.

Banking (Licensing) Law, 5741–1981 – Vests the Governor of the Bank of Israel with licensing power and change of control. This Law also restricts the Bank's holdings and prescribes its activities. No accountability to the government is required in terms of government approval.

Banking (Service to Customer) Law, 5741–1981 – Vests the Supervisor of Banks to establish consumer protection via instituting fair practices between banks and their customers, as well as, to promote adequate disclosure and to perform oversight concerning banks fees and commissions.

Anti Money Laundering and Terrorist Financing (AML and CFT) laws – the supervisor of Banks supervises the compliance of AML/CFT laws by banking corporations.

of directors and managers in more severe cases and, in extreme cases, revocation of license. A recent amendment to the Banking Ordinance Law enables the Banking Supervisor to levy fines if he has reasonable grounds to assume that a banking corporation has committed a violation of the "Proper Conduct of Banking Business" directive. The Supervisor is authorised to conduct vetting procedures concerning individuals holding senior and key positions in banks (Fit & Proper Test).

Most Israeli banks are controlled by fairly compact groups of investors. As a result the BoI has regulations covering fit and proper owners for banks and related party transactions. The Supervisor is also in charge of consumer protection in banking.

The Banking Supervision Department employs about 140 employees and is organised along functional lines with 6 divisions: 1) off-site division 2) on-site division, 3) policy and regulation division, 4) bank-consumer relations division 5) Basel II division and 6) central services division. Off-site supervision is organised by banking groups and on-site supervision is organised by categories of risk.

Israel has adopted the minimum risk-based capital ratio as recommended by the Basel Committee for Banking Supervision in the 1988 Capital Accords, dubbed Basel I¹⁸. In 1999, the minimum required risk-based capital ratio level for Israeli banks was raised from 8% to 9%. The required regulatory capital ratio of 9% applies to all banks, but the Supervisor of Banks has the prerogative to apply a higher ratio to banks with a higher risk profile. At present the total risk based capital ratio of Israeli banks ranges from 9.5 -11.5%. In 2008, the Supervisor of Banks began to encourage banks to raise their capital ratio to 12–13% by the end of 2009.

Israeli banks will be required to adopt the Basel II regime by year-end 2009. At the onset, the banks will implement the standardised approaches for credit risk and operational risk. The banks recently completed a test of the standardised approach to credit risk and the results are being analysed and discussed with the industry. In addition to strengthening the stability of the banking system, the implementation of Basel II will align Israeli practice with international standards. It will also level the playing field between domestic and foreign banks since differing practices regarding capital adequacy will cease to be a major distortion among banks operating internationally¹⁹.

Banks are subject to stringent disclosure requirements. Annual and quarterly reports of banks must include the financial statements, the auditors opinion on the presentation of the financial statements, the report of directors and the review of management (similar to the MD&A and the description of business in US), a statement of the directors and management regarding their responsibility for the annual report, and statements of the CEO and the CFO regarding disclosure in the annual report and disclosure controls. From the end of 2008 reports will include a statement regarding management assessment of the adequacy of internal controls over financial reporting and an attestation by the auditors regarding management assessment of these controls.

¹⁸ The Israeli Minimum Capital Directive No. 311 is similar to the Basel I version adjusted to the Israeli accounting system (i.e., financial future instruments). Other capital ratios (such as Tier 1/Risk Weighted Assets) are reported and analysed by the banking supervisors.

¹⁹ See the Bank of Israel's Internet site for more details of the Banking Supervision Department's preparations for the implementation of the Basel II directives.

Capital Markets Oversight

Israel Securities Authority (ISA)

The regulatory body responsible for administering the Israeli securities laws is the Israel Securities Authority (ISA)²⁰. The ISA's main function is to protect the interests of investors by overseeing the activities of the TASE supervising public securities offerings, and mandating disclosure of material information by listed companies by means of publications such as prospectuses, financial reports and other periodic reports. Companies whose securities have been offered to the public in Israel by prospectus or whose securities are traded on the TASE are required to file quarterly and annual reports and certain current reports with the ISA, the TASE and the Registrar of Companies.

The Israel Securities Authority (ISA) was established under the Securities Law to protect the interests of the investing public. The Minister of Finance appoints the chairman of the ISA and its Commissioners. Commissioners are selected from the public, the civil service and the Bank of Israel. The plenum meets once a month.

The ISA has a wide range of responsibilities and powers. Within the framework of this mandate the ISA is charged, *inter alia*, with handling the following issues:

- Issuing permits to publish prospectuses for public securities offerings of corporate issuers, as well prospectuses for mutual fund units to the public;
- Examining corporate filings including current reports as well as quarterly and annual periodic financial statements; filings concerning related-party transactions;
- Regulating and supervising the activities of the CIS industry including on-going monitoring of CIS filings;
- Overseeing the fair, orderly and efficient conduct of secondary markets;
- Licensing and supervising portfolio managers, investment advisers and investment marketing agents. This includes examining compliance as well preparing disciplinary complaints against these investment professionals;
- Investigating violations under various laws and regulations;
- Supervision of compliance of portfolio managers and non-bank stock exchange members to the Prohibition on Money Laundering Law.
- Imposing sanctions for violations of laws and regulations.

²⁰ The three main primary laws for which the ISA is responsible give a good indication of the areas and issues upon which its regulatory activity is focused:

The Securities Law 5728-1968 (“the Securities Law”) is the Act that created the ISA. It relates primarily to the offer of shares and bonds to the public in Israel but also covers such duties and powers of the ISA as supervision of the rules and activities of stock exchanges and general enforcement powers.

The Joint Investment Trust Law, 5754-1994 (“the Joint Investment Trust Law”) is the central pillar of the regulatory regime applying to mutual funds.

The Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law, 5755-1995 (“the Investment Law”) sets out the main regulatory requirements relating to the provision of investment advice and portfolio management services.

The ISA has a duty to oversee and supervise the orderly and fair operation of the TASE. If the ISA is of the opinion, after first having granted the Chairman of the exchange the opportunity to be heard, that the stock exchange is operating contrary to the provisions of its rules or in a way contrary to orderly and fair operation, it may direct the exchange to change its actions. The ISA also monitors the operations of the Tel Aviv Stock Exchange Clearing House and the MAOF Clearing House and may impose fines for certain infractions.

In carrying out its functions, the ISA monitors ongoing reports, such as periodic reports that include financial statements, directors' reports on the status of the corporation's affairs, and any additional information report, quarterly financial reports and immediate reports, which are filed immediately after the occurrence of certain events that could have a material influence on the corporation or on the price of its securities. These reporting requirements are enforceable by the Israeli courts upon the petition of the ISA, which also has certain powers to direct the TASE to suspend trading of a company's securities. The ISA also regulates the CIS industry's activities, supervises, licenses and disciplines portfolio managers and investment advisors and conducts investigations into violations of securities laws.

In some cases the ISA authority is delegated to an SRO (mainly the TASE) as explained above. The ISA drafts and initiates virtually all legislation pertaining to securities law in Israel. In addition, it cooperates with other government departments and the other authorities that regulate the Israeli financial system in formulating policies and laws pertaining to capital market activity. The ISA also collaborates with the Institute of Certified Public Accountants in Israel, in operating and financing the Israel Accounting Standards Board, which is charged with setting accounting standards for Israeli companies.

Securities regulation in Israel is primarily enacted as secondary legislation. Within this process the ISA is by far the most influential player, deciding what issues should be put into regulation, formulating the purpose and boundaries of the regulation, drafting the regulation and explaining the need for the regulation to the Knesset (legislature) Finance Committee and Minister. However, the power to actually enact the regulation rests with the Minister of Finance and the Knesset Finance Committee. Some relatively minor matters (e.g. the format of reports mentioned above) are within the ISA's power but all important issues require the Minister's support to become regulation.

