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CONTROL OF FINANCIAL FIRMS IN THE ISRAELI ECONOMY: PROBLEMS AND POLICIES

A Report Prepared for the Committee on Increasing Competitiveness in the Economy

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I. INTRODUCTION AND EXECUTIVE SUMMARY

A. The Engagement

This report describes analysis that I have conducted and conclusions that I have reached with respect to the use of pyramidal holding structures by Israeli business groups in the course of my work for the Committee on Increasing Competitiveness in the Economy (the "Committee"), appointed by the Prime Minister of Israel, the Minister of Finance, and the Governor of the Bank of Israel.[1] I was engaged to serve as the outside expert for the Committee and to prepare a written report providing my analysis and recommendations.

In the course of my work for the Committee I have provided expert opinions on measures considered by the Committee, and I have developed and proposed additional policy measures for consideration by the Committee. To carry out my work, I participated in meetings of the Committee during the period leading up to the Interim Report that the Committee issued on October 11, 2011 (the "Interim Committee Report");[2] in hearings held by the Committee; in meetings of the Committee held to develop the Committee's final recommendations; and in individual meetings with the Committee's chair, individual members, and/or staff members assisting the Committee's work. My work has benefited from data and information I received from the Bank of Israel, the Israeli Securities Authority, the Israeli Ministry of Justice, and the Capital Markets, Insurance, and Savings Department of the Ministry of Finance, and I am grateful to each of these organizations and governmental units and their staffs for their assistance.

Because of the broad scope of the work that I have undertaken and the opinions and recommendations that I have provided, I have divided my final written submission into several reports. This report focuses on control of financial firms, one of the main subjects examined by

[1] The members of the Committee, which was headed by the former Director General of the Ministry of Finance, Mr. Chaim Shani, include Prof. Eugene Kandel, Head of the National Economic Council in the Office of the Prime Minister; Prof. Shmuel Hauser, Chairman of the Israel Securities Authority; Dr. Karnit Flug, Assistant Governor of the Bank of Israel; Mr. David Zaken, Supervisor of Banks at the Bank of Israel; Mr. Gal Hershkovitz, Budget Director; Prof. Oded Sarig, Commissioner of Capital Markets, Insurance and Savings; Adv. Avi Licht, Deputy Attorney General; Prof. David Gilo, Antitrust Commissioner; and Dr. Gitit Gur-Gershgoren, Economics Department Director in the Israel Securities Authority.

[2] A description of my work for the Committee during this stage of its work is provided in the interim expert report I submitted on October 9, 2011 (hereinafter "Interim Expert Report"), which was attached as an appendix to the Interim Committee Report and is available at http://mof.gov.il/Lists/CompetitivenessCommittee/Attachments/36/2011-1111.pdf.

the Committee. Two other reports focus on other issues discussed in the Committee's final report: the use of pyramidal structures, and limits on concentration of investments by Israel's long-term savings funds.[3] I may submit later a supplementary report on measures concerning excessive leverage and bondholder protection that would be worthwhile adopting to supplement the Committee's recommendations.

As background for this report, I should note my prior work for the Israeli government on a related subject. In 1995 the Brodet Committee recommended, relying on a report that I co-authored that was attached as an appendix to the Brodet Committee Report,[4] that limitations be placed on banks' ownership of non-financial groups. In the expert report for the Brodet Committee that I co-authored, we indicated that, although we focused on problems arising from banks' control of non-financial groups, similar problems arise from control of banks by non-financial groups. We concluded that at some time in the future Israeli public officials should consider the question of what type of parties should be permitted to control banks.[5] Given this earlier conclusion, I am pleased that the Israeli government and the Committee have chosen to consider the subject.

B. Executive Summary

This report focuses on the structural separation between significant financial firms and significant non-financial groups recommended by the Committee. I analyze the concerns that the control of financial firms by non-financial groups raises, and I explain the case for the structural approach that the Committee adopted with my support. I also explain that, in my view, it would be desirable to supplement the Committee's recommendations with additional limitations on permissible combinations of financial and non-financial firms.

This report is organized as follows. Part II briefly describes the control of financial firms by non-financial groups in the Israeli economy. Part III focuses on the concerns raised by such control and analyzes distortions that such control could produce, including favoring parties related to the controller, favoring other non-financial groups that control financial firms,

[3] See Lucian Bebchuk, Corporate Pyramids in the Israeli Economy: Problems and Policies, A Report Prepared for the Committee on Enhancing Competitiveness, March 2012; Lucian Bebchuk, Concentration of Investments and Systemic Risks in Israel's Long-Term Savings Funds: Problems and Policies, A Report Prepared for the Committee on Enhancing Competitiveness, March 2012.

[4] Lucian A. Bebchuk, Jesse M. Fried and Louis Kaplow, "Concentration in the Israeli Economy and Bank Investment in Nonfinancial Companies," (1995), included as an Appendix to the Brodet Committee report and issued as Harvard Law School Olin Discussion Paper No. 209 (1995) (subsequently published in Hebrew translation in *The Economic Quarterly*).

