Structural reform in the capital market

Inter-ministerial committee report

Executive Summary

September 2004

Background

In April 2004, the finance minister appointed an inter-ministerial committee (hereafter ("the committee") to make recommendations with respect to the actions required for establishing an efficient and competitive capital market in Israel. The committee was comprised of representatives from all of the regulatory and supervisory authorities dealing with Israel's capital market — the Securities Authority, the Anti-trust Authority, the Bank of Israel including the Bank Supervision department, the Ministry of Justice, and the Capital Market, Insurance and Savings Division of the Ministry of Finance.

From its very inception, the committee was charged with setting out the practical steps required for the implementation of its designated goals. Hence, it did not engage in independent research but has based its recommendations on the work of prior committees; the accumulated experience of the organizations from which its members were drawn; as well as numerous meetings and discussions with academics and practitioners, with expertise in capital markets, from both Israel and abroad.

The committee’s recommendations are not intended to stand in isolation, but rather constitute an integral part of a comprehensive set of governmental policies designed to create a more competitive and efficient capital market. These additional policies include the sale of new pension funds, the downsizing of issues of "earmarked" bonds (i.e. long governmental bonds with guaranteed yields), the equalization of tax rates on capital gains from foreign securities with those on domestic securities, and others.

We wish to emphasize that the committee's recommendations, important as they may be, are a necessary, but not sufficient condition, for the solution of the other problems confronting the Israeli capital market (e.g. development of the securitization markets, commercial papers, private equity, etc). Therefore, along with the implementation of the structural changes recommended by this committee, there remains the need to continue the search for appropriate solutions for the remaining problems afflicting the Israeli capital market.

Israel's Capital Market - An Overview

Capital markets are the meeting place between savers (suppliers of capital) and investors (individuals and businesses that generate demand for capital). The role of "financial intermediaries" who participate in these markets, for example, banks, provident and pension funds, insurance companies, and others is to facilitate the efficient exchange of funds between savers and investors. Because this transfer of capital by financial intermediaries is a critical factor affecting the performance of non-financial (real) markets, the creation of efficient financial intermediaries is a *pre-condition* for achieving high levels of economic growth and welfare.

In capital markets over the world, numerous non-bank financial intermediaries function along side the commercial banks. This type of diverse market encourages competition among intermediaries, reduces the cost of intermediation (spreads and agency costs), thereby enhancing the efficiency and performance of the economy as a whole.

In contrast to accepted practice abroad in Israel, both the commercial banking and the financial intermediation are completely dominated by the banks, as the following table shows.

Banking	**Mutual funds**	**Provident funds**	**Underwriting**
Deposits	*Assets managed*	*Assets managed*	*Number of issues*
Poalim—30% Leumi—30% IDB—18%	Poalim—36% Leumi—31% IDB—13%	Poalim—41% Leumi—19% IDB—13%	Poalim—27% Leumi—24% Clal—14%
78%	**80%**	**73%**	**65%**

In addition to the banks' domination of the capital market, the commercial banking industry itself is also highly concentrated and virtually controlled by two banking groups, as the following table shows.

	Deposits		Credit		Mutual funds (assets managed)		Pension funds (assets managed)		Underwriting
	NIS bl	*%*	*NIS bl*	*%*	*NIS bl*	*%*	*NIS bl*	*%*	*% of total issues*
Poalim	**204**	**30%**	**184**	**33%**	**30**	**40%**	**78**	**47%**	**46%**
Leumi	**204**	**30%**	**169**	**30%**	**26**	**35%**	**37**	**22%**	**42%**
Discount	120	18%	76	13%	11	15%	24	15%	11%
UMB	66	10%	59	10%	3	4%	9	5%	—
FIBI	55	8%	46	8%	4	5%	16	10%	1%
Union	17	2%	15	3%	1	1%	1	1%	—
Jerusalem	6	1%	6	1%	—	—	—	—	—
Other	6	1%	11	2%	—	—	—	—	—
Total	**678**	**100%**	**566**	**100%**	**75**	**100%**	**165**	**100%**	**100%**

The existing market structure, with the banks dominant in all aspects of financial intermediation and with no other significant financial intermediates, creates the following problems that adversely affect and preclude the development of an efficient competitive capital market:

* The direct & indirect control of almost all capital allocation by the banking system is a major obstacle to the development of non-banking financial markets.
* The absence of a non-banking credit market has made the business sector almost solely dependent on the banks. This dependence, in turn, concentrates credit decisions in the hands of a small number of participants and limits the array of available sources of capital (both debt and equity).
* The absence of competition and the acute dependency on the banking system make capital more expensive, thereby inhibiting economic growth.
* The banks' market power, together with their ability to exert pressure on their customers (who are often a "captive audience"), have created a significant obstacle to the development of a competitive capital market.
* The high level of concentration, and the dependency that it creates, constitute a significant risk to the country’s financial stability.