The realities of the market often require swifter intervention than the secondary legislation process can supply and the ISA can in some circumstances employ semi-formal methods to influence market participants. An important example of a semi-formal method is the publication by the ISA on its website of staff legal bulletins (SLBs) and staff accounting bulletins (SABs). These are statements of the ISA's position on regulations in relation to issues that have arisen in specific real life cases and which the ISA believe are likely to occur again in the future. In effect these amount to statements of how the ISA will enforce certain regulations and therefore strongly encourage market participants to act in a way that is in accordance with the ISA position.

Current Challenges in Capital Markets Oversight

A number of clear challenges face those areas of the capital market concerned with securities and the provision of regulated investment services to the market. While it is the responsibility of the intermediaries active in these fields to adapt efficiently to these challenges, it remains the responsibility of the ISA to ensure that the regulatory framework within which these intermediaries operate helps facilitate the changes required whilst continuing to offer a high level of investor protection in these new conditions.

In this context globalisation raises many challenges both for the market and its regulators. The ISA has for some years made the harmonisation of Israeli and foreign securities regulation a long-term strategic priority. Today, no new legislative initiative proceeds without a detailed examination of how it will affect cross-border business. A number of projects exemplify the strong emphasis placed by the ISA on integration with foreign markets. For example, the recent MoU between the ISA and the French regulator, the AMF, will probably be indicative of future patterns of international cooperation in securities trading and regulation. As a result of the MoU, an Israeli company will be entitled to have its shares admitted to trading on a French regulated market using its Israeli prospectus, and a French company will enjoy the same benefits in listing on TASE. The ISA and AMF are currently working on an addendum to the MoU that will allow company reports in one jurisdiction to be accepted as equivalent in the other so as to reduce the regulatory burden of a dual listing as far as possible. Amendment to the Joint Investment Trust Law and the Investment Law will open up the CIS market and the investment advisory and management industry to far greater foreign involvement.

Another important challenge is the huge growth in complex products (see next paragraph.). With liberalisation and deregulation, a new investment climate has emerged. As a result of growing competition, institutional investors began to seek alternative investment opportunities. This climate has encouraged financial intermediaries to increase and vary product offerings, creating greater public access to complex, sophisticated financial instruments, which grant potentially greater returns but engender higher risk as well. Various financial intermediaries have begun to market complex financial products via special purpose companies that are set up specifically for the purpose of issuing exchange traded debt instruments for listing on TASE. As traded securities, these instruments are readily available to the public at large, despite the fact that due to their complexity and other characteristics, they are essentially not suitable for the retail market. During 2008, in response to the above issues, a series of directives were issued to the market requiring enhanced disclosure in relation to complex products from their issuers.

This environment has led to a substantial increase in the number of Israeli financial companies offering securities to the public. The hallmark of these companies is their conduct of complex financial activity and lack of public disclosure. For example it is often not evident how these companies cover payment liabilities to the purchasers of their products. Among the complex and opaque activities of these investment companies are: a) issuance of index linked notes; b) securitisation of cash flows from deposits and loans or from corporate bonds; and c) issuance of notes with embedded structured products. In many cases the core business of these companies whose is the pursuit of aggressive investment strategies involving high leverage and derivatives. These corporations, which are often private companies issuing debt instruments with embedded complex products, are exempt from the corporate governance provisions of the Companies Law governing public companies (such as approval of related party transactions, the appointment of outside directors, internal auditors, etc.), as well as from the substantive regulation under the Joint Investment Trust Law.

In light of the importance of this issue, the ISA has set up a Financial Instruments Committee to examine the need for changes to the regulation of financial instruments traded on TASE. In October 2007 the Committee published an interim reports setting out the issues involved in its mandate and its goals. Since then the ISA has consulted with various industry participants and also held an open discussion forum at its offices attended by representatives of many of the major Israeli intermediaries (deposit and non-deposit taking). The Committee's work continues and its final report has not yet been issued.

Current Regulatory Reforms for capital markets

The ISA is currently working on a wide range of regulatory reforms covering diverse aspects of its work. The current heavy agenda is partly a result of measures introduced as responses to the financial crisis.

Regarding bonds, the ISA is preparing legislation that will improve bond holders rights and powers both in its relationship with the issuer and with the trustee. New rules are also designed to improve the quality of trustees' activity on behalf of bond holders. Also extensive new disclosure requirements for debt instruments focus on providing investors with full disclosure of cash flow and sources for debt repayment. Other new requirements aimed at revealing data relating to the issuer's ability to meet its obligations require disclosure by the issuer of its exposure to macroeconomic events. Public companies that are investment firms must also disclose risks arising from assets it holds for its own account.

Various new disclosure requirements are being put in place in relation to financial instruments. These include the need to disclose the basis of valuations used in ETNs and other index based products and also the exposure of issuers of financial products to the credit risk of other financial institutions involved in the structuring of the product.

In the field of CIS, current reforms include an amendment to the Joint Investment Trust Law, opening the Israeli market to foreign funds for the first time (known as Amendment 13). In the wake of the crisis the ISA has produced a number of new pieces of regulation setting out enhanced disclosure rules relating to both fund prospectuses and financial statement of funds. These give special attention to reporting of funds' exposure to high risk assets.

The ISA has issued for public comment the first draft of a new law regulating credit rating agencies both in terms of requiring licensing and in terms of their ongoing activities.

One of the most wide reaching pieces of legislation currently being prepared is the Financial Intermediaries Law. This new law is designed to bring all providers of financial services under a coherent and comprehensive regulatory regime. The first internal draft of this law was recently completed and this is currently being developed internally within the ISA.

An important amendment to the Securities Law bringing dealer (internet) platforms under a regulatory regime recently completed its period of public comment and a revised text has been published by the ISA.

Over the last year or so amendments to the Securities Law and Investment Advisors and Portfolio Managers Law has provided the ISA with new powers to impose civil sanctions. This development is part of a wider programme to increase the responsiveness of the ISA to fast moving events of the capital markets. The next stage includes ISA proposals to increase its own rule making powers and the setting up of an expert court for corporate matters that would hear cases stemming from securities law.

B. Financial Stability Oversight and Macro-Prudential Surveillance

As mentioned above, financial supervision is structured along institutional lines with different agencies regulating the different sectors of the financial industry. As in other countries the development of new financial instruments and the emergence of complex pattern of risk with systemic implications have raised the awareness of the need for coordination of financial supervision, especially to buttress the capability of the supervisors to prevent and manage crises.

Traditionally, financial stability has not been a uniformly critical concern for all Israeli financial supervisors. For example, the ISA has historically been concerned mostly with issues of market conduct and investor protection. Of course, the development of complex and opaque financial products as described in the preceding section raises a number of issues that the capital markets supervisors must now confront to a far greater degree than in the past. Insurance companies, pension funds and provident funds traditionally did not assume many of the risks that could lead to systemic strain. However, these institutions are now increasingly exposed to the corporate sector and to exotic products.

The institution that has the strongest history of involvement with stability issues is the Bank of Israel. Banks are the category of institution where official intervention in response to the risk of a failing institution has been most likely. Indeed, as discussed above the authorities have been obliged to intervene in the past to rescue and/or resolve failed banks. Furthermore, since banks are important throughout the financial system and control many non-bank financial institutions, banks are likely to be at the centre of any future crises. At the same time many non-bank institutions are assuming risks that could have systemic consequences and could require the central bank to act as lender of last resort. As a result, interest in systemic risk and the safeguarding of systemic stability, some of which may arise outside of the banking system narrowly defined, has been increasing.

In June 2007 the Banking Supervision Department, the Israel Securities Authority and the Capital Market, Insurance and Savings Division of the Ministry of Finance signed a memorandum of understanding (MoU) on cooperation and sharing of data.

The stated objectives of the MoU include:

- To advance the coordinated, efficient, fair and uniform supervision of the Israeli financial system;
- To strengthen the stability, transparency and fairness of Israeli financial markets; and
- To advance the implementation of best supervisory practises commonly accepted around the world.