[5] Bebchuk, Fried, and Kaplow, supra note 4, at pp. 36-37.

following policies and strategies that favor non-financial groups over capital providers, and disadvantaging competitors of non-financial groups controlling financial firms.

Part IV considers policy choices. I explain the benefits of the structural approach that the Committee developed, with my support, which places limits on the ability of non-financial groups to control financial firms. I discuss precedents for the use of such a structural approach in other countries, and how this approach would complement existing Israeli legislation that precludes banks from controlling non-financial firms. I also explain that the transition arrangements recommended by the Committee are reasonable and proportionate, and adequately address legitimate expectations of current controllers.

Part IV then proceeds to consider the delineation of which combinations of financial firms and non-financial groups should be permissible. In my interim expert report, I expressed the view that the Interim Committee Report suggested conservative thresholds, and that it would be desirable to consider further limits on the set of permissible combinations.[6] I have subsequently proposed to the Committee ways in which this set should be refined and narrowed, and the Committee has adopted some of these recommendations.[7] The thresholds specified in the Committee's final recommendations still represent conservative choices, and it would be desirable for the subsequent legislative process to avoid expanding the set of permissible combinations and instead focus on further narrowing of the set of permissible combinations. In particular, to improve the effectiveness of the adopted legislation in addressing the concerns underlying the Committee's recommendations, it would be desirable to supplement the recommendations of the Committee with:

(i) stricter rules with respect to control of extremely significant financial firms (ones with assets that greatly exceed the Committee's suggested threshold of 40 billion NIS), and with respect to control of financial firms by extremely significant non-financial groups (ones with Israeli revenues or debt that greatly exceed the Committee's suggested threshold of 6 billion NIS); and

(ii) stricter rules for the control of asset management firms, which would prohibit the control of asset management firms by a controller with meaningful non-financial operations.

[6] See Interim Expert Report, supra note 2, at pp. 14.

[7] For example, the Committee has adopted my recommendation that debt to the Israeli financial sector be used to determine the thresholds above which non-financial firms would be prohibited from controlling financial firms. In my view, the amount of such debt is a superior proxy for the magnitude of relevant concerns than the measure that had previously been used (the total value of assets).

II. CONTROL OF FINANCIAL FIRMS IN THE ISRAELI ECONOMY

The Interim Committee Report documents two aspects of the Israeli financial sector that, in my view, should draw the close attention of policymakers. First, the financial sector is substantially concentrated. Second, major financial firms (both banks and investment management firms) generally have controlling shareholders, and some of those controllers belong to non-financial business groups.

To begin with concentration, the Interim Committee Report documents that the Israeli banking sector is dominated by five major banks: Bank Leumi, Bank Hapoalim, Bank Discount, Bank Mizrahi-Tefahot and First International Bank.[8] These five banks hold approximately 95% of the public deposits, and the rest are controlled by three smaller banks. The two big banks, Leumi and Hapoalim, play a dominant role in the banking sector, together holding 57% of the public deposits. In addition, these banks also serve as brokers and custodians for a significant fraction of the securities beneficially owned by the Israeli public as well as foreigners working through Israeli financial firms.

The Interim Committee Reports further documents that the investment management sector is also highly concentrated.[9] Six major non-banking financial groups – Migdal, Clal, Harel, Menora, Psagot Investment House, and The Phoenix and Excellence – manage approximately 69% of the long-term retirement assets of the public, with Migdal and Clal Insurance together holding approximately 31% of such assets. Migdal, Harel, Psagot and Excellence operate four mutual funds that together hold 51.5% of all public financial assets managed by mutual funds. Harel, Psagot and Excellence together manage approximately 53.5% of the ETF businesses, and Migdal, Clal, Psagot and Excellence together control 48% of the public assets managed by portfolio managers.

Turning to the control of financial firms, most of the significant financial firms in both the banking and investment management sectors have a controlling shareholder.[10] Importantly for the purposes of the discussion below, many of these controllers also own significant non-financial businesses operating in the Israeli economy, and some of these controllers belong to the set of the largest non-financial groups in the economy.

[8] The Interim Committee Report, pp. 31-32.
[9] Id., pp. 30-34.
[10] Id., pp. 15 and 34.

III. COSTS AND DISTORTIONS

The financial sector plays a critical intermediation role in the economy. It allocates the capital of all the individuals and entities in the economy among that capital's various possible uses. A financial system that functions well is supposed to allocate capital to its most valuable uses. When financial firms are controlled by major business groups, there are concerns that decisions by financial firms will be distorted and will adversely affect the effective allocation of capital.

