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**Balancing Prudential Regulation and Competition Considerations in Banking – Note by
Israel**

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1. Introduction

1. The Israel Competition Authority (the "ICA" or the "Authority") has chosen to focus this contribution on the topic of regulatory balance and policy design, in accordance with the core of its institutional efforts in recent years.
2. The Israel Competition Authority operates under the Competition Law, 5748-1988 (the "Law", or the "Competition Law"), and fulfills a dual function: exercising its powers under the Law (including enforcement, merger approval, etc.) and pro-competitive advocacy vis-à-vis other regulators. This latter role requires the Authority to issue formal opinions and actively participate in public committees tasked with examining financial markets and shaping policy.
3. The governmental coordination and discussion on the balance between prudential regulation and promoting competition are typically conducted within the framework of ad-hoc committees and joint initiatives. The Inter-Ministerial Committee to Examine Measures for Increasing Competition in the Retail Banking System ("the Committee"), which will be further elaborated upon in this Contribution, represents a classic example of this institutional mechanism. The composition of the Committee included all key financial regulators and served as a platform for integrating competitive-economic analysis at the early stage of policy-making. Upon the completion of its work in August 2025, the Committee's recommendations were adopted by the Minister of Finance and the Governor of the Bank of Israel and are currently being prepared for legislation.

2. Historical Background: Concentration of the Israeli Banking System and the Need for Structural Reform

4. For decades, the Israeli financial system has been characterized by severe, cross-sectoral structural concentration. This concentration is still evident today, with the two largest banks in Israel holding a joint market share of approximately 60% to 70% of the retail credit and deposit markets, as well as a significant share of the business credit markets, and five banking groups controlling nearly all the market. This concentration across the financial markets has created a series of structural failures, including high barriers to entry for new players and internal institutional conflicts of interest. These shortcomings necessitated comprehensive governmental intervention.
5. The dominance of the banks in Israel's financial markets, and the banks' conflicts of interest, led to a severe financial crisis in the 1980s, after which several structural reforms were enacted, the main one being the Bachar Reform (2005). The Bachar Committee identified the link between the banks' concentration and structural integration in the capital market and systemic risk. Therefore, the Bachar Committee's recommendation, which was adopted, was mandatory divestiture: obligating the banks to sell the provident funds and mutual funds they owned, prohibiting banks from holding provident funds and mutual funds, and prohibiting companies that manage savings from owning a bank. The objective of the reform was twofold: firstly, to reduce the conflicts of interest arising from a bank's

¹ The information provided in this Contribution does not, and is not intended to, constitute legal advice, nor does it purport to encompass all aspects arising with reference to this subject.

activity both as a producer of savings products and as their distributor, and thereby to increase competition in the long-term savings market. Concurrently, the reform aimed to address the systemic risk stemming from the concentration of public funds in the hands of the banks.

6. Ten years later, the Strum Reform required the two largest banks to divest from the credit card companies that they controlled, required all the banks to reduce their holdings in the credit card switch and promoted regulation of non-bank payment services, account information services and payment initiation.

7. A retrospective examination of the implications of the Bachar Reform and the Strum Reform found that while the large business credit segment opened up to competition between banks and non-bank entities, banking services for retail customers and small-to-medium businesses still suffer from a low level of competition, and the deposit spread for households is significantly higher than that for large businesses.

8. These findings led the Minister of Finance and the Governor of Bank of Israel, in November 2024, to establish an Inter-Ministerial Committee headed by the Supervisor of Banks and the Director general of the Budget Department at the Ministry of Finance to examine measures for promoting competition in common banking services for retail customers. The Committee included the Chairman of the Israel Securities Authority (who also supervises payment service providers and information service providers in Israel), the Commissioner of Capital Market, Insurance and Savings (who supervises institutional entities and other non-bank financial players), the Director of the Financial Division in the Bank of Israel's Research Department, the Director-General of the Competition Authority, and Deputy Attorney General (Economic Affairs).

9. It should be noted that while there are other players in the retail credit market, these entities cannot accept deposits from the public. This restriction arises from the need to protect the stability of the banking system and the public's funds – only a bank may simultaneously accept deposits and extend credit. But it also increases the funding gap between non-bank entities and the banks, which benefit from relatively stable and cheap funding through retail deposits, thereby reinforcing the market power and dominance of the incumbent banks.

3. Regulatory Balance

10. The Committee focused on the regulatory frictions that inhibit the entry of new competitors into retail banking services. The recommendations concentrated on ways to embed competition considerations at the core of stability regulation.