In the initial phase the Supervisor of Banks, the Chairman of the ISA and the Commissioner of the Capital Markets, Insurance and Savings, and the Anti-Trust Commissioner will convene monthly meetings for discussions and exchanging information.

C. Resolution Framework for Individual Financial Institutions and Deposit Insurance

The Governor of the BoI is empowered by law to manage banking crises, including the formulation and execution of resolution procedures. The relevant law states that if, after consulting the Supervisor of Banks, it is concluded that a particular bank is unable to meet its obligations or that its business was conducted in a manner seriously deviating from sound practice, the Governor may appoint (a) an administrator to manage the bank (b) special examiner to supervise its management or (c) a management committee to advise the administrator.

In cases where circumstances require the action to be taken without delay, the Governor may take such action without providing the bank a prior opportunity to defend its conduct. The law grants the Governor a short time span in which to formulate an appropriate resolution plan for the bank before the courts intervene. When the BoI has intervened in a bank, the ability of courts to order wind-up, insolvency or related action is circumscribed for a certain time.

The Governor's options for resolving troubled institutions include: (1) liquidation, which is typically seen as the least desirable form of resolution; (2) acquisition by the government. This option, while theoretically possible, would be seen as an inferior option to other forms of resolutions, especially after the privatisation that took place in the last decade; (3) consolidation with a stronger institution under terms negotiated between the BoI and the acquiring bank; and (4) open bank assistance. The Bank of Israel can function as a lender of last resort, especially if the bank is seen as potentially solvent. The BoI may make emergency loans and advances, even if the bank's solvency is in question, if this is judged to be the most expeditious course of action. There is no legal impediment to the exit of banks from the market.

As noted above there is no formal deposit insurance scheme, however, the law specifies that (a) the Governor may decide to guarantee in whole or in part (1) deposits of a bank in which the BoI has intervened or (2) other classes of bank liabilities. The guarantee may be for a limited or unlimited time, subject to conditions or unconditional. The implicit government guarantee is a result of the precedent established in 1983 when the government saved the major Israeli banks by nationalising them. The authorities strengthened this precedent by guaranteeing the deposits of two small banks which failed in 1985 and in 2002. The Governor of the Bank of Israel is empowered to guarantee deposits upon receiving the Government's approval. In fact, the authorities have never permitted bank depositors to lose money and market participants believe that the government has an implicit guarantee for all bank deposits.

Foreign banks which operated in Israel in 1983, whether through subsidiaries or branches, did not need government intervention; nor did a few local banks. In a recent pronouncement on this subject, the authorities indicated that there would be no discrimination between local and foreign banks. Also the reform proposals that are currently being considered would include the deposits in subsidiaries or branches of foreign banks. The authorities indicate that if a formal deposit insurance scheme were to be established, there would be equal treatment of local banks and foreign banks' subsidiaries and branches.

D. International Surveillance Assessment of Israeli Financial Supervision

The IMF and World Bank conducted the first FSAP of Israel in September 2000. The reports were published in 2001, and can be found on the IMF website. The mission conducted an extensive review of the financial sector in Israel and, where applicable, assessed compliance with international standards and codes (ROSC). A follow-up report was conducted in 2002.

The assessment of Israel's systems for financial supervision and for crisis management were essentially positive. No major sources of systemic risk were identified in the banking system which was judged to be adequately capitalised and supervised with reasonable risk profiles and sound risk management systems. However, some issues did warrant mention and calls for subsequent action were made. In particular, several points of vulnerability were noted in the payments system. The reports also highlighted problems in the legal structure involving the central bank law and the laws governing the payments system. The lack of a formal deposit scheme, especially in the case of a country with a history of banking crises was noted. Problems of coordination and information sharing among the various supervisors were also mentioned (for a summary of the recommendations, see Box 1). Most of the suggestions for improvement have been implemented but a few are still in the process of formulation. For example deposit insurance and revision of the central bank law are still being discussed.

The IMF have conducted several missions in 2006-2007 that dealt with the architecture of the Banking Supervision Department, the overall structure of financial supervision in Israel and the

assessing the reforms implemented in the financial sector in recent years. These reports have been published on the IMF Website.

Box 1. Summary of Recommendations

To the Bank of Israel:

Monetary Policy

- Adjust the design and use of monetary policy instruments to improve the implementation of monetary policy and to boost money market development (standing facilities, reserve requirement, open market operations)

Banking supervision and policies

- Allow banks to broaden scope but with prudential and customer protection restrictions
- Improve bank reporting on collateral
- Encourage banks to adopt uniform credit rating categories
- Adopt explicit deposit insurance

Payment System

- Establish clear Bol oversight of payment systems
- Develop a LVTS compliant with the Core Principles
- Establish a National Payments Council

To the Ministry of Finance

Securities

- Remove limits on issuance of “Makam” monetary policy bills

Capital Controls

- Phase out remaining controls

Insurance and pension supervision

- Transfer supervision of provident funds for short to medium term savings to ISA
- Phase out use of non-tradable fixed real return government securities and liberalise investment options
- Strengthen supervision staff and capabilities
- Give Commissioner of insurance more independence and more flexible intervention powers
- Separate the governance overview and management of pension funds

To the Israel Securities Authority:

- Obtain the authority to impose civil sanctions
- Stop providing financial support for class action suits

To the Government:

- Establish a council to coordinate financial sector supervision
- Relevant laws should be amended to allow sharing of supervisory information among supervisors
- Adopt tax reforms leveling the playing field in financial instruments
- Strengthen Bol independence and accountability by adopting a new central bank law that reflects Maastricht principles as recommended by the Levin Committee report of December 1998
- Strengthen legal basis of banking supervision and bank exit
- Adopt a modern payment law

VII. INTERNATIONAL FINANCIAL INTEGRATION AND MARKET ACCESS

As mentioned earlier, exports and imports account for a large share of national income. On the capital account as well, the degree of Israel's financial integration into the global economy, as measured by direct and portfolio investment, has grown appreciably in the recent decade mainly due to the adoption of a freely floating exchange rate regime, the stabilisation of inflation, the lifting of exchange controls and the structural reforms that were implemented during this period. The latter reforms removed barriers to investment, removed elements of distortion in investment decisions, and contributed to a greater foreign investment in Israel and diversification of Israel's portfolio abroad.

A. Recent Developments in Cross Border Investment

The analysis of cross-border investment can be subdivided into four segments: (1) foreign residents' positions in Israel and overseas investment by three categories of domestic residents, (2) households, (3) the business sector and (4) institutional investors (see Table 11).

Table 11. Summary of Israel's International Investment Position, end-2008 (US \$ million)

	(end-of-year balance, NIS billion)		
	2006	2007	2008
Total assets	167.2	191.5	191.2
<i>of which</i> Debt instruments	120.1	132.1	131.6
Direct investment abroad	39.8	48.5	54.6
Portfolio investment	37.1	44.7	35.7
Other investments abroad	60.8	69.5	58.3
Reserve assets of general government	29.5	28.8	42.7
Total liabilities	174.4	202.4	184.4
<i>of which</i> External Debt	86.7	89.1	85.3
Direct investment	49.4	55.7	56.9
Portfolio investment	70.5	87.6	71.6
Other investments	54.5	59.1	55.8
Net liabilities	7.1	10.8	-6.8
<i>of which</i> Net external debt	-33.5	-43.0	-46.3

Source: Bank of Israel

The expansion in **foreign residents'** direct investment in recent years, which was centred in high-tech companies and that continued in 2007 despite the cessation of major privatisations, reflects foreign investors' confidence in the Israeli economy and its technological position. Foreign residents' activity in equity instruments was more moderate than in 2006, while their purchases of debt instruments increased. Foreign residents' investments in Israeli equities totalled \$ 12 billion in 2007.