Generally speaking, decision-makers in financial firms should manage the capital in their hands to maximize its risk-adjusted returns. Problems arise when a non-financial group has a significant influence on decision-making in an affiliated financial firm. Such influence may lead the decision-makers of the financial firm to take into account the way in which their decisions will affect not only the returns to the financial firm's capital, but also the various interests of the non-financial group. Taking these interests into consideration, in turn, may produce significant distortions, and the Interim Committee's report identifies several of such distortions:

A. Funding Related Parties

The first distortion is caused by the provision of capital in excessive amounts or on excessively favorable terms to firms affiliated with the controlling non-financial group. Such related lending is naturally the first issue to consider, even though its costs can be mitigated by effective limits, as now exist in Israel, on the amount that firms can lend to related parties.

There is significant empirical evidence about the distortions that might arise from related lending. In particular, Rafael La Porta, Lopez-de-Silanes and Guillermo Zamarripa, studying data from Mexico, find evidence consistent with the idea that banks provide capital on better terms to related lenders, including firms controlled by the bank's controlling shareholders.[11] They find that related borrowers both pay lower interest rates than unrelated borrowers and are less likely than unrelated borrowers to eventually pay back their debts. This combination – lower interest rate but higher risk as proxied by the ex-post incidence of default – is consistent with favoritism toward the interests of the controller. In another study, Hadiye Aslan and Praveen Kumar, studying syndicated loans in major European and East Asian countries, find that there is a qualitative difference between loans made to affiliated companies and arms-length lending: bank loans to firms not affiliated with the financial institutions are screened more

[11] Rafael La Porta, Florencio Lopez-de-Silanes and Guillermo Zamarripa, "Related Lending," 118(1) *Quarterly Journal of Economics* 231–68 (2003).

systematically.[12] This result is consistent with the view that affiliated companies use their relationships with financial institutions to get favorable and softer treatment, such as a diluted screening process.

While the above studies focus on the provision of capital to related parties by banks, Aharon Cohen Mohliver and Gitit Gur-Gershgoren, studying data from the Israeli economy, document that the investment decisions made by investment companies are consistent with favoritism to related companies affiliated with the controller of an investment management company.[13] In particular, the authors study the investments made by mutual funds in IPOs of Israeli companies. They find that mutual funds are much more likely to invest in an IPO of a non-financial company that belongs to their business group than in a company that is not affiliated with the group. Furthermore, such investments in group-affiliated companies are made despite the fact that their IPO prices are, on average, at a premium to the market price, and the mutual funds subsequently dispose of those shares quickly and at consistent losses.

There is another concern that arises as long as related lending is not precluded. In times of financial crisis, when liquidity is tight, financial firms controlled by non-financial groups may display favoritism to affiliates of the controlling group. They can be softer to, and more accommodating of, the concerns of these affiliates than those of unrelated borrowers. Furthermore, financial firms might allocate their limited liquidity to affiliated firms, conserving their resources to help such firms at the expense of denying liquidity to unrelated firms. These distortions would have an effect both on financial firms as well as on how well an economy would respond to a financial crisis.[14]

The problem of related funding can be limited in scope by regulatory fiat – placing tight restrictions on the amounts of related lending. However, once general permission to grant any significant amount of loans to affiliated parties is in place, it would be difficult for regulators to monitor related lending. To begin with, the initial terms of the loan often involve discretionary decisions, which are difficult for an outside regulator to micromanage. Moreover, once a loan is

[12] Hadiye Aslan and Praveen Kumar, "Controlling Shareholders and the Agency Cost of Debt: Evidence from Syndicated Loans," FIRS Prague Meetings and EFA 2009 Bergen Meetings Working Paper (2009), available at: http://ssrn.com/abstract=1334886.

[13] See Aharon Cohen Mohliver and Gitit Gur-Gershgoren, "Channeling Funds into the Group: IPO Pricing in Business Groups," Working Paper (2010), available at: http://ssrn.com/abstract=1904603.

[14] See Robert Cull, Stephen Haber and Masami Imai, "Related Lending and Banking Development," 42(3) *Journal of International Business Studies* 406-426 (2011). These authors are skeptical of the magnitude of related lending problems in economies with effective rule of law systems, but they recognize that such problems lead to distortions in the treatment of related and unrelated firms during financial crises, by banks controlled by non-financial groups.

granted, there are many discretionary decisions made in the course of the life of the loan, such as how to enforce the lenders rights and how "soft" or "hard" to be toward request for adjustments or concessions. Again, these types of discretionary decisions would be difficult for a regulator to micromanage.

Finally, while the costs of related lending can be limited by regulatory fiat, the evidence about the above-mentioned costs in countries without such limits is still telling. Thus, the above evidence is relevant because it shows that control can lead financial firms to take into account interests of the controlling non-financial group, and not be guided solely by a desire to maximize risk-adjusted returns to the financial firm's capital.