Even after the series of mergers and acquisitions in the banking industries of developed countries, the degree of concentration of Israel's banking system and capital market remains one of the worlds highest. The degree of concentration of the Israeli capital market, as compared to capital markets abroad, is even more striking when considering Israel's unique characteristics.

For example, while in most countries, commercial banks do not play a role in long-term pension savings, the Israeli banks almost completely dominate the country's provident funds (which comprise a significant component of pension savings). While in most countries a significant network of non-bank intermediaries operates along side the banks, and provides a viable alternative to banking services, such non-bank intermediaries are virtually absent in Israel. While many highly concentrated financial markets abroad face the "threat" of competition from neighboring countries, thereby limiting the ability to exploit market power, the Israeli banks, because of the country's geographical and political isolation, virtually do not face similar competitive threats.

Concentration in itself would not necessarily be an impermeable barrier to the development of the capital market if it were not combined with the existence of structural conflicts of interest in financial intermediation. The broad range of activities in which Israel's banks engage, creates material conflicts of interest between their own business interests and their customers' interests.

* Because the banks are both investment advisors and owners/managers of provident and mutual funds, they have an incentive to advise their customers to invest in financial products of the entities that the banks manage (as opposed to the best product for the customer).
* Because the banks are both credit providers and underwriters, they have an incentive to underwrite selected borrowers, in cases where the proceeds of the new issue will be used to repay an outstanding loan at the underwriting bank.
* Because the banks are both underwriters and owners/managers of provident and mutual funds, they have an incentive to sell newly issued securities to the institutions under their control, thereby reducing their underwriting risk while compromising their fiduciary duties.
* Because the banks are both credit providers and the owners/managers of provident and mutual funds, they have an incentive to channel the investments of the institutions under their control to companies that are in debt to the bank, in order to mitigate problems facing the bank.
* Because the banks are both providers of a wide range of commercial banking services and the owners/managers of provident and mutual funds, they have an incentive to have the funds receive these services from the parent bank, without considering the market alternatives and without attempting to acquire the best possible terms for the services in question.

In Israel, the above-mentioned conflicts of interest have proved to be immune despite the vast array of restrictions and regulations ("Chinese Walls") designed to control them. In the words of the State Comptroller, "the Chinese walls erected by the Ministry of Finance and Bank of Israel are not strong enough to overcome the conflicts of interest, and entail regulatory costs."

Apart from the above conflicts between the bank's interests and those of its customers, there also exists a structural conflict of interest between the bank's interest in maintaining its position in the credit market and the general economic interest in developing a more efficient capital market by fostering competition (in the credit markets) between the provident and mutual funds and the banks.

The provident and mutual funds are financial intermediaries that could potentially compete with the banks in a variety of activities. However, a question arises as to whether the failure of such competition to evolve is simply a byproduct of the banks' complete domination of the provident and mutual funds. A similar question arises with respect to underwriting. Since new security issues constitute potential competition to the banks in the credit market, fostering competition in underwriting, i.e., in the pricing and marketing of new issues, is especially important for the development of an efficient capital markets.

Potential conflicts of interest, in themselves, constitute a problematic and undesirable situation. Even the more so since allegations have been made with respect to the exploitation of such conflicts in practice.

* The State Comptroller's report for the year 2003 finds that, "a large proportion of the investments of provident funds are channeled to institutions and companies, either owned by or related to, the parent bank. In addition, all of the funds' financial transactions (brokerage fees, custodian, etc.) are carried out, for a fee, via the parent bank that controls or manages the funds."
* The report for 2003 also finds large differentials in the fees paid by various funds (e.g., Gadish, Otzma, Tamar, etc.), to the parent bank and concludes that, "One possible explanation is that the managers of the funds do not take sufficient action *vis a vis* the parent bank in order to obtain the lowest possible rates of commissions for the fund, or do not turn to other banks and brokers to seek lower fees". The report also finds that "Provident funds controlled by banks paid [the parent banks] higher commissions than those paid to the same bank by provident funds controlled by others, for identical services."