The vast majority of this activity took the form of FDI, which although more moderate than in 2006 was higher than the multi-year average. Unlike in 2006, direct investments were dispersed evenly throughout 2007 and were comprised of numerous small transactions. The volume of foreign investment in shares traded on the Tel Aviv Stock Exchange increased in 2007 compared to 2006. The development of this investment in the course of the year was mainly affected by trends in global investment in the emerging markets. However, the influx of foreign investment onto the Tel Aviv Stock Exchange early in the year and the reversal of the trend after the global crisis were more moderate than the capital flows in the other emerging markets.

Activity by **households and institutional investors** during 2007 was mainly affected by the tax reform (which went into effect at the beginning of 2005), the development of relative prices in the local and global financial markets, and by assessments regarding the development of shekel exchange rates. Households' response to geopolitical developments in the course of 2007—unlike in the past—appears to have been moderate.

At the beginning of 2005, the terms of taxation applying to investments abroad and in Israel for households, mutual funds and part of the institutional investors (provident funds and pension funds) were equalised. This measure, which increased the relative attractiveness of investment in foreign assets, spurred a process of portfolio adjustment by households and institutional investors. Since the implementation of the tax reform, long and medium-term **institutional investors**²¹ increased their rate of investment in foreign assets by 8 percentage points (See Figure 8). Their rate of investment abroad, which amounted to 10 % at the end of 2007²², is still lower than the rates usual in similar countries (25 % on average). This is indicative of the potential for further portfolio diversification in the future. Institutional investors' rate of investment abroad is notable for high variability: While life insurance plans' rate of investment abroad amounted to 18 % at the end of 2007, the rate of investment by the provident funds and new pension funds was 10 % and that of the established pension funds—only 4%. The differences in the rates of investment mainly derived from differences in the timing of the removal of the barriers to investment abroad: The permit to invest abroad for the established pension funds was only issued at the end of 2005, while insurance companies have been diversifying their assets globally since 2001.

Households diversify investments abroad directly and indirectly by accruing assets in CIS specialising in investment in foreign securities, and via investment in ETFs on foreign share indices. Households' activity in these assets during 2007 was not uniform. Households' redemptions of mutual funds specialising in foreign securities which began in the second half of 2006 continued. At the same time direct investments in foreign securities and investments via ETFs on foreign indices continued to rise.

B. Internationalisation and Capital Market Regulation

Market Access for Foreign Institutions and Investors

As mentioned above, Israel lifted exchange controls in the 1990s. Israel's policies toward the establishment of foreign banks and to foreign investment in the Israeli market have also been liberalised considerably in recent years. Moreover, data from the Bank of Israel show that banks owned by foreigners and Israeli branches of foreign banks account for approximately 18% of the total

²¹ Provident funds, advanced study funds, insurance companies and pension funds.

²² Including investment in ETFs on foreign equities markets and excluding investment in Israeli shares traded abroad.

banking assets. The Israeli authorities indicate that it is their policy to encourage greater foreign involvement in their financial system in order to spur competition and raise domestic efficiency, and that there are only minimal regulatory entry barriers in the banking sector.

At the same time it can be observed that comparatively few foreign banks and securities houses are established in Israel. Despite the BOI's efforts to encourage the expansion of foreign banks activity in Israel, only four of them have opened branches in Israel: Citibank, HSBC, BNP Paribas and the State Bank of India. Moreover, these banks prefer private banking and serving big enterprises rather than in retail banking which requires a high level of investment in branches.

At the same time it can be observed that comparatively few foreign banks and securities houses are established in Israel. Thus, only four foreign banks have established branches in the country and only a few foreign securities houses are established. Several investment institutions operate through local representative offices, and two foreign institutions UBS and Deutsche Bank are members of the TASE. The Israeli authorities require foreign banks to set aside capital for their local branches and can require foreign institutions to establish as subsidiaries rather than as branches. However, it is unclear whether this can explain the rather limited established presence of foreign institutions.

Investment banking was the first field to experience widespread foreign activity in Israel. Foreign institutions are now prominent in this field, not only in arranging international operations, but also participating in local activity by Israeli corporations in offerings or mergers and acquisitions. Foreign institutions have a sizeable presence in asset management and their presence in this field is expected to grow. Foreign institutions control some independent institutions that offer CIS. On the other hand, foreign institutions have not been active in the retail market where local banks still dominate despite official policies of encouraging more competition. Until recently, the ISA required foreign institutions to establish an Israeli subsidiary in order to offer CIS or to provide investment advice. Recent ISA rulings may enhance the possibility to offer such products and services on a cross border basis.

In summary, there is an apparent paradox in the eagerness of the authorities to expand foreign participation in the financial system and the relatively modest foreign presence, at least in an established form that can be observed.

International Reserves

When the Bank of Israel initially announced its program of foreign currency purchases in March 2008, it announced the goal of increasing its foreign currency reserves to \$35-40 billion. In November, 2008, when the reserves stood at \$37 billion, the Bank announced that it had revised its assessment of the appropriate level of the reserves to \$40 - \$44 billion. The BOI therefore indicated that it would extend the program and would continue to purchase about \$100 million per business day. In March, 2009, when the reserves reached approximately \$44 billion, the Bank announced that, against the background of the world economic situation and in the context of its overall policy, it would continue to purchase on average US\$100 million per day, as part of its program to increase the level of the foreign exchange reserves. At that time it did not announce a new target for the reserves' level. At the time of its announcement in March, 2009, the Bank stated that, "The Bank will continue to review the program from time to time and make adjustments if and when they are required." Decisions in that process of continuing review are being made in light of the current level of the foreign reserves and the Bank's target level for the reserves, which may change from time to time as economic and financial market conditions warrant (changes which may or may not be announced), and they are in all cases subordinate to the Bank's policy goals of maintaining price stability and, subject to that, supporting the economic policy of the government (promoting growth and employment) and supporting financial stability.

It was announced that the purchase of foreign exchange by the Bank will be conducted so as to avoid any inappropriate impact on the exchange rate and to minimise interference with the market mechanism. The Bank's daily purchases would be small compared to the average daily volume in the Israeli foreign exchange market, currently over \$ 2 billion daily. In August 2009, the BoI announced that it will act in the foreign exchange market in the event of unusual movements. Following the adoption of this new operating policy, it discontinued its program of daily purchases of \$ 100 million.

The program to increase foreign exchange reserves involves no changes to the Bank's policy goals – maintaining price stability and subject to that, supporting the economic policy of the government – promoting growth and employment and supporting financial stability. The program does not change the investment policy of the foreign exchange reserves.

The trend of the ratio of Israel's foreign currency assets to its foreign currency liabilities has generally been positive over the past eight years, rising from about 52% at the end of 1999 to a high of 92% at the end of 2006 and declining slightly to 87% at the end of 2007. The rise in this ratio reflects in part the fact that Israel's financial account has shown a net outflow of capital every year since 2001, responding to surpluses in the current account, changes in the field of retirement savings, and the gradual adjustment of portfolio composition by individual and institutional investors in the wake of foreign currency liberalisation.

Prospective domestic financial system reforms should contribute to greater integration of Israel into the global economy and global financial system, with positive effects for the composition of Israel's foreign currency assets and liabilities.

Sovereign rating Upgrades

Important upgrades of the ranking of Israel's economy by international agencies have taken place. At the end of November 2007, Standard & Poor's raised Israel's long-term foreign currency rating from A- to A. At the same time, the agency kept its credit outlook on Israel at "Positive". On July 16, 2009, Standard and Poor's Rating Services affirmed its A/A-1 foreign- currency and AA-/A-1+ local-currency rating of the State of Israel, with stable outlook. In early February 2008, Fitch also raised Israel's long-term foreign currency rating from A- to A with a "stable" outlook.