B. Parallel Favoring of Non-Financial Groups Controlling other Financial Firms

Even when a regulator places limits on how much capital a firm can provide to the non-financial group controlling it, there are certain distortions that cannot be easily addressed by regulatory mandates. One of them is the concern of reciprocal favoring of non-financial groups that control other financial firms. Consider financial firms F1 and F2 controlled by groups G1 and G2, respectively. If F1 and F2 seek to benefit G1 and G2, respectively, and they both face constraint on the amount of capital that each of them can provide to its controller, one could worry that they might gravitate into a situation in which F1 provides capital to G2 in excessive amounts and in exchange F2 does the same for G1. In addition, this might down the road develop into F1 giving soft treatment to G2 and F2 giving soft treatment to G1. Even when this pattern is governed by an explicit agreement, it is hard for the regulator to limit and scrutinize it.

The above concern is consistent with the empirical evidence indicating that non-financial groups with ties to banks tend to have better access to capital. Yupana Wiwattanakantang, Raja Kali and Chutatong Charumilind, studying data from Thailand, show that firms with "crony" ties to banks, as measured by affiliation to one of the largest Thai business groups or by presence of bankers on the board of a firm and as executives of a firm, enjoy preferential access to long-term debt and are able to obtain it with less collateral than firms without such ties.[15]

Another study by Mariassunta Giannetti and Steven Ongena, using data from 14 Eastern European countries, shows that when foreign bank presence becomes more pervasive,

[15] Yupana Wiwattanakantang, Raja Kali and Chutatong Charumilind, "Crony Lending in Thailand Before the Financial Crisis," 79(1) *The Journal of Business* 181-218 (2006). Note, however, that their findings suggest that the mere ownership of banks and financial companies does not necessarily make it easier for the owners to excess more long-term loans, but rather focuses on firms' connections to influential families.

"connected firms"[16] receive relatively fewer loans, grow less and pay a higher interest rate on their financial debt.[17] Because foreign banks are more likely to be making lending decisions on the sole basis of payoffs to their capital, their increased role reduces the distortions produced by the presence of connected firms.

C. Pursuing Policies Favoring Non-Financial Groups over Capital Providers

Financial firms that hold various securities make many choices as to how to enforce and use their rights as shareholders and debtholders. For example, they choose how to vote on interested party transactions as a shareholder; and they choose how to vote and negotiate debt settlements when firms are in financial distress and ask for concessions from bondholders. Firms try to be consistent in those policies and strategies for both external and internal reasons.

In this situation, one could expect that firms controlled by non-financial groups will tend to be "soft" in using their rights vis-à-vis publicly traded firms in general, not just with respect to those that belong to the non-financial group controlling them. Being soft toward other unaffiliated firms will enable them to also be soft for firms affiliated with the controlling group without being viewed as being motivated by favoritism; using a soft approach in general would not obligate a financial firm to justify its softness toward affiliated firms. Furthermore, a non-financial group might have an interest in the development of norms and conventions in the marketplace in which institutional investors are soft with respect to the use of their rights, and any significant financial firm that is controlled by a non-financial group will therefore take into account the effects of its decisions and choices on the development of such norms and conventions.

Yishay Yafeh and Assaf Hamdani, studying institutional investors in Israel, find that institutional investors with certain other business activities (e.g., underwriting) and those owned by public companies or affiliated with business groups (in most tests) tend to be softer toward insiders and more likely to support insider-sponsored proposals than "pure-play" stand-alone investors, such as government or employee-owned funds. This difference between pure-play and affiliated institutional investors persists even when votes do not affect outcomes. They conclude that, in order for institutional investors to effectively enforce and use their rights as shareholders

[16] Their definition of "connected firm" includes firms that have the government or domestic banks as shareholders, or firms that own a block in a domestic bank. The effect they report is statistically significant and similar if the definition is narrowed down to bank ownership ties only.

[17] Mariassunta Giannetti and Steven Ongena, "Financial Integration and Firm Performance: Evidence from Foreign Bank Entry in Emerging Markets." 13(2) *Review of Finance* 181-223 (2009).

and debtholders, what matters most is the absence of conflicts of interest rather than the legal power granted to them.[18]

D. Disadvantage to Competitors

A financial firm F controlled by a non-financial group G may fail to provide funds to a firm that now competes or considers competing with firms that are part of or affiliated with group G. Such excessive tendency not to fund certain firms is hard to deal with at the regulatory level, as regulators may encounter difficulties in monitoring and reviewing what financial firms avoid doing rather than what they actually do. This, in turn, might create impediment to entry and competition. This disadvantage to competitors of the financial firm is especially strong when the financial sector is concentrated. In such a case, not being able to get adequate capital from firm F could be a substantial barrier.

A related concern noted by the Committee is leakage of information to the controller, which also would discourage actual and potential competitors from approaching a financial firm controlled by a non-financial group. Again, this issue is difficult to eliminate completely by regulation of financial firms' decisions.