3.1. The Principle of Proportional Licensing and Supervisory Hierarchy

11. The Committee recognized that "one-size-fits-all" banking regulation created significant barriers to entry for new competitors. The traditional regulatory system required uniform capital and compliance requirements from all banks. For new players, startup costs are high, and the need to comply with comprehensive regulation upfront creates a disproportionate compliance burden that threatens their ability to establish a sustainable business model – to a degree not proportionate with the lower risk that they pose.

12. The Committee recommended that the Supervision of Banks adopt a customized and tiered licensing model that would enable the emergence of small banking institutions. This model will be implemented through a supervisory hierarchy defining three tiers for banking corporations based on their asset volume (for example: up to NIS 15 billion, NIS

15 to 50 billion, and over NIS 50 billion). For each tier, regulations will be tailored to ease requirements for capital, liquidity, disclosure, and corporate governance in accordance with the bank's size and risk level, thereby reducing the obligation of disproportionate compliance burden. In addition, a preparation period of up to three years was set for new banks, allowing for the gradual implementation of the required regulation.

3.2. The Principle of Opening Business Areas and Removing Universal Service Obligations

13. Banking regulation in Israel traditionally defined a closed set of activities in which banks are permitted to engage, while simultaneously requiring all banks to provide a minimum number of services to all customers (universal service obligation). In addition, banks may only charge fees that align with the fee models approved by the regulator.

14. These restrictions are important for preventing structural conflicts of interest that may endanger the stability of the system, as well as for protecting consumers from the banks' market power. On the other hand, these obligations limited flexibility in business models and imposed high costs on small banks due to the need to set up dedicated technological infrastructure for the full range of services, even if these services are not core to their business model. Another consequence of the business restriction is to reduce the incentive for non-bank financial entities to apply for a banking license, as obtaining the license would require them to abandon their existing businesses.

15. In light of the reduced risk arising from small banks versus the regulatory burden imposed on them, the Committee recommended a dual structural change concerning small banks:

16. The first part of the structural change is removing most universal service obligations from small banks, which allows them to develop unique business models that can focus on the most profitable services or the services for which there is the most demand. The recommendation also includes allowing flexibility in fee models to encourage innovative pricing models, subject to full transparency. The second part is to permit small banks to engage in additional fields not included in the traditional closed list (such as marketing general insurance). This change is intended to create flexibility in business models and allow new institutions to generate profitability in complementary markets.

3.3. The Structural Dilemma: Balancing the Entry of Institutional Entities into the Retail Credit Market

17. A central issue discussed by the Committee was the need to balance encouraging competition through the entry of institutional entities into the banking market against the stability and competitive concerns associated with this structure. In Israel, institutional entities are a significant player in the non-bank credit market, *inter alia* because some of them control retail credit companies such as credit card companies and credit card settlement aggregators² - companies that are natural candidates to receive a small bank license under the new regulation and generate competition in the retail credit market. Conversely, the inclusion of institutional entities leads to stability concerns, primarily the risk that an institutional entity might funnel funds to distressed borrowers enabling them to repay the credit owed to the controlled bank, and the moral hazard that arises because the institutional entity, due to its control over a bank, assumes an implicit guarantee, by counting on the Bank of Israel to act as the Lender of Last Resort. Additional concerns

² Payment aggregator, but only for credit card payments.

raised regarding the entry of institutional entities into competition in the banking market were specifically competitive, including the concern that the bank would recommend the investment products of the controlling institutional entity to its customers, thereby excluding competing investment product producers from the market.

18. Due to these concerns, the Committee recommended a model of controlled and tiered entry, allowing institutional entities to compete with banks, subject to restrictions:

- **Asset Limit:** A bank may have ties to an institutional entity only if its share of the total assets in the banking system is less than 2.5% (there is a mechanism for raising this threshold). This limitation fences off the potential systemic risk, given that the potential companies to receive a bank license are currently far from this asset volume.
- **Marketing Prohibition:** To reduce conflicts of interest and stability risk, the Committee's recommendations included a prohibition on a bank with ties to an institutional entity from engaging in the advising, marketing, or brokering of investment and savings products of the kind offered by the financial group. This prohibition preserves the historical lessons learned in Israel about the risks of allowing banks to distribute savings instruments and aims to maintain the objectivity of advice to the end customer.