Remarks of the OECD Investment Committee

In response to a request by the OECD Investment Committee, Israel announced that the Governor of the Bank of Israel has decided no longer to apply the requirement that investors, including foreign investors, holding a controlling interest in an Israeli bank must maintain their investments for at least five years.

Regarding cross-border services, Israel is planning to eliminate the existing residency requirement for advisory and agency services via the proposed amendment to the Regulation of Investment Advice, Investment Marketing and Portfolio Management Law (so called "Amendment 11"). Under this draft amendment, a non-resident intermediary would be able to provide advisory and agency services under the same requirements as Israeli residents. Israel also agreed to eliminate the restriction on the establishment of branches of investment advisors, investment marketers and portfolio managers, and the establishment requirement for underwriters.

With respect to the establishment of representative offices of foreign bank, Israel assured the Investment Committee that the Governor of the Bank of Israel intends to grant a general consent to an entity that has been incorporated and licensed to operate as a bank in an OECD country and is

supervised by the regulatory authority in that country on a consolidated basis, to use the word "Bank" in the name of the Representative Office (referred to as: Rep office) that will open in Israel. This general consent will be subject to the following conditions:

- The Representative Office will engage solely in promoting business on behalf of its parent bank,
- Notice was given prior to the opening of the Representative Office in Israel, and
- The Representative Office will clearly indicate, while promoting business, the fact that it is a Rep office.

Upon adoption of the measures outlined above, Israel will maintain reservations only regarding pension fund management, notably the cross-border provision (item E/4 of the CLCIO) and the establishment of branches (item I/A of the CLCM and item E/7 of the CLCIO) in this sector.

The full account of Israel's position under the OECD Codes of Liberalisation can be found in the report of the Investment Committee [DAF/INV/ACS(2008)2/FINAL].

VIII. COMPLIANCE WITH THE OECD LEGAL INSTRUMENTS ON FINANCIAL MARKETS²³

C(2009)62 and C(2009)62/CORR1: Recommendation of the Council on Good Practices on Financial Education and Awareness Relating to Credit

Israel accepts the recommendation.

Israel considers that its policy in this area is consistent with the principles in the document in the field of banking, insurance and pensions.

Israel notes that financial education is one of the goals of the Bank of Israel and of the Banking Supervision Department (the BSD). One of its four divisions is devoted solely to banking customer protection, in order to maintain fairness in relations between a bank and its customers. The division handles public inquiries and complaints, and rectifies individual wrongdoings as well as system-wide faults. The inquiries and complaints provide feedback which, in some cases, leads to the amendment of an existing regulation or the issuance of a new one. The division also submits requests to eliminate discriminatory terms from banks' uniform contracts to the Uniform Contracts Court. According to the authorities, the division deals annually with thousands of inquiries and complaints, and in its responses gives detailed explanation on related matters, and guides the public to relevant publications.

The authorities emphasise that there is a broad banking customers protection legislation, as well as regulations which regulate various matters, including, inter alia, the following: list of terms and conditions that a bank should provide to its customer at the initial stage of a transaction, including a loan; procedures for extending a mortgage at various stages, including information that a bank should provide at the negotiation stage; loan management procedures; fees on early repayment of a loan; terms and conditions of credit line; debit cards; providing an alternative home in case of a mortgage foreclosure; a reform of banking fees, including loan fees which enhanced transparency and the ability of customers to compare fees among banks; limit on interest on late loan repayment. There are specific protections on minors' banking accounts, and transparency regulations covering banks dealing with new immigrants. The BSD enforces compliance with these regulations.

The BSD promotes financial education and awareness by placing the legislation and regulations on the Bank of Israel's website. This website includes also guides on mortgages, current accounts, fees and other matters. These guides include, inter alia, important advice on what questions to ask a bank in order to reach a rational decision before signing a loan document. The website includes also answers to most frequently-asked questions, links to relevant laws and regulations.

The BSD issues an annual report which includes a chapter on the work of the customers' protection division. The BSD also issues public information notes on relevant topics which appear in newspapers and other media, gives interviews and conducts information campaigns. According to the

²³ Israel's complete submission on all the legal instruments except C(2009)62 can be found in Israel's Initial Memorandum, which is made available to the Committee [DAF/CMF/ACS(2008)3]. Israel's submission on C(2009)62, which was adopted after the submission of the Initial Memorandum, is set out below.

authorities, the BSD will continue to narrow the gap between the bank customer's knowledge and that of the bank.

The Capital Markets, Insurance and Savings Division (CMISD), together with the Ministry of Education, have formulated a financial consumer education program based on the principles of the OECD documents. The program was introduced into the "life skills" program in elementary schools in 2007, and it has been expanded to secondary schools in 2009.

In addition, the CMISD is also working to provide information to the Israeli public by launching a website providing tools for comparing different pension plans, insurance companies and provident funds.

According to the authorities, the importance of the fairness of the services that the Israeli public is enjoying is reflected in the work done by the Consumer Ombudsman Unit of the CMISD, which examines complaints received from the public relating to all bodies that are supervised by the CMISD.

C(2005)55/Rev1: Recommendation of the Council on Principles and Good Practices for Financial Education and Awareness

Israel accepts this Recommendation

According to the Israeli authorities, there is extensive financial education activity in Israel. The Israel Securities Authority (ISA) in cooperation with the Tel Aviv Stock Exchange (TASE) held a campaign to educate investors, focused on providing basic knowledge about the capital markets and on increasing the public's awareness of the rights of financial consumers. In 2007, the ISA set up a unit dedicated to enhancing investors' understanding of the financial markets.

The Capital Market, Insurance, and Savings Division, together with the Ministry of Education, have formulated a financial consumer education program based on the principles of the OECD document.

C(75)198: Recommendation of the Council concerning Minimum Disclosure and Procedure Rules to be Complied with before Securities may be Offered to the Public

Israel accepts this Recommendation

Israel considers that its disclosure requirements, both with respect to prospectuses and ongoing reporting are in compliance with the international standards established by the OECD and IOSCO.

Israel's disclosure regime is based on reporting in prospectuses at the time of initial public offering; ongoing reporting of financial information; information regarding a company's corporate officers and other (non-quantitative) business information.

C(74)157: Recommendation of the Council concerning Regulations for the Public Offer and for Stock Exchange Listing or Quotation of Foreign Securities

Israel accepts this Recommendation with the following observation:

Israel accepts the recommendations in the document, subject to the retention of the present requirements for the recognition of dual listing.

Foreign Companies are required to publish in Israel a prospectus prior to the listing of their securities for trade on TASE and are subject to disclosure and reporting requirements identical to those applicable to Israeli companies.²⁴

Israel allows dual listing of securities issued in countries and on stock exchanges where disclosure requirements and the quality of supervision have been examined and recognised by Israel as providing adequate protection for the investors. In 2000, the Securities Law was amended with the purpose of encouraging dual listing on TASE of companies whose securities are traded in foreign countries, by granting an exemption from the listing requirements. The meaning of this exemption is that reliance is placed on the regulation and supervision of the foreign regulators (in this case, in the United States and in London), and that the costs usually involved in dual listing can be avoided.

Nevertheless, the dual listing arrangement is permitted only with regard to those stock exchanges and countries in which Israel has examined the disclosure requirements and the quality of the regulation and supervision and has found them to be appropriate. The arrangement is used with regard to companies whose shares have been offered on the NASDAQ, AMEX, NYSE and LSE Main Market Primary Listings.

The intention of the ISA is to move towards reaching mutual recognition agreements with other national regulators - such that Israel will recognise the regulation of another country and that country will recognise Israel's regulation, for the purpose of listing companies' securities for trading.

C(74)156: Recommendation of the Council concerning Disclosure Requirements and Procedures to be Applicable to all Publicly Offered Securities

Israel accepts this Recommendation.

Israel considers that its policy in this area is consistent with the principles and standards detailed in the IOSCO document, "Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities" (Oct. 2002). Israel considers that it fully complies with the disclosure requirements stipulated in the OECD documents.