IV. STRUCTURAL SEPARATION

The Committee concluded that it would be desirable to place substantial limits on the ability of large non-financial groups to control significant financial firms. In my opinion, this approach is warranted, and is a natural complement to the long-standing restriction on the ability of banks to control non-financial groups.[19] Section A of this Part first describes international precedents for this approach. Section B then explains why structural separation would be beneficial. Finally, Section C explains that the set of permissible combinations of financial and non-financial groups delineated by the Committee is quite conservative, and that it would be desirable to further limit the set of permissible combinations. In particular, I discuss how the aims of the proposed structural separation would be served by supplementing the Committee's recommendation with (1) stricter limits on control of extremely significant financial firms, and

[18] Yishay Yafeh and Assaf Hamdani, "Institutional Investors as Minority Shareholders," 5th Annual Conference on Empirical Legal Studies Paper, ECGI Law Working Paper No. 172/2010 (2011), available at: http://ssrn.com/abstract=1641138.

[19] Another recommendation of the Committee – prohibiting individuals closely affiliated with large non-financial groups from serving as directors of significant financial firms – is a natural and warranted element of the policy of severing substantial links between large non-financial groups and significant financial firms.

on control of financial firms by extremely significant non-financial groups; and (2) stricter limits on the control of asset management firms by non-financial groups.

A. International Precedents

Limits on the ability of non-financial groups to control financial companies have a number of precedents in other countries. Below I note three important examples.

1. United States

As a general matter, the Unites States is characterized by a relatively high degree of separation between the financial and non-financial sector.[20] For the purposes of the subject under consideration, it is worth noting certain limitations imposed by US law on the ability of companies that have a controlling interest in a bank to engage in non-financial activities. Under US law, the acquisition of control of a bank or a bank holding company subjects the acquirer to ongoing regulation as a bank holding company.[21] As a bank holding company, the acquirer is subject to substantial restrictions on its ability to conduct non-financial activities.[22]

A company is deemed to "control" a bank under the BHC Act if the company (i) owns 25% or more of any class of voting equity, (ii) has the power to appoint a majority of the board of directors, or (iii) if the Federal Reserve determines that it exercises a "controlling influence" over the management and policies of the bank or company.[23] Subject to certain exemptions, bank

[20] Because the Brodet committee focused on banks' holding of blocks in non-financial groups, the report I co-authored for the Brodet committee highlighted the limits imposed by US law on the ability of banks to hold large blocks in non-financial groups. See Bebchuk, Fried, and Kaplow, supra note 4.

[21] Section 3 of the Bank Holding Company Act of 1956 (the "BHC Act"). The BHC Act defines a bank holding company as an entity that "controls" a "bank." A "bank" generally means an institution that both accepts deposits and is engaged in the business of making commercial loans, but certain institutions, such as industrial loan companies, are exempted from the definition of "bank." See Pauline B. Heller and Melanie L. Fein, Federal Bank Holding Company Law (2006), 2.04[1]-[3].

[22] It should be noted that the BHC Act only applies to "companies" that acquire control of a bank or bank holding company, and does not apply to individuals, who are subject to the Change in Bank Control Act.

[23] BHC Act §1(a)(2). The Federal Reserve regulations identify a number of situations in which there is a rebuttable presumption that a company "controls" a bank for purposes of the BHC Act. This presumption will apply under certain circumstances which show that a company, alone or together with its principal shareholders or other affiliated companies, exercises significant influence over the bank or its management. For more information, see the USA Chapter in Banking Regulation 2011 in 27 jurisdictions worldwide (Contributing editor: David E Shapiro, available at: http://www.gettingthedealthrough.com/books/updates/article/28401/.

holding companies cannot engage in commerce or any non-banking activity, other than a list of activities determined by the Federal Reserve to be "closely related to banking as to be a proper incident thereto."[24] Similarly, financial holdings companies[25] cannot engage in any non-bank activity, other than certain activities, which are financial "in nature," incidental, or complementary to financial activities.[26] Following the enactment of the Gramm–Leach–Bliley Act (GLB)[27], financial holdings companies may acquire the equity of a non-financial corporation, but they may only hold the equity of non-banking companies for a limited period and are prohibited from active or routine management or operation of those companies.[28]

2. Canada

In Canada, large banks, which are defined in the Canadian Bank Act as banks with equity of CAD$8 billion or more, are required to be widely held at the level of the holding company.[29] To this end, Canadian law prohibits any person or entity from being a major shareholder of the holding company of such large banks. A "major shareholder" is defined as a person who beneficially owns, either directly or indirectly, more than 20% of the outstanding voting stock of a bank, or beneficially owns more than 30% of any class of nonvoting stock of a bank. In addition, no shareholder is permitted to have "control in fact" over a bank.[30]

3. Korea

Finally, under Korean law, a "non-financial business operator" ("NFBO"), whose main business activity is non-financial business, is prohibited from owning more than a small

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[24] § 4(c)(8).

