Increasing Competition in Israel's Banking and Financial Services
(Including a Reference to the Strum Committee Interim Report)

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This paper presents the data on Israel's banking-financial system and credit market; reviews the policy measures that have been taken in recent years regarding competition; describes and explains the economic rationale behind the policy guidelines detailed in the Interim Report of the Committee to Increase Competition in Common Banking and Financial Services (the Strum Committee); and presents accordant recommendations.

The **first chapter** introduces the subject and the paper's main recommendations.
The **second chapter** provides the background data on Israel's banking-financial system and credit market.
The **third chapter** traces the policy steps taken in recent years.
The **fourth chapter** discusses the Strum Committee's interim report.
The **fifth chapter** details additional or complementary policy steps.
The **sixth chapter** makes the case for changing the oversight structure to a single regulatory authority.

Summary
Israel's banking system has a higher level of concentration than other developed countries. This excessive concentration affects all parameters of the competitive system, including credit accessibility, credit prices, and credit allocation methods, which in turn affects economic growth and economic inequality. The high concentration and lack of competition in the banking and financial sector also increase the level of systemic risk, thus affecting the system's long-term stability.

The Israeli banking system faces three types of barriers. The **regulatory barrier** is stability-based, meant to hedge against the macroprudential (macro-economic) risk caused mainly by the fact that crises in the financial system can intensify and spread rapidly and powerfully throughout the entire economy; close supervision of this system allows for the anticipation of the risks involved. The **"economies of scale" barrier** stems from the banking system's reliance on infrastructures such as information or clearing systems. The high costs of both establishment and maintenance involved in this infrastructure justify the use of external service providers such as information systems companies for optimal pricing of bank credit,

the operation of shared clearing systems, and the like. However, the division of the bank's core functions among different entities poses a certain risk to the resilience of the entire system. The **'network' economy barrier** is a result of the industry's characteristics as a network economy (particularly the credit card market): The more widespread a credit card is, the greater the benefit a new customer derives from it.

The credit card market is similar to the banking sector in being dominated by a small number of players. The banks’ ownership of the credit card companies, the low level of competition in the market, and the credit card companies’ presence across all segments of activity create an alignment of interests between the credit card companies and the banking groups. This significantly raises the barrier to entry into the credit market for new players. The control of the three major banking groups over the credit card companies reinforces the level of market concentration and the lack of competitive threat in the credit market.

The clearing market in Israel is also highly concentrated, and is effectively controlled by three credit card companies, which are themselves owned by the banks. This situation allows for relatively high clearing fees and also limits competition, despite the recent reduction of clearing fees prompted by the Israel Competition Authority. The two key obstacles preventing new competitors from entering Israel's payment clearing market are the banks' exclusive ownership of existing clearing companies and technological barriers to entry.

The Lerner Index for measuring market power reveals that under Israel's current system, households and small businesses have no structural bargaining power against the banking system. As a result, they are at a structural disadvantage in their access to credit and credit terms, despite households being responsible for most of the banks' operating income by a significant margin compared to all other sectors in the economy, and their volume in doubtful and lost debts is relatively low.

Banking in Israel is currently regulated by three bodies, which supervise different parts of the capital market. This structure causes duplication as well as a lack of uniformity, both leading to distortions in credit allocation. The current structure also creates the potential for conflicts of interest. The multiplicity of supervisory bodies creates inconsistency, since the result of two financial institutions engaging in the same activity is different supervision and regulations for each– which lacks economic and constitutional logic. The multiplicity of supervisory bodies and responsibility for them (mainly shared by the Ministry of Finance and the Bank of Israel) creates additional structural problems.

In 2015, government coalition agreements outlined plans to reform the banking and financial system to increase competition; reduce costs on long term savings, increase small businesses' and households' access to credit and change the oversight structure of the system. These agreements led to the establishment of the Committee to Increase

Competition in Common Banking and Financial Services, or the Strum Committee, charged with examining ways to increase the entry of new players to compete in the provision of banking and common financing services, among others, by separating the ownership of banks and credit companies; the steps necessary to implement such ways and the removal of barriers to competition. The Strum Committee submitted its report in December 2015.

The idea of increasing competition is a positive one, especially in light of the banking market's over-concentration. However, some of the Strum Committee recommendations went too far in restricting banks and increasing government interference, while transparency requirements regarding the fees and interest on credit and banking services were not sufficiently stringent. Also, several points that were included in the committee's mandate were only minimally discussed, such as additional or complementary policy measures in the credit market, changes to the structure of supervision over the financial system, and governance in the financial-banking sector.

Recommendations:

1. Apply to existing market players more stringent rules regarding transparency of the fees and interest payments for credit services and checking account management that consumers pay.
2. Prohibit bank control of credit card companies to reduce concentration in the retail credit market and increase competition, thus decreasing credit prices for consumers and creating a desirable alternative to credit provision by banks through competing entities that are not owned by them. No material conflict of interest justifies or dictates the extreme policy measure of prohibiting the issuance of credit cards, as proposed by the Committee; prohibiting banks from controlling credit card companies is a necessary and sufficient step to encourage competition.
3. Apply the separation of credit card companies from banks to all banks without exception, since this measure is directed at preventing banks from having excessive power over customers through control of credit card companies (and perhaps also in card issuance).
4. Create a uniform technological standard that meets international norms, to regulate the clearing system in Israel and encourage the entry of new players.
5. Limit the granting of loans against tax-subsidized pension savings. There is no sense in creating a situation where individuals enjoy tax benefits at the public's expense – ostensibly to save for a pension – only to use this "savings" for consumption. This is to patch up a distortion: first providing tax benefits to encourage pension savings, then providing an 'exemption' to neutralize the requirement to preserve the full savings for the pension period. Instead, these tax benefits should be eliminated altogether, thereby expanding the tax base

and reducing tax rates for all workers, as well as increasing individual freedom in choosing the scope of present and future consumption.

6. Ensure an appropriate risk allocation between the self-participation of new lenders and government participation in systemic credit risk, while creating a hierarchy of responsibility
7. Apply deposit insurance to all banks in the sector; it is however, advisable to set a relatively low ceiling for the amount of insured deposit for a single customer in each bank. Additionally, limit the number of banks where a customer can deposit funds that will be insured by the insuring authority. There is no need for insurance of customer assets.
8. The Credit Data Law legislation should be completed as approved by the Ministerial Committee. Without it, market players lack access to reliable information – both positive and negative – about customers' repayment ability. In such a situation, only banks have the ability to price interest rates according to customer quality, and new players will find it difficult to compete in providing credit to the retail sector.
9. Establish a unified regulatory authority, vested with the authority of the three existing bodies (including banking supervision). This will balance consumer protection, competitiveness, and stability. It is also expected to increase the effectiveness of the capital market, eliminate its inconsistency, and improve the way credit is allocated in the economy. This authority can be one of the three following options: (a) An independent authority subordinate to neither the Ministry of Finance nor the Bank of Israel; (b) An authority that is an integral part of the Bank of Israel; (c) An authority that is not part of the Bank of Israel but is subordinate to the Governor of the Bank of Israel.

For the full Hebrew paper