C(74)61: Recommendation of the Council concerning the Review of any Restrictions which Member Countries Impose on Portfolio Investment in Unlisted or Unquoted Securities

Israel accepts this Recommendation.

Israel submits that its policy in the area in question is consistent with the principles in the document. In general, no restrictions are imposed in Israel on the purchase of securities not traded on the stock exchange. The few restrictions that exist are imposed in order to protect investors. The agencies responsible for supervision of the securities market do not attempt to influence investors' investment decisions and do not attempt to present securities traded on the stock exchange as "approved" securities. There are, according to the authorities, no restrictions on foreign investments by Israeli citizens or residents.

²⁴ Israel's adoption of the international financial reporting standards (IFRS), beginning on 1 January 2008, makes it easier for foreign companies wishing to offer their shares in Israel.

C(71)234: Recommendation of The Council concerning Standard Rules for the Operation of Institutions for Collective Investment in Securities

Israel accepts this Recommendation

Israel considers that its policy in the area in question is consistent with the principles in the document. The authorities consider that mutual funds are tightly supervised in Israel, in line with the principles in the document. This supervision is carried out by the Israel Securities Authority, pursuant to the Joint Investment Trust Law of 1994. Foreign mutual funds interested in marketing units in Israel are subject to all requirements applicable to local funds. Israel is in the process of changing legislation in order to facilitate the marketing of units by foreign mutual funds in Israel.

New legislation was recently enacted which enables the establishment of an Israeli “fund of foreign funds” which will invest most of its assets in foreign funds. This arrangement will enable the Israeli public to have actual access to foreign funds, and will allow the managers of foreign funds to have access to the Israeli public. Under the current system there is nothing preventing Israeli fund managers, pursuant to the Joint Investment Trusts Law, from investing all of the assets in the funds that are under their management in foreign securities, nor does anything prevent them from transferring the management of their funds’ portfolios to foreign portfolio managers.

According to a proposed amendment to the Joint Investment Trust Law known as Amendment 13, (which is still in the early stages of the legislative process) the Finance Minister upon the ISA’s recommendation, will be authorised to stipulate provisions that if fulfilled shall allow the ISA to permit the offer of foreign funds in Israel based on their local regulation without further need to comply with Israeli regulation. The said provisions will be included in secondary regulation and their parameters have not been finalised. However they might relate, inter alia, to the fund’s country of origin, the law under which the fund was established, standards of supervision of the fund, fund investment policy and characteristics of the fund's manager.

C(71)176: Recommendation of the Council on International Security Issues

Israel accepts this Recommendation.

Israel considers that its policy in the area in question is consistent with the principles in the document. There are no restrictions imposed in Israel on the purchase of foreign securities by residents of Israel. Following a tax reform, as of 2005 there is no discrimination in the taxation of income derived from investments in foreign securities versus local securities. Further, in general there are no restrictions imposed on the purchase of Israeli securities, including the purchase of government bonds, by citizens of foreign countries.²⁵

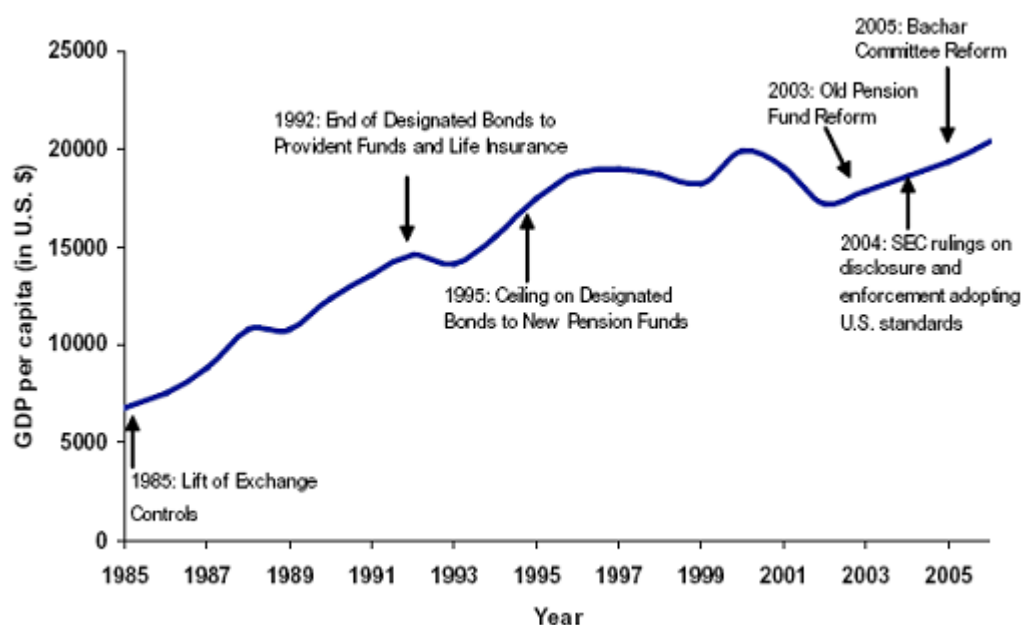
²⁵ Subject to the provisions of the Prohibition on Terrorist Financing Law, 2005.

As there are no limitations regarding the purchase of foreign securities, there are also no limitations on Israeli companies who wish to offer their shares abroad. Thus there are 278 Israeli companies that/[whose securities] are listed for trading on stock exchanges outside of Israel: 205 companies are listed for trading in the United States and 73 are listed for trading on European stock exchanges.

ANNEX I - FIGURES

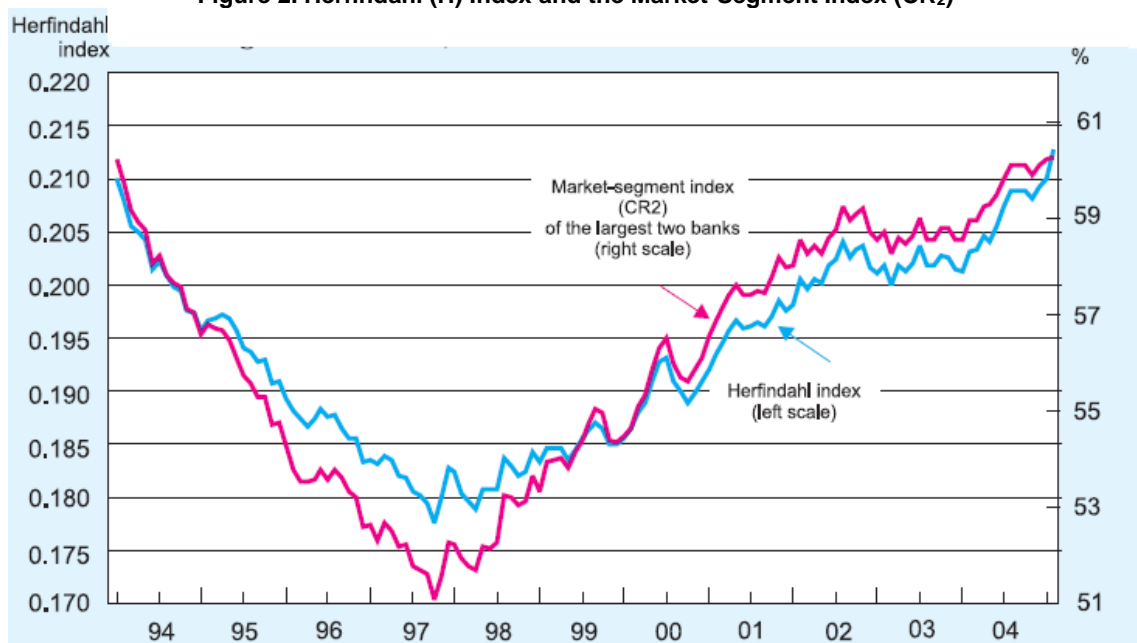
- Figure 1. Capital Market Reforms in Israel 1985-2006
- Figure 2. Herfindahl (H) Index and the Market-Segment Index (CR_2)
- Figure 3. Relative Excess Capital Adequacy in Selected Banking Systems, 2006
- Figure 4. Structure of Government Debt
- Figure 5. Issuance of New Government Debt, 1992-2007
- Figure 6. Breakdown of Shares Ownership on Tase
- Figure 7. The Public's Holdings in Exchange-Traded Funds (ETFs), 2003-07
- Figure 8. Investments and Rate of Investment of Institutional Investors in Foreign Assets, December 2001 to December 2007

Figure 1. Figure 1. Capital Market Reforms in Israel 1985-2006



Source: Amit Goldwasser, Diana Zaks, and Shahar Shlush, *Beyond Bachar: Next Steps for Financial Reform*, Koret-Milken Institute 2007.