[25] A bank holding company that meets certain criteria relating to capital adequacy, management and service to their local communities can elect to be treated as a "financial holding company" and enjoy expanded powers and authorization to engage in wide range of activities that are financial in nature. See Heller, 2-8.1.

[26] The Gramm–Leach–Bliley Act, Section 103(a) (codified at 12 U.S.C. 1843(k)). The Federal Reserve has discretion to determine which activities are considered "complementary to financial activities."

[27] Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).

[28] See Bernard Shull, "Banking Commerce and Competition under GLBA." 44 *Antitrust Bull.* 25, 38-40 (2002); Patricia McCoy, Update to *Banking Law Manual Federal Regulation of Financial Holding Companies, Banks and Thrifts*, Lexis Publishing (2010); pp. 5-113.

[29] The Canadian Bank Act (S.C. 1991, c. 46.), § 2.2, 3(1)(d), 374(1)-(2) and 377(1). For a general description of the relevant legislation, see the Canada chapter in Banking Regulation 2011.

[30] There is no bright line test in order to identify when control exists, and determining the existence of "control" remains largely an exercise of judgment. Note that the definition of "control" also includes controlling more than 50% of the votes that may be cast to elect directors.

percentage of the voting shares of a nationwide commercial bank, and is thereby precluded from controlling such a bank.[31] A 2009 amendment to the Bank Act, which was passed to ease regulations governing the ownership of Korean banks, established a limit of 9% on the percentage of the voting shares of a nationwide commercial bank that a NFBO may own. Prior to the passage of this amendment, the limitation was even more restrictive - a NFBO was prohibited from exercising any voting rights with respect to shares exceeding a 4% of the company (though the NFBO could own up to 10% of such shares).

B. The Case for Structural Separation

As explained above, it is difficult to design regulation of financial firms' decisions that addresses concerns that control of financial firms by business groups might distort such decisions. The limited ability of regulation to address such concerns suggests a structural solution. Therefore, as the Committee concluded with my support, it would be desirable to adopt limits on the ability of non-financial groups and their controllers to control financial firms.

There is little basis to expect that separation would result in any forgone efficiencies from synergies, and in the hearings affected parties did not suggest that this is the case. Therefore, the long-term costs of mandating such separation in terms of economic efficiency are likely to be limited or non-existent. Of course, to the extent that a controller of business groups would extract private benefits from controlling financial firms, those private benefits would be lost if separation were mandated. However, the loss of such private benefits would not represent a social cost; on the contrary, to the extent that private benefits come from private gains accompanying the distortion of financial firms' decision-making, eliminating the opportunities for controllers to extract such private benefits would produce social benefits.

Although affected parties have not argued that mandating separation would result in efficiency losses, it has been argued that such separation could negatively affect current controllers' property rights and legitimate expectations. In my view, however, given that the Committee provides for a substantial transition period, the Committee's approach is a reasonable and proportionate measure that appropriately respects parties' legitimate expectations.

[31] See the client memorandum prepared by the Korean law firm, Kim & Chang, dated May 29, 2009, available at: http://www.kimchang.com/UserFiles/files/KandCLegal_Updates_Amendment_to_Bank_Act__Bank_Ownership__090529.pdf. See also the Korea Chapter by David E Shapiro in Banking Regulation 2011, available at http://www.kimchang.com/UserFiles/files/GTDT-BankingRegulation2011.pdf.

The area of banking regulation has long been a dynamic field in which rules concerning which assets banks and their controllers are permitted to own has evolved as the potential problems in this area have become better understood. Furthermore, in my view, allowing controllers that do not meet the new requirements four years to rearrange their affairs (by selling all or part of their financial holdings or their non-financial holdings) would enable such controllers to capture the fair value of their assets without the losses that would result from a rushed sale. Given the substantial transition period the Commission recommends, the Committee's approach would be a proportionate and reasonable measure that responds to the new understanding of the desirable structure of ownership in this field, while taking into account the needs of those whose affairs do not currently comply with the new measures.

Of course, a controller of a financial firm could complain that the new approach prevents them from selling their control block in a financial firm to another large business group that would be willing to pay a higher premium. However, a main reason a large business group may be willing to pay a higher premium for a control block is that it would enable the controller to divert value to its business group in one of the manners discussed above. Not being able to sell to a large business group would prevent the current controller from realizing the monetary value of the stream of such future private benefits. But current controllers should not be viewed as having an entitlement or legitimate expectations of capturing the value of such a stream of private benefits.

C. Delineating the Set of Impermissible Combinations

1. The Committee's Recommended Thresholds

The limitations recommended by the Committee would prohibit a significant non-financial firm from controlling a significant financial firm. In my opinion, the set of permissible combinations delineated by the Committee is conservative. It would therefore be desirable for Israeli legislators considering the Committee's recommendations to avoid expanding the suggested set of permissible combinations.