3.3.1. The ICA's Stance on Non-Organic Entry:

19. In the Committee's report, the Israel Competition Authority addressed the possibility of institutional entities entering the banking sector through the acquisition of an existing small bank or an existing entity that is a likely potential competitor. The ICA stated that such an acquisition is highly likely to cause significant competitive harm. One reason for this is that such a merger would cause the acquired company to be subject to additional regulatory constraints due to its links with an institutional entity (such as the asset limit and the prohibition on brokering investment and savings products). These restrictions, despite being necessary for stability, impair the competitive capacity of the acquired company compared to its capacity as an independent entity.

4. Institutional Coordination Challenges and Regulatory Gaps

4.1. Division of Authority and Inter-Ministerial Coordination Challenges

20. The financial supervision system in Israel is characterized by entity-based supervision, so that each supervisor has entities under their responsibility. In brief, the Supervision of Banks supervises banks and large credit card companies, the Capital Market Authority supervises insurance and pension companies and non-bank credit providers, and the Israel Securities Authority supervises the Stock Exchange, public companies, payment service providers, and information service providers. This supervisory structure creates inherent competitive and institutional challenges, including: dual regulation where an entity engages in multiple types of activities subject to different regulators; identical activity being subject to multiple, non-harmonious regulatory regimes; and the creation of barriers to entry due to regulatory uncertainty, which impairs the incentive for new financial entities to grow.

21. To overcome the stability risks arising from the structure of financial regulation, the Bank of Israel Law established the "Financial Stability Committee." This is a joint committee of all financial regulators established to ensure financial stability in Israel.

However, there is no corresponding formal or informal committee established to coordinate pro-competitive aspects.

22. The mechanism through which competitive issues common to several regulators are addressed is working groups and inter-ministerial committees. These teams can be informal teams, but they can also be established by appointment of the Minister of Finance or as a result of a request from a parliamentary committee.

4.2. Regulatory Gaps Impeding Non-Bank Competition

23. The Committee identified a series of barriers to entry arising from gaps in the implementation of regulation between the banking sector and the non-bank sector. These barriers stem directly from the fragmented supervision structure and require the establishment of inter-ministerial working groups to bridge these gaps:

4.2.1. Anti-Money Laundering and Counter-Terrorism Financing

24. There are significant gaps and a lack of mutual recognition in Anti-Money Laundering (AML) orders between the different financial sectors (banks, payment companies, etc.), as each financial regulator is authorized to issue instructions regarding AML for the entities under its supervision.

25. Currently, staff work is being conducted by the Ministry of Justice and the Israel Money Laundering and Terror Financing Prohibition Authority, which is examining cross-sectoral, principle-base regulation of AML/CTF aspects across all entities in Israel. Regarding this regulation, the Committee recommended allowing financial entities to rely on third parties that are supervised financial entities for the purpose of implementing the KYC process. This recommendation means mutual recognition by the financial regulators of the effectiveness of each other's supervision over the KYC process in the entities under their supervision, thereby bridging the difference in regulation.

4.2.2. Implementation of Open Banking

26. Israel adopted the principles of open banking in the Financial Information Services Law, 5782-2021. This law obligates financial entities holding customer information to allow supervised information service providers access to the customer's financial information via API. Information service providers are supervised by the Israel Securities Authority, while the financial entities holding the customer's information are supervised by other regulators. Currently, despite the legal obligation to make financial information fully and accurately accessible, information services companies face ongoing challenges in accessing banking information.

27. To deal with these challenges, the Committee recommended the establishment of a joint team between the Supervision of Banks and the Israel Securities Authority, which will examine steps for upgrading, maintaining, and implementing the Open Banking standard in Israel.

5. Summary and Conclusions

28. The structural and regulatory analysis in Israel indicates that the prevailing notion of an inevitable tension between competition and stability requires re-examination. Experience shows that structural concentration in the banking system is itself an amplifying factor of systemic risk, as proven by the Bachar Reform, which resolved stability risks through mandatory structural separation. Hence, the central lesson is that healthy

competition is a stability-supporting factor. Concurrently, strict stability regulation is not an obstacle, but an essential pre-condition for creating the public trust required, without which there cannot be meaningful entry of new competitors into the financial sector.

29. The Inter-Ministerial Committee's recommendations reflect a comprehensive strategy aimed at designing proportionate regulation that actively supports competition. This strategy includes: implementing a tiered licensing model to lower entry barriers for small banks; allowing small banks more flexibility in developing novel business models; controlled regulation of the entry of institutional entities into the retail credit market (while imposing targeted restrictions to prevent conflicts of interest and systemic risk); and addressing sectoral regulatory gaps that impede non-bank competition, such as the need to bridge AML rules and fully implement the Open Banking requirement. The ultimate goal is the creation of a financial system that optimally combines systemic stability with a high and diverse level of competition.