

# **Structural reform in the capital market**

Inter-ministerial committee report

Executive Summary

## Background

In April 2004, the finance minister appointed an inter-ministerial committee (hereinafter: "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 Antitrust Authority, the Bank of Israel including its 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; on the accumulated experience of the organizations from which its members were drawn; and on numerous meetings and discussions with academics and practitioners with expertise in capital markets, from both Israel and abroad.

The Committee published its report in September 2004. The report was approved by the Government in early November (with minor changes), and enacted as legislation by the Israeli parliament on the 25<sup>th</sup> of July 2005.

The committee's recommendations are not intended to stand alone, but rather to 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, among others, the sale of new pension funds, the downsizing of issues of "earmarked" bonds (i.e. long-term government bonds with guaranteed yields) and the equalization of tax rates on capital gains from foreign securities with those on domestic securities.

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

## Israel's Capital Market - An Overview

A capital market is a meeting place for savers (the suppliers of capital) and investors (individuals and businesses who 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 throughout the world, numerous non-bank financial intermediaries function alongside the commercial banks. This type of diverse market encourages competition among intermediaries and reduces the cost of intermediation (spreads and agency costs), thereby enhancing the efficiency and performance of the economy as a whole.

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

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

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

	Deposits		Credit		Mutual funds (assets managed)		Pension funds (assets managed)		Underwriting
	<i>NIS billion</i>	%	<i>NIS billion</i>	%	<i>NIS billion</i>	%	<i>NIS billion</i>	%	% of total issues
<b>Poalim</b>	<b>204</b>	<b>30%</b>	<b>184</b>	<b>33%</b>	<b>30</b>	<b>40%</b>	<b>78</b>	<b>47%</b>	<b>46%</b>
<b>Leumi</b>	<b>204</b>	<b>30%</b>	<b>169</b>	<b>30%</b>	<b>26</b>	<b>35%</b>	<b>37</b>	<b>22%</b>	<b>42%</b>
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%	—	—	—	—	—
<b>Total</b>	<b>678</b>	<b>100%</b>	<b>566</b>	<b>100%</b>	<b>75</b>	<b>100%</b>	<b>165</b>	<b>100%</b>	<b>100%</b>

The existing market structure, in which the banks are dominant in all aspects of financial intermediation and there are no other significant financial intermediaries, creates significant problems. These difficulties, listed below, adversely affect and preclude the development of an efficient competitive capital market:

- \* The banks' direct & indirect control of almost all capital allocation 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 entirely 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, which inhibits economic growth.
- \* The banks' market power, together with their ability to exert pressure on their customers (who are often a "captive audience"), has created a significant obstacle to the development of a competitive capital market.
- \* The high level of concentration, as well as the dependency that it creates, constitutes a significant risk to the country's financial stability.

Even after the series of mergers and acquisitions that have taken place in recent years within the banking industries of developed countries, the degree of concentration of Israel's banking system and capital market remains one of the highest in the world. 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 dominate, almost completely, the country's provident funds (which comprise a significant component of pension savings). Additionally, while in most countries a significant network of non-bank intermediaries operates alongside the banks and provides a viable alternative to banking services, such non-bank intermediaries are virtually absent in Israel. Furthermore, while many highly concentrated financial markets abroad face the "threat" of competition from neighboring countries which limits their ability to exploit market power, the Israeli banks, because of the country's geographical and political isolation, face almost no similar competitive threats.

The high degree of 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 the 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 from 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 with respect to such debt.
- \* 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 these funds receive these commercial services from the parent bank, without considering market alternatives and without attempting to acquire the best possible terms for the services in question.

In Israel, the above-mentioned conflicts of interest remain firmly in place, 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 an individual bank's perpetual interest in maintaining its position in the credit market and the national 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, the fostering of competition in underwriting, is especially important for the development of an efficient capital market.