Before proceeding to discuss particular ways in which the set of permissible combinations could be further limited, it is worth highlighting that the approach of the committee was more conservative than the approach taken by the Brodet Committee in 1995. The Brodet Committee recommended (and legislation subsequently implemented) that *any* bank, however small, be precluded from controlling *any* non-financial corporation, however small. By contrast, the Committee recommends precluding combinations in which a non-financial firm controls a financial firm only if both the non-financial firm and the financial firm exceed a certain significance threshold.

The Committee's conservative approach is reflected in its determination of the significance threshold. According to the Committee's recommendation, a non-financial firm would face limits on its ability to control financial firms only if it borrows more than 6 billion NIS from the Israel financial sector or its revenues in Israel exceed 6 billion NIS. Data reviewed by the Committee indicates that only 9 companies currently have Israeli revenues exceeding the significance threshold, and only 12 companies currently have credit from the Israeli finance sector that exceed the significance threshold. Altogether, the data indicates that only 16 Israeli non-financial groups would currently be precluded from controlling significant financial institutions. Similarly, out of 66 financial firms, only 13 financial firms – 5 banks and 8 asset management companies – currently exceed the significance threshold. According to the Committee's recommendations, non-financial firms, however large and dominant, would not be precluded from controlling any financial firm other than those 13 firms exceeding the significance threshold.

In my view, the goals of the structural approach adopted by the Committee would be served by further limiting the set of permissible combinations. Below I discuss two specific ways for further limiting this set that Israeli legislators and regulators should consider.

2. Supplementary Limits for "Extremely Significant" Financial Firms and Non-Financial Groups

The Committee's recommendations are based on a judgment that the magnitude of distortions is a product of both (i) the scale of the controlled financial firm, and (ii) the scale of the controlling non-financial group. The greater the scale of the financial firm or the non-financial group, the greater the distortion costs resulting from the combination. Given the Committee's view, it would be desirable to adopt an especially strict approach with respect to (i) control of financial firms that are extremely significant, i.e., firms that greatly exceed the thresholds specified by the Committee in defining significant financial firms, and (ii) control of financial firms by non-financial groups that are extremely significant, i.e., non-financial groups that greatly exceed the threshold specified by the Committee for defining significant non-financial groups.

The Committee set a threshold of 40 billion NIS of assets for a financial institution to be classified as significant. While some financial firms exceed this threshold by a limited amount, a small number of financial firms have assets that are a significant multiple of the threshold. In particular, data reviewed by the Committee indicates that two Israeli banks each have assets under management exceeding 320 billion NIS – more than eight times greater than the 40 billion NIS threshold. Four other Israeli financial firms – two banks and two asset management firms–

each have assets valued at more than three times the specified threshold. Three other asset management firms each have assets valued between two and three times the specified threshold.

Similarly, data reviewed by the Committee suggests that some non-financial groups have revenues or debt in Israel that greatly exceed the specified significance threshold. At least five non-financial groups have debt to the Israeli financial sector that is more than twice the specified threshold of 6 billion NIS. Three non-financial groups have revenues in Israel that are at least twice the specified threshold of 6 billion NIS.

According to the Committee's recommendations, whether a combination between a financial firm and a non-financial firm would be permissible would depend on the yes-no question of whether each of the firms exceeds the significance thresholds specified for financial firms and non-financial groups. The amount by which the financial firm exceeds the significance threshold for financial firms, and the amount by which the non-financial group exceeds the significance threshold for non-financial groups, would be given no weight. However, these amounts have considerable significance in assessing the potential distortions likely to arise from the control of financial firms by non-financial groups that motivate the Committee's approach.

Consider (i) the combination of a financial firm that has assets worth 40 billion NIS with a non-financial firm that has Israeli debt exceeding 6 billion NIS, which would be impermissible under the Committee's recommendation. And compare with (ii) the combination of a financial firm that has assets of 80 billion NIS with a non-financial firm that has Israeli debt of 5.5 billion NIS, or (iii) the combination of a financial firm that has assets of 35 billion NIS with a non-financial firm that has Israeli debt of 12 billion NIS. It seems that combinations (ii) and (iii), which would be permitted if the Committee's recommendations were adopted without any supplementary rules, raise greater concerns than combination (i), which would be prohibited.