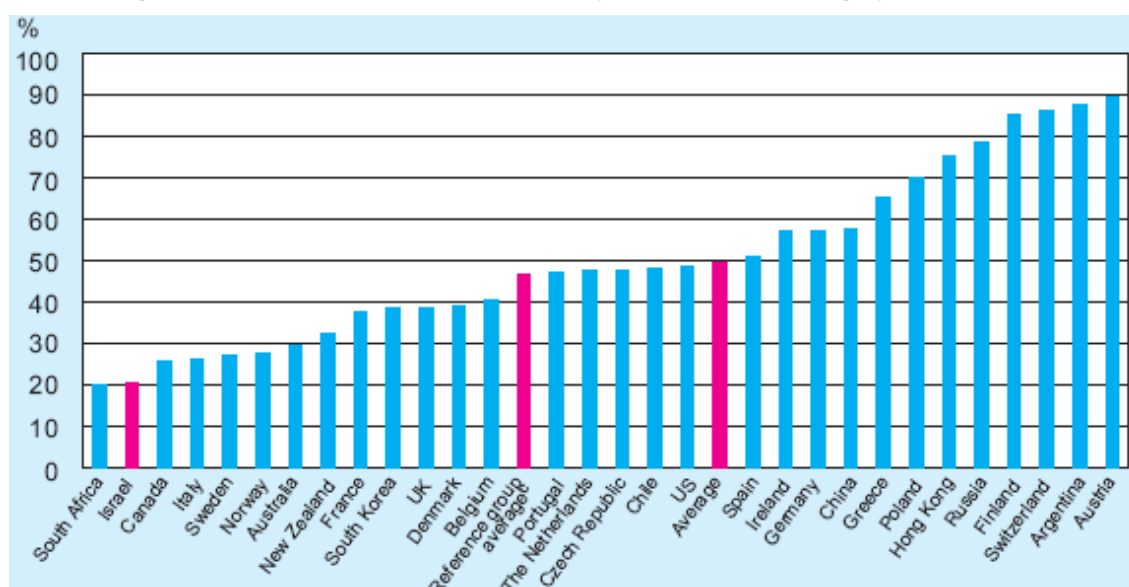
Figure 2. Herfindahl (H) Index and the Market-Segment Index (CR₂)^a



^a The concentration indices are calculated from data on individual banks on credit to the public in the non-indexed local currency segment.

Source: Ruthenberg, David (2005), "Competitiveness in the Banking Industry: Theoretical Aspects and Empirical Evidence from Israel and Abroad", Working Paper 05.02, Research Unit, Bank of Israel Banking Supervision.

Figure 3. Relative Excess Capital Adequacy^a in Selected Banking Systems^b, 2006



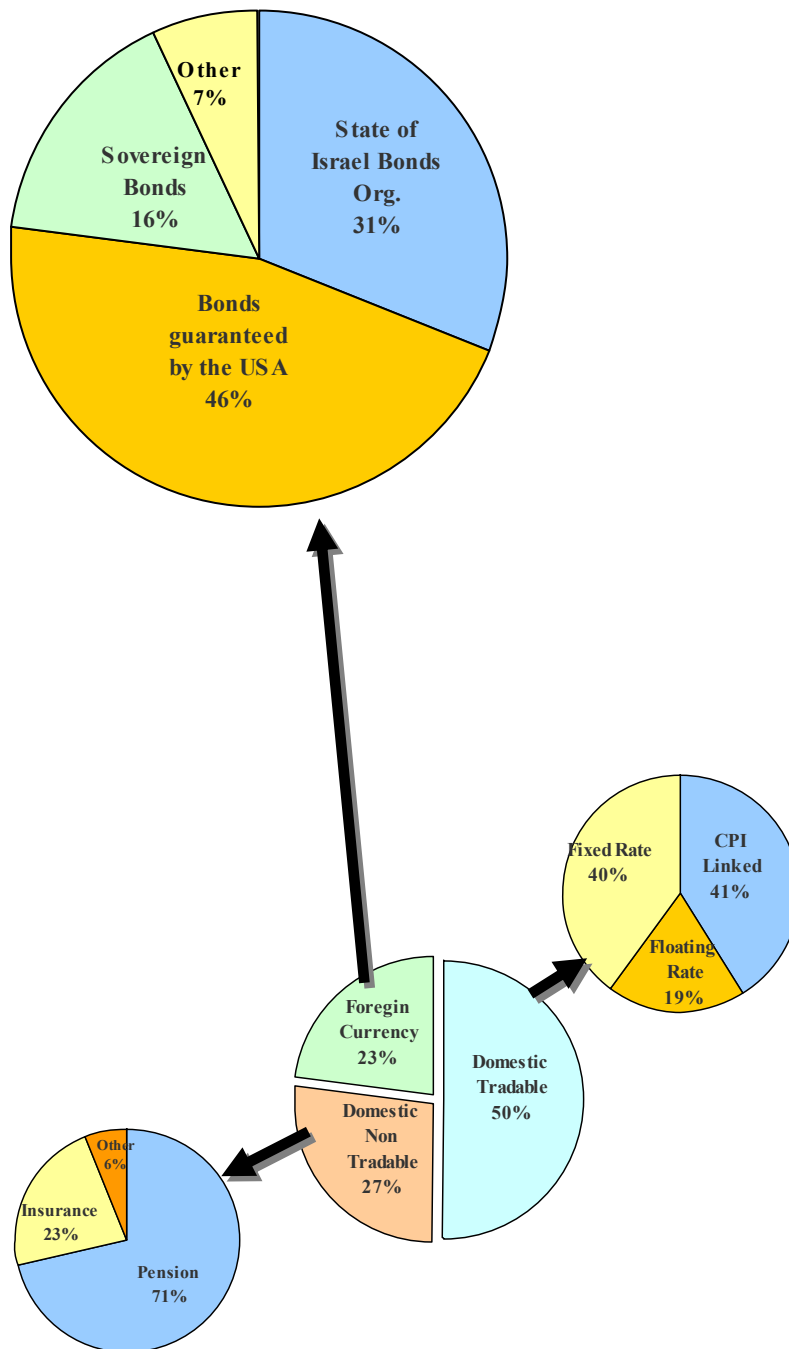
^a Calculated as excess capital as a percent of minimum capital required in each country. The minimum capital ratio is 8 percent in all the countries except for Israel, where it is 9 percent, and South Africa, where it is 10 percent.

^b In all countries in the figure the data relate to the largest ten banking groups, except for the US, where they relate to the largest 50 groups, Chile, Portugal, and South Korea, where they relate to the largest seven groups, South Africa, where they relate to the largest six groups, Israel, Belgium and the Czech Republic, where they relate to the largest five groups, and New Zealand, where they relate to the largest four groups.

^c The reference group consists of eight countries comparable to Israel with regard to their GDP and banking systems: Belgium, Denmark, Ireland, Greece, Norway, Portugal, Finland and SouthAfrica.