* The report of the "Bejski Commission" documents in exhaustive detail the illegal exploitation of conflicts of interest by the banks for their own benefit, at the expense of their customers' welfare.

* The bulk of a bank's customers' investments in provident and mutual funds is, in practice, directed by the bank's investment counselors to those provident and mutual funds controlled or managed by the bank, despite the legal obligation to provide customers with objective investment advice that gives equal consideration to all of the available alternatives.

The combination of a high degree of concentration and far reaching conflicts of interest among financial intermediaries in Israel's capital market has created a "vicious cycle" that preserves the status quo. Concentration taken together with involvement in a wide variety of activities creates structural conflicts of interest; and the exploitation of these conflicts serves to preserve the concentration.

Because all attempts to curtail conflicts of interest by means of "Chinese Walls" have failed, basic structural changes are required to eliminate, as much as possible, conflicts of interest among financial intermediaries. At the same time, stringent actions are called for to reduce concentration. In order to break the above-mentioned "vicious cycle", deliberate government intervention in the structure of ownership and the activities of financial intermediaries is required. Only if the "vicious circle" is broken, can the capital market be effectively opened to additional financial institutions, thereby helping to create, in the course of time, a truly competitive climate.

The committee is convinced that the structural changes it proposes are a *pre-condition* for creating the underlying conditions necessary for the emergence of robust competition in the capital market. The committee's recommendations are based on the same general principle that has been adopted by the government when dealing with legislation relating to market structure, i.e., to create a competitive market structure that can replace cumbersome regulatory mechanisms and eliminate distortions that have arisen due to the absence of competition.

The creation of 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 decentralizing the management of existing investment vehicles.
* *Enhancing competition in credit provision* — by developing non-banking credit instruments.
* *Enhancing competition vis-a-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.

Main Recommendations

The committee's members are of the opinion that at this point in time, various entities, both domestic and international, are interested in involvement in the Israeli economy in general and in the capital market in particular. Hence, the committee believes that this is the appropriate time to recommend the optimal structural change that will take a significant "bite" out of the degree of concentration, while at the same time, substantially reduce the conflict of interests.

Against the background of concentration and conflicts of interest, we propose that **banks will not be permitted to hold any interest at all in a company that manages a provident or mutual fund nor will they be permitted to hold as much as a 5% interest in any firm or institution that holds more than a 5% interest in a company that manages such funds.** Furthermore, it is proposed that **a controlling shareholder of a bank, and all entities subject to his control will not be allowed to hold a 5% or more interest in a provident or mutual fund, or in any firm or institution that holds more than a 5% interest in a company that manages such funds.**

For this purpose, **"banks" refer to all banks excluding those with less than 1000 customers whose assets or liabilities in the bank are less then 5 million NIS.**

The separation of provident and mutual funds from the banks reflects the need to both reduce concentration in the capital market and mitigate conflicts of interest. The sale of the funds by the banks will significantly reduce structural conflicts of interest in the banks' activities, help decentralize financial management and open these markets to competition, thereby leading to an improvement in services and increased returns on savings.

Alternative solutions, focusing on compulsory "outsourcing" of the management of financial assets, while permitting the banks to retain (partial or complete) ownership do not eliminate the potential conflict of interest, and artificially separate accountability to fund members from powers of management. Such an artificial separation is not viable and is bound to become meaningless over time.

Solutions of the opposite kind (sale of ownership and retention of management) do not answer the needs of the market because they would allow the banks to retain their control over most of the allocation of resources in the economy while absolving them of any economic interest in the funds whose assets they manage.

