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English - Or. English

12 November 2025

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

Competition in Artificial Intelligence Infrastructure – Note by Israel

5 December 2025

This document reproduces a written contribution from Israel submitted for Item 7 of the 147th OECD Competition Committee meeting on 4-5 December 2025.

Antonio CAPOBIANCO
Antonio.Capobianco@oecd.org, +(33-1) 45 24 98 08

JT03576523

Israel

1. Introduction

1. The Israeli Competition Authority (the "ICA") took part in an intergovernmental task force for examining the use of artificial intelligence in the financial sector. The team brought together representatives from the Ministries of Justice and Finance, financial regulators and the ICA and published an intermediate report in October 2024 (the "Report").

2. The team's work comes as a continuation of governmental engagement with the subject of artificial intelligence in Israel. This engagement included, among other things, Government Resolution 212 from 2021 and Government Resolution 173 from 2023, which dealt with formulating a national plan regarding AI; a policy document by the Ministries of Innovation and Justice from 2023, which presented a regulatory strategy for dealing with AI; and a report by the Israeli Ministry of Justice and a group of researchers from Tel Aviv University, which dealt with AI applications in the financial sector. The team's work is a continuation of the recommendations included in the policy document, that regulation in the AI field be done on a sectoral basis (as opposed to horizontal regulation), aligned with regulation practiced in leading countries worldwide, and be flexible and "soft" in order to enable technological advancement. The Report implements this approach.

3. The Report does not focus on infrastructure inputs underpinning developments in AI. Nonetheless it has meaningful insight on AI regulation that can impact competition in AI infrastructure inputs in the financial sector.

4. AI has the potential to increase productivity in the financial sector, drive innovation, and enable the creation of entirely new products and services that will benefit the public. Recent developments in artificial intelligence technologies are generating expectations that AI will be integrated over time in a more significant manner in the financial sector. For example, AI applications may be used in core operations in decision-making processes in the fields of credit, insurance and investment, in work interfaces with customers and investors such as clarifying customer needs, tailoring product offerings and handling their requests, and in streamlining internal processes such as risk management and fraud prevention.

5. To the extent that this promise, inherent in AI advancement, is indeed realized, it may yield numerous benefits for the general public, including significant improvement in the quality of financial products and services, cost reduction, and making services more accessible. At the same time, the entry of AI raises many concerns. These relate both to new and unique challenges such as understanding how AI systems operate and their outputs, and to existing challenges that may change and intensify, such as risks of discrimination or manipulation. Specifically, developing technologies, implementing them in markets, and allowing consumers to obtain their benefits, requires effective and dynamic competition.

2. Artificial Intelligence in The Financial Sector – Intermediate Report

6. The report lays out the background, developments and regulatory trends relating to AI in general, and the financial sector in particular. The report establishes the general approach and guiding principles for addressing AI challenges in the financial sector. These

principles include, for example, relying on risk-based regulation, technological neutrality, and aspiration for regulatory uniformity regarding similar services and risks, and more. The report also discusses horizontal issues arising as a result of using AI applications such as the "black box" problem, explainability and human involvement; the legal framework applying to supervised entities in the financial field relating discrimination and privacy; financial stability, and risks of fraud, cyber and disinformation; corporate governance and risk management. Regarding competition concerns, as we will demonstrate in the following chapter, the report highlighted that given the expected importance of artificial intelligence in the coming years, the question of competition in this field is also becoming highly significant. The report concludes with general recommendations for dealing with AI within financial regulation.

7. The interim report was published for public comments, and calls on any interested party to respond and contribute information and insights they have on the matter.

3. AI and Competition in the financial sector

8. As will be detailed below, most competition concerns in the field of developing AI models relate to barriers in accessing required inputs, concern about strengthening the dominant position of large technology companies through AI models, and concern about the development of markets with "winner-takes-all" or "winner-takes-most" dynamics.

9. Based on the work by OECD competition committee, the report divides the AI supply chain into three main groups: Suppliers of knowledge and inputs for developing AI models (information, code building, chips, server farms, etc.); competitors active in developing and designing models; and users of the models who integrate them into their work processes, products, and services.

10. Financial institutions in Israel are, generally, purchasers of the of AI models. However, given that financial institutions in Israel hold extensive information about customers, there may be financial institutions that will also develop models themselves or institutions that will develop models in cooperation with technology companies who will provide the additional inputs required for model development.

11. Israeli financial players are also expected to integrate AI models into the existing services they offer customers. There is a possibility that AI models will enable them to offer new financial services, and there is even a possibility that through collaborations, these financial institutions will become service providers of AI services to other financial institutions in Israel.

12. Despite various regulatory steps taken in recent years aimed at increasing competition in the financial field and enabling entry of new competitors into the markets, there are various markets in Israel's financial sector characterized by high concentration, partly due to high entry and switching barriers. Thus, in banking, the five largest banking groups hold approximately 98% of the market share. The sector is characterized by high entry and switching barriers and low level of competition, in which banks rarely compete aggressively for customers of other banks.

13. The insurance sector generally is characterized by a higher level of competition, although even in certain insurance markets there is a high level of concentration, for example, health insurance and life insurance. There are also serious structural problems regarding the activities and incentives of insurance agents. These characteristics lead to restricted competition.

14. Moreover, in general, financial services are characterized by clear economies of scale, with significant importance for personalizing the service to the customer and their individual characteristics.