Such potential conflicts of interest, in themselves, constitute a problematic and undesirable situation. They are even more problematic in light of allegations that have been made indicating that some of the potential has been realized, and that these conflicts are in fact being exploited 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 that are either owned by, or related to, the parent bank. In addition, all of the funds' financial transactions (brokerage, custodial services, 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 "a 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 "the 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 are, in practice, directed by the bank's investment counselors to those provident and mutual funds controlled or managed by the bank, despite the bank's 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 of far reaching conflicts of interest among financial intermediaries in Israel's capital market has created a vicious cycle that perpetuates 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, these conflicts of interest among financial intermediaries. At the same time, stringent actions are required to reduce concentration. Though it is not in our favor, deliberate government intervention in the structure of ownership and the activities of financial intermediaries is required in order to break the above-mentioned vicious cycle. Only then can the capital market be effectively opened to additional financial institutions, which will help 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., the need 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, and at the same time substantially reduce the conflict of interests.

Against the background of the above-described concentration and conflicts of interest, it is proposed that **banks should not be permitted to hold any interest at all in a company that manages a provident or mutual fund or to hold as much as a 10% interest in any firm or institution that controls a company that manages such funds.** Furthermore, it is proposed that **a controlling shareholder of a bank, and all entities subject to his control should not be allowed to hold a 5% or more interest in a provident or mutual fund, nor should they be permitted to hold as much as a 10% of any firm or institution that manages such funds.**

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

This exception for banks with limited retail banking activity is meant to enable such banks to take part in the management of the assets (i.e., the funds) to be sold by the banks that are covered by the legislation, 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 of the various conflicts of interest described above.

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, decentralize financial management and open these markets to competition, thereby leading to an improvement in services and increased returns on savings.

Alternative solutions that focus on the 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 (i.e., the sale of ownership and retention of management power) 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 removing activities from the banking system, the Committee proposes **the following gradual selling process:**

	<b>Maximum market share of assets permitted to be managed, relative to total assets managed in the market</b>			
	<i>"Large Banks"</i>		<i>"Medium-Small Banks"</i>	
	<i>Provident funds</i>	<i>Mutual funds</i>	<i>Provident funds</i>	<i>Mutual funds</i>
Two years after legislation	18%	25%	18%	25%
Three years after legislation		12.5%	10%	12.5%
Four years after legislation		0%	6%	6%
Five years after legislation			6%	6%
Six years after legislation			0%	6%
Seven years after legislation				6%
Eight years after legislation				0%

The use of stages in the process described above creates 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. A longer period was given to the "Medium-Small Banks" in order to improve their competitive edge in the banking industry. 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.

For this purpose, **"Large Banks" are defined as banking corporations belonging to a banking group whose equity exceeds NIS 10 billion.**



Due to conflicts of interest in the activities of underwriters, especially between their interest in acting on behalf of related debtors and their fiduciary undertakings to the investing public, the Committee proposes that **existing regulations should be strengthened as follows: an underwriter should not be permitted to 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 issuing company’s outstanding debt to the underwriter exceeds NIS 5 million, and comprises more than 10 percent of the issuing company’s total financial liabilities.**

Furthermore, in order to limit underwriters’ ability to reward related entities with “attractive” issues, or, alternatively, to limit their ability to sell “unsuccessful” issues to such entities (for the purpose of avoiding their underwriting obligations), the Committee proposes that **an underwriter should not be permitted to sell 5 percent or more of the value of securities offered in an issue to itself or to all the institutional entities in its group put together.**

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 than the benefits to be provided by the further mitigation of conflicts of interest. The Committee is convinced that after the steps mentioned above are implemented in order to minimize the banks’ potential conflicts of interest, the banks’ 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 who do not belong to a banking group, but who are expected, either individually or by members of their group, to be active in the field of wholesale credit, will not encounter the potential conflicts of interest described above.