In view of the need and desire to implement the proposed measures quickly, but with the awareness of the need to proceed with caution when separating activities from the banking system, the committee proposes a **gradual selling process as follows:**

	Maximum proportion of assets managed, relative to total assets managed on the day of legislation	
	Provident funds	*Mutual funds*
Date of legislation	100%	100%
One year after legislation	80%	80%
Two years after legislation	40%	60%
Three years after legislation	**0%**	**40%**
Four years after legislation	—	0%

The above "stepping stones" create a reasonable and measured balance between the desire to reduce possible adverse effects on the sale price, (and the need to afford the banks ample time to adjust to changes that are material from their standpoint), and the general need to rid the capital market of its ailments as quickly as possible. Provident funds are to be sold at a faster rate than mutual funds because of their similarity to certain banking activities, especially credit. Hence, an earlier sale of the provident funds should make a more meaningful contribution to the development of a non-banking credit market.

The exception regarding banks with limited retail banking activity is meant to enable them to take part in the management of the assets to be sold, and by so doing, to reduce market concentration. The committee has assumed that the clients of these banks, who possess considerable financial wealth and bargaining power themselves, are effectively immune to the negative effects from the attempt to exploit conflicts of interest.

Due to conflicts of interest in the activities of underwriters, especially between their interest in acting on behalf of connected debtors and their fiduciary undertakings to the investing public, the committee proposes that **existing regulations should be strengthened as follows: an underwriter shall not serve in a price-setting capacity in any public offering of securities if it has loaned large sums of money to the issuing company, i.e., if the outstanding balance exceeds NIS 5 million, and it comprises more than 10 percent of the total financial liabilities of the issuing company.**

To limit underwriters' ability to reward related entities with "attractive" issues, or, alternatively, to avail themselves of said entities in "unsuccessful" issues (for the purpose of avoiding their underwriting obligations), the committee proposes that **an underwriter not be allowed to sell 5 percent or more of the value of securities offered in an issue, to itself and the totality of institutional entities in its group.**

After considering the possibility of precluding banks from serving as underwriters, the committee reached the conclusion that the potential damage of this exclusion to the competitiveness of the industry will be greater then the benefits from the mitigation of conflicts of interest. The committee is convinced that after minimizing the bank's potential conflicts of interest, their contribution to underwriting development and competition will be significant. The implementation of the committee's recommendations regarding underwriting will allow the banks to continue to operate in the field under the specified conditions. The implementation of these recommendations will also ensure that other underwriters, which do not belong to a banking group, but are expected, either individually or by members of their group, to be active in the field of wholesale credit, be absolved of these potential conflicts of interest.

In view of the importance of the regulatory infrastructure, of supervision and of enforcement, **a Provident Funds Law should be enacted and its provisions, as well as existing provisions pertaining to other institutions, should be adjusted to make the norms in managing financial assets as similar as possible.**

Furthermore, in order to ensure appropriate management norms and to consolidate the public's trust in the managers of its assets, the committee proposes that **it be determined in legislation that any controlling stake in an institutional entity beyond a certain limit shall require a permit.**

To reduce the risk of severe concentration amongst alternative asset managers, the committee proposes that **no permit for the acquisition of a provident fund be given if, after the acquisition, the market share of the purchaser, and its group of companies, in the long-term savings industry exceeds 15 percent, and that no permit be given for the acquisition of a mutual fund if, after the acquisition, the market share of the purchaser, and its group of companies, in the mutual fund field, exceeds 20 percent.**

For this purpose, the "long-term savings industry" consists of the cumulative amount of assets managed in provident funds, new pension funds, and participating portfolios of life-insurance policies.

Limiting the relative size of purchasers will prevent the “migration” of concentration into other branches of the capital market, lead to a decentralization of decision-making centers and increase the probability of attracting international institutions to take part in financial intermediation in Israel. Limiting the relative size of purchasers will also give fund members greater freedom of choice and enhance market competition. These developments, in turn, will reduce the likelihood of the exploitation of potential purchasers’ conflicts of interest. It should be emphasized that the limitations on the size of market share pertain solely to mergers and acquisitions; they will not apply to an increase in market share that emanates from competition or changes emanating from market fluctuations.

As part of legislation relating to the capital market, the committee recommends that **investment counseling and the marketing of "financial products" (including securities, mutual funds and bank accounts) and "pension products" (provident funds, life insurance and pensions) should require licensing.**

Experience has shown that the involvement of investment advisors with the very products upon which offer their advice creates an environment in which legislation alone is insufficient to provide the investing public with adequate protection. In actual practice, financial advice in Israel takes place in an environment that raises the question of the possible exploitation of conflicts of interest, while pension's advice (including retirement products and life insurance) is virtually non-existent. And this is the situation, despite the fact that the provision of objective investment advice on financial and pension products is an essential service that the state should ensure that its citizens receive.