Source: Based on Bankscope data.

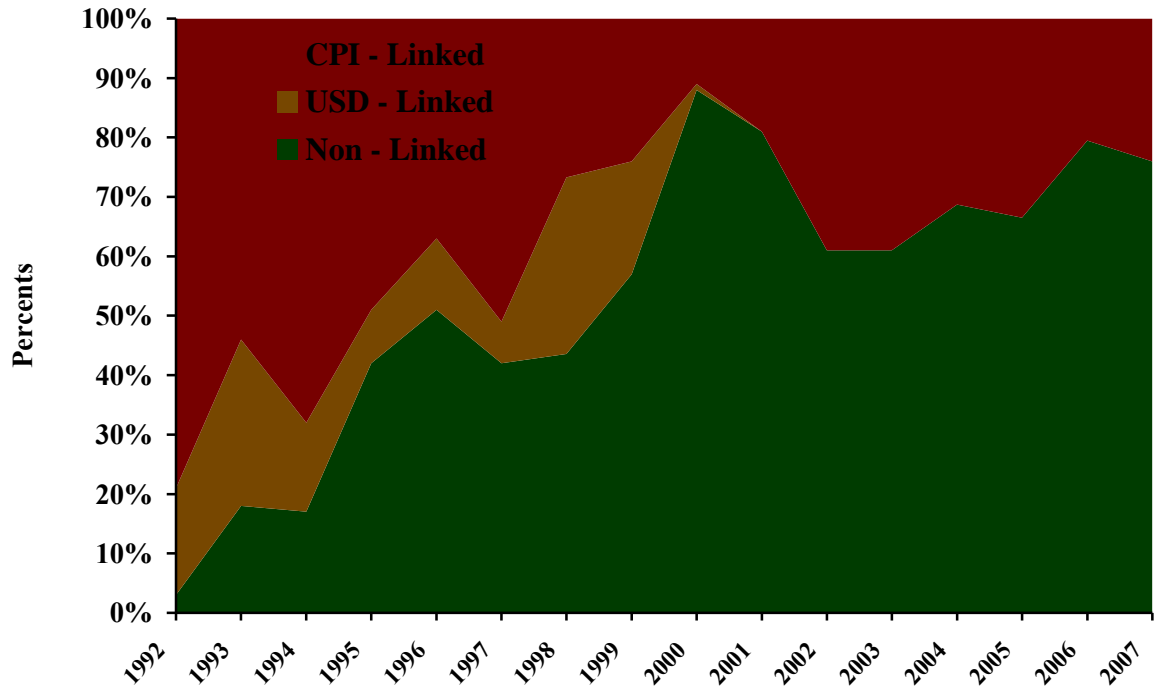
Figure 4. Structure of Government Debt²⁶



Source: Israeli Ministry of Finance

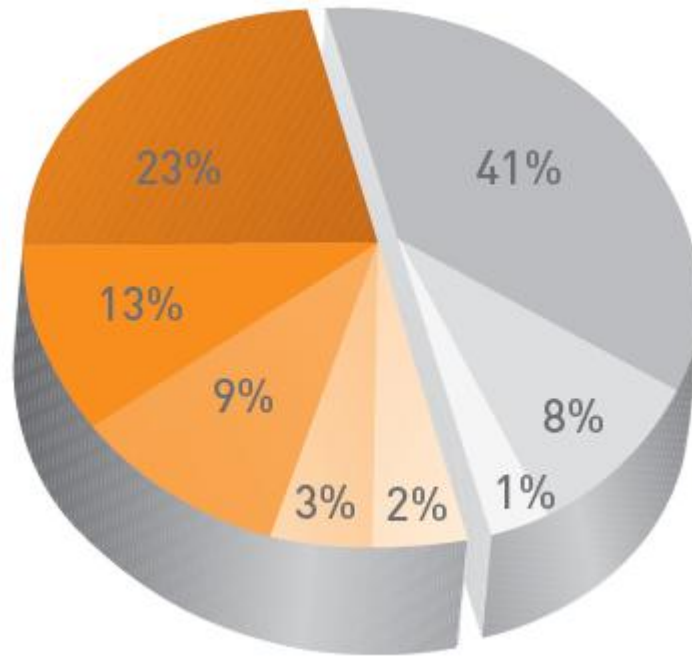
²⁶ State of Israel bonds are issued by the "Israel Bonds" organisation which raises funds mainly from Jewish communities outside of Israel through retail bonds. Of the 80% new non-linked debt that was issued in 2007 5% was floating-rate. Out of the total domestic debt issued in 2007 13% was non-tradable.

Figure 5. Issuance of New Government Debt, 1992-2007



Source: Bank of Israel

**Figure 6. Breakdown of Shares Ownership on TASE
(2007)**



"Float" (50%)

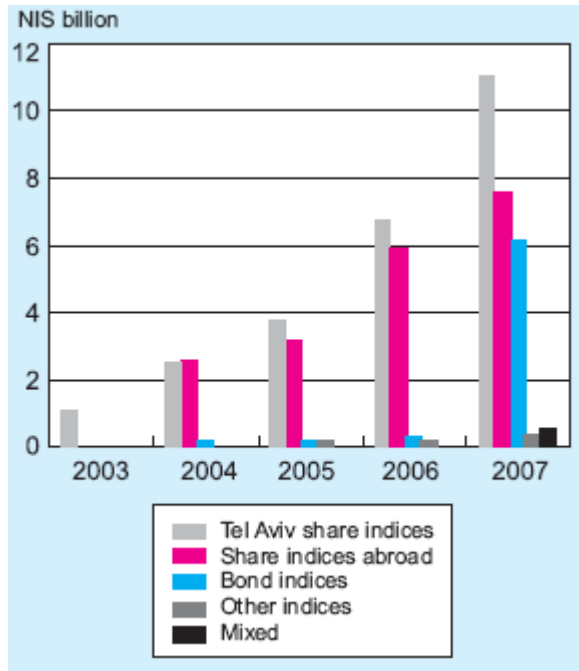
- International Public & Institutionals (23%)
- Israeli Public (13%)
- Provident & Pension Funds (9%)
- Insurance Companies (3%)
- Mutual Funds (2%)

Interested Parties (50%)

- Israeli (41%)
- International (8%)
- Government (1%)

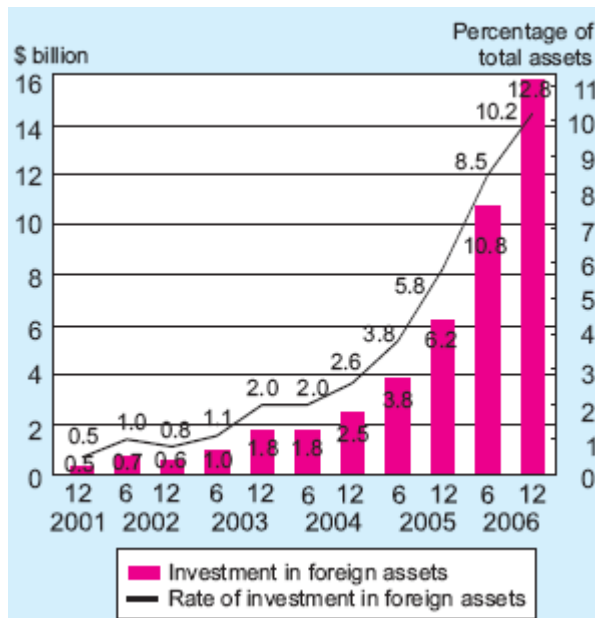
Source: Tel-Aviv Stock Exchange (TASE)

Figure 7. The Public's Holdings in Exchange-Traded Funds (ETFs), 2003-07



Source: TelAviv Stock Exchange

Figure 8. Investments and Rate of Investment of Institutional Investors in Foreign Assets, December 2001 to December 2007



Source: Bank of Israel.