The rules proposed by the Committee could be refined to respond to this problem without becoming excessively complex. In particular, the rules could be refined to impose stricter limitations in connection with financial firms and non-financial groups that are extremely significant. To illustrate, the Committee's recommendation could be supplemented by a rule that would (i) prohibit any financial firm with assets exceeding a certain higher threshold (e.g., 100 billion NIS, which is 2.5 times the Committee's basic threshold) from being controlled by any non-financial firms whose Israeli debt or revenues exceed a lower threshold of significance (e.g., 2.4 billion NIS, which is the Committee's threshold divided by 2.5); and (ii) prohibit any non-financial group whose Israeli debt or revenues exceed a certain higher threshold (e.g., 15 billion NIS, which is 2.5 times the Committee's threshold) from owning a wider set of financial firms (say, any firm with assets valued at more than 16 billion NIS, which is the Committee's threshold divided by 2.5). Even stricter rules could be adopted for control of financial firms that

exceed an even higher threshold of significance (e.g., those firms with assets whose value is more than 5 or 6 times the 40 billion NIS threshold), or control by non-financial groups whose debt or revenues surpass an even higher threshold of significance (e.g., those with Israeli debt or revenues exceeding 5 times the 6 billion NIS threshold). Adopting such simple refinements would improve the effectiveness of the structural recommendations adopted by the Committee.

3. Supplementary Limits on Controllers of Asset Management Firms

The Committee's approach is intended to apply to several types of financial firms – banks, insurers, financial clearinghouses and asset managers. The Committee's recommendations would apply the same thresholds for all types of financial firms, for both the definition of a significant financial institution and the definition of a significant business group. In my view, however, there is a strong case for applying stricter rules to the control of asset management firms by non-financial groups. In particular, it would be desirable to prohibit the control of any asset manager by any meaningful non-financial group (say, any non-financial group that has more than 1-2 billion NIS in Israeli revenues or debt).

There are two reasons for why the thresholds should be set differently for banks and insurers than for asset managers (that is, managers of mutual funds, ETFs, private portfolios, etc.). First, banks and insurers require capital to back up the claims of depositors and policyholders. The Committee's choice of thresholds was partly aimed at permitting controllers of banks and insurers that have "deep pockets" and substantial outside resources. The controller could use such outside capital to provide additional capital at a time of need, thereby contributing to financial stability.[32] By contrast, asset managers generally manage "other people's money" for investors, without guaranteeing outsiders any payoffs using the managers' own resources. Accordingly, because it is much less important for an asset manager to have a controller with substantial outside resources, the main advantage identified by the Committee for allowing control of financial firms by non-financial groups does not apply to asset managers.[33]

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[32] See, e.g., Committee on Enhancing Competitiveness, Presentation Slides with Principal Recommendations, February 2012, p. 12 (noting that the stability derived from having a controller with substantial capital is an advantage of having a combination of a financial firm with a non-financial group).

[33] Of course, someone wishing to purchase a controlling block in an asset manager will need capital to finance the acquisition. However, for banks and insurers, Israeli regulators appear to favor having a controller with not just the capital invested in the bank/insurer but also additional capital outside the bank/insurer that can be used to replenish the bank's/insurer's capital in a time of need. This consideration is not applicable for an asset manager. For this reason, Israeli regulators, who have in the past demonstrated a significant preference for having a controlling shareholder for banks and insurers (rather than dispersed ownership), should not have such a preference with respect to asset managers.

Second, in the case of a bank or insurance company, because any reduction in profit is first borne by shareholders, a controller would personally bear a significant fraction of the costs resulting from any distorted decision-making. Owning a significant proportion of the capital of a banking or insurance firm provides the controller with significant incentives whose presence mitigates some of the concerns raised by a combination of the firm with a non-financial group. By contrast, the controller of an asset manager firm would not have similar incentives. Compare a controller that owns 25% of the capital of a banking firm with a controller of an asset management firm that manages other people's money and charge a 1% management fee. Suppose both firms are considering a decision that would result in a given loss to the portfolio of assets managed by their firm, but would confer a given benefit on their non-financial operations. In this example, the proportion of the loss to the portfolio that the controller would bear *directly* would be substantially smaller in the case of the asset management firm than in the case of the banking firm. As a result, concerns that decisions would be distorted by the non-financial interests of the controller would be more substantial in the case of the controlled asset manager than in the case of the controlled banking firm.

Both of the considerations discussed above operate to recommend a stricter approach with respect to the control of asset management firms by non-financial groups. The control of asset management firms by non-financial groups raises concerns that are especially significant, and the rules governing such control need not be influenced by a desire to attract controllers with substantial capital outside the firm. Supplementing the Committee's recommendations with stricter limitations on the control of asset management firms would therefore increase the effectiveness of the structural approach recommended by the Committee. The supplemental limitations on asset management firms should prohibit such firms from being controlled by a group with meaningful non-financial operations (i.e., operations with debt or revenues that exceed thresholds that are substantially lower than those set for control of banks and insurers by non-financial groups).

V. CONCLUSION

The control of financial firms by significant non-financial groups in the Israeli economy raises substantial concerns and warrants the adoption of significant measures. The structural approach adopted by the Committee with my support would make a significant contribution to addressing these concerns. Supplementing the rules recommended by the Committee with additional, stricter limitations with respect to financial firms and non-financial groups that are extremely significant and not merely significant, as well as to asset managers, would enhance the benefits of the structural approach recommended by the Committee.