We conclude from the above, that **participants in the capital market should be required to choose between marketing and consultancy, under the following limitations and conditions:**

	Consulting	**Marketing**
Institutional entities	—	✓
Banking corporations	✓	—
Reliability and prudence requirements	Vis-à-vis customer only, including prohibition of preference	Vis-à-vis customer, excluding prohibition of preference
Sale of products (distribution)	✓	✓
Range of products sold	Most of products in the market	Only products of two institutions

In order to assure that an entity that chooses to engage in consulting will be independent and unbiased it is proposed that **an entity that chooses to engage in consulting, its controlled companies and its controlling shareholders, will not be allowed to hold 5% or more of holdings in institutional entities. Also, they will not be allowed to advise or sell products of institutional entities that hold 5% or more of holdings of theirs.**

In order to guarantee the provision of unbiased investment advice, the committee recommends that **entities engaged in consultancy, including banks, be precluded from accepting remuneration from the owner of a financial or pension instrument, including remuneration for the sale and distribution of its products. However, this restriction does not apply to remuneration received for custodian and other accepted banking services**

The guiding principle of these proposals derives from the accepted practice in the provision of advice to investors in common stock. Investment advisors in this area do not receive any financial consideration from corporations for advising on or selling their securities. Similarly, the consultants at issue here should not be permitted to accept consideration from the institutions whose products they sell or about which they offer advice.

In essence, these recommendations regarding remuneration differentiate management fees from commissions on the sale and distribution of the financial product, thereby making such fees transparent to the consumer. This separation can be expected to create two areas of competition that have not existed thus far –

* Objective and unbiased consulting services will create an identity of interests between consumers and consultants in a way that will enhance competition among institutions, who will have to show that their products outperform those of their competitors, and that their management fees for services are competitive.
* Consultants will have to compete over the level of their sales commissions, both vis-a-vis direct marketers and vis-à-vis the banks and other consultants.

In order to make better use of the banks' consulting and distribution networks, and to afford more convenient access to financial services, we recommend that **banking corporations, that have divested themselves of their holdings in provident funds and are not principals in an insurer (including a pension fund), be licensed to sell and provide consulting services about life-insurance and pension products, subject to the restrictions pertaining to the provision of financial advice as set out above.**

Life-insurance policies, pension plans, and provident funds are financial instruments for long-term saving that are to a significant degree substitutes, one for another. The encouragement of all forms of pension savings is a national, social and economic goal. The provision of financial advice along with the distribution of these products at bank branches will make the products more easily accessible to segments of the population who are currently uninsured. Moreover, the distribution of life-insurance and pension products by banking corporations creates competition with insurance agents, and can be expected to eventually lower prices to consumers.

In order to reduce the likelihood that this expansion of the range of products sold by banks will lead to greater concentration in the capital market, **we recommend that a banking corporation belonging to a banking group that has more than NIS 10 billion in equity, be allowed to offer advice and to sell life-insurance and pension products, only upon the completion of the sale of all its holdings in provident and mutual funds and on the condition that it is not a principal in an insurer.**

Since large banks have an advantage in the material resources at their disposal (e.g., computer and information systems), and in their network of branches, there is a possibility that the distribution of insurance and pension products by the banking system could lead to "new" concentration. Hence, we feel that the measures designed to reduce concentration, must be applied even more rigorously vis-a-vis the banks at which the problem is most serious, i.e., the two largest banks.

Along with the implementation of the structural changes recommended by this committee, there remains, as we pointed out above, the need to continue the search for appropriate solutions for the remaining structural problems afflicting the Israeli capital market. Hence, we **recommend that the members of the committee be permitted to continue functioning as a "steering committee" for the purpose of assisting in the legislative process related to the implementation the recommendations. Moreover, we would continue to deal with issues pertaining to the goal of further enhancing competition in the capital market. These additional issues include, among others, money market funds, commercial paper, repos, distribution of mutual-funds by non-members of the Stock Exchange, facilitating the transfer of customers' accounts between banks, deposit insurance, banks' "nostro" investments, banks as market makers, and the implementation of securitization programs in the Israeli banking system. The committee will present its recommendations to the Minister of Finance on these issues by June 30, 2005.**