In view of the importance of the regulatory infrastructure, of supervision and of enforcement, **a Provident Funds Law should be enacted; its provisions and those of the various statutes pertaining to other institutions should all be coordinated so that the norms for the management of all types of financial assets are 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 **the enactment of legislation requiring a permit for the acquisition of any controlling stake, beyond a certain percentage of ownership, in an institutional entity.**



Furthermore, in order to reduce the risk of serious concentration among the non-bank asset managers, the Committee proposes that **no permit for the acquisition of a provident fund be given if, after the acquisition, the purchaser and its group of affiliated companies will control more than a 15 percent market share in the long-term savings industry** Additionally, **no permit should be granted for the acquisition of a mutual fund if, after the acquisition, the purchaser and its group of affiliated companies will control more than a 20 percent share of the in the mutual fund market.**

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; it will 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 customers 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 **licensing should be required for those engaged in investment counseling and in the marketing of "financial products" (including securities, mutual funds and bank accounts) and "pension products" (provident funds, life insurance and pensions).**

In actual practice, financial counseling in Israel is provided in an environment that raises the question of possible exploitation of conflicts of interest, while advice regarding pension products (including retirement products and life insurance) is virtually non-existent. And this is so despite the fact that the provision of objective investment advice on financial and pension products is an essential service. When objectivity is so critical, the State should be taking measures to ensure that the advice given to the public by consultants is not tainted by conflicts of interest, and that the public has complete information regarding the interests of those who are marketing financial products.

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

	<b>Consulting</b>	<b>Marketing</b>
<b>Institutional entities</b>	—	ü
<b>Banking corporations</b>	ü	—
<b>Reliability and prudence requirements</b>	Vis-à-vis customer only, not permitted to prefer particular products	Vis-à-vis customer, permitted to prefer particular products
<b>Sale of products (distribution)</b>	ü	ü
<b>Range of products sold</b>	Most products in the market	As participants choose

In order to assure that an entity that chooses to engage in consulting will be independent and unbiased, it is proposed that **if an entity chooses to engage in consulting, its controlled companies and its controlling shareholders will not be allowed to have indirect holdings of 10% or more in institutional entities (or direct holdings of 5% or more). Also, they should not be allowed to offer advise regarding or to sell products of institutional entities that hold 10% or more holdings in the advising entities themselves.**

Furthermore, in order to guarantee that the methods of remuneration do not harm the provision of unbiased investment advice, the Committee recommends the following

- Distribution of financial, provident and pension products - The Committee recommends that **advisors should be allowed to collect a direct distribution fee from the institutions or entities providing the financial products, for the sale of such products, (as long as such distribution fees are standard - equal fees to be collected from all institutions or entities -), transparent, and controlled [capped]).**
- Distribution of life insurance - Since the banks' involvement in this field is new, the Committee recommends that **advisors be precluded from accepting remuneration from the owner of a life insurance instrument, including remuneration for the sale and distribution of its products. However, this restriction does not apply to remuneration received for custodial and other accepted banking services.**

In essence, these recommendations regarding remuneration serve to differentiate management fees from commissions on the sale and distribution of financial products, thereby making such fees transparent to the consumer.

In order to make better use of the banks' consulting and distribution networks, and to afford more convenient access to financial services, the committee recommended expanding the range of pension products that may be sold by banks. 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.

In order to reduce the likelihood that this expansion of the range of products sold by the banks will lead to greater concentration within the capital market, the Committee recommends different "market entry conditions" for "Large" and "Medium-Small" banks, as stated below:

— Selling and providing consulting services about provident and pension products:

- "Medium-Small Banks" may engage in such activity after they have divested themselves of their controlling stakes in provident funds and if they do not have indirect holdings of 10% or more in an insurer.
- "Large Banks" may engage in such activity after they have divested themselves of all their holdings in provident funds and mutual funds and if they do not have indirect holdings of 10% or more in an insurer.

— Selling and providing consulting services about life insurance products:

- "Medium-Small Banks" may engage in such activity after they have divested themselves of all their holdings in provident funds and mutual funds and if they do not have indirect holdings of 10% or more in an insurer, but not before 2010.
- "Large Banks" may engage in such activity five years after they have divested themselves of all their holdings in provident funds and mutual funds and if they do not have indirect holdings of 10% or more in an insurer.

Along with the implementation of the structural changes recommended by this committee, there is still, as noted above, a need to continue the search for appropriate solutions for the remaining structural problems afflicting the Israeli capital market. **Hence, the Committee will 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.**