15. Given the above, the report found that there is concern about the development of market power in providing AI services to Israel's financial sector and that Israeli financial institutions' use of AI will increase the existing concentration in the financial field itself, as detailed below:

16. As a result of economies of scale, network effects, and the importance of reputation in providing AI services, and against the possibility that AI markets in various fields will develop toward 'winner takes all' (or most) markets, there is concern about the creation and strengthening of market power by AI service providers, for example large technology companies, vis-à-vis financial institutions in Israel.

17. Lack of access to inputs is one of the most significant competition concerns. Existing competitors in the financial field have access to extensive proprietary information that has accumulated with them during their years of activity in the field and continues to accumulate and update continuously. Through this information, AI models can be developed, adapted to different needs of each financial institution, and the model can be adapted to the constant and changing needs of each and every customer. Admittedly, developing an AI model requires additional inputs, such as computational capabilities and expertise, but existing financial institutions can overcome this through collaborations with technology companies to develop models that will serve only them. New financial players who do not have data at similar scales may face significant entry and expansion barriers due to the inability to develop and train a model based on existing information.

18. Moreover, there may be competitive advantages for competitors developing AI models first. The fact that existing financial institutions will be first to implement AI models may provide them with market advantages, such as creating network effects, strengthening brand loyalty, or low entry costs, which new competitors will find difficult to bridge at a later stage.

19. The fact that existing financial institutions are large entities with high financial stability and some are active in many markets enables them to develop a model and use it in many financial services and even use the existing customer base to improve the model efficiently and quickly. Accumulating to entry or expansion barriers for other competitors in the markets.

20. The report also found that AI models may directly or indirectly engage in practices of self-preferencing, customer discrimination, or tying between services. The more personalized the service and pricing given to each customer and the more significant the information about each customer is for pricing, the greater the possibility to discriminate between customers, tie between services, or self-preference. Therefore, in the financial sector, which is characterized by providing personalized service to each customer based on personal information and by the fact that existing financial institutions hold extensive information about their customers, there is concern that AI models will exploit this and discriminate between customers in a way that could harm competition development in the field. Additionally, AI models may enable large financial institutions to better tie between products – the models will identify customer preferences, their desires and behavior patterns, and create tying between products that will maximize company profits. Some of these practices can sometimes contribute to consumers, but in certain circumstances may also cause harm to competition and the public. Another concern is a situation where financial institutions with information required for developing AI models will restrict or harm access to that information and unreasonably refuse to provide it to their competitors.

21. Finally, the report found that there are concerns about anti-competition coordination in the market. The concern stems from many financial institutions using the same model. The more different financial institutions use the same model for making business decisions, for example investment decisions, credit granting and pricing decisions, etc., the greater the concerns of coordination or alignment between them. The more concentrated the financial market among existing players, the more significant this concern is. It should be noted that this concern may affect both prudent and competition in the sector.

4. Intermediate Report Recommendations

22. First, the report emphasize that competition laws will continue to apply even where anti-competitive practices are carried out through AI models or as a result of operating such models. For example: A restrictive arrangement perfected through AI will constitute a violation of Section 2 of the Israeli Competition Law, where the violators may be both the model users and the model manufacturer. Another example is a case where a monopoly prevents competitors' access to inputs required for developing AI models, such as information. Such a case could constitute a violation of Sections 29 and 29a of the Israeli Competition Law. This is also true in the case of preventing access to models under certain circumstances. Similarly, where a monopoly ties financial services or discriminate between customers, the actions could constitute a violation of Section 29a of the Israeli Competition Law, even if the action was performed through AI models.

23. Second, the report stated that in evaluating mergers, the ICA will consider, among other things, competition concerns about the creation of market power or barriers to competition in the contexts described above, as well as concerns about creating the ability to perform such practices that could harm competition. An example of this is the Authority's opposition in early 2024 to the merger between credit card company Isracard and insurance company Harel that was detailed in ICA submission to the OECD round table on the intersection between competition and data privacy.¹

24. Third, the report proposed that in order to enable conditions for competition development in providing AI services in Israel's financial sector, and against the background of the concerns presented above, financial institutions will be allow to access aggregated and anonymous information from the database held at the Bank of Israel in the credit data repository, as well as use of means and existing infrastructure under open banking to expand the information accessible to different financial players, in a way that will enable those entities to develop AI models through use of that information. As of today, open banking enables customers of banks, credit card companies, and additional entities to share their financial information with third parties. Thus, financial players can access the customer's bank account, with their consent, and offer them banking services adapted to their needs. However, to develop AI models, access to extensive information over time is required, and data about a single customer or data collected according to individual customer consent is insufficient.

25. Fourth, the report proposed not to be satisfied with dealing with entry barriers and switching barriers to providing AI services to Israel's financial sector, problematic mergers, and Competition Law violations, but to prevent, in advance, the development of market power in this field. Market power of an AI service provider can lead both to exercising

¹ Written contribution from Israel submitted for Item 8 of the 143rd OECD Competition Committee meeting on 12-14 June 2024: [https://one.oecd.org/document/DAF/COMP/WD\(2024\)25/en/pdf](https://one.oecd.org/document/DAF/COMP/WD(2024)25/en/pdf)

market power toward financial institutions, to higher chances of alignment or coordination between different players in the market as a result of using the same model, to bargaining power of that entity vis-à-vis financial institutions and regulators, and to stability concerns, among other things as a result of dependence on one significant entity. Various ways can be considered to prevent development of that market power. For example, a regulatory provision can be established whereby one AI service provider will not provide service to players who cumulatively hold above a certain market share in a specific service in Israel. Or for example, the regulation could establish an obligation for financial players in a certain market or with certain characteristics to work with more than one AI service provider. Naturally, each provision has advantages and disadvantages, and it is recommended to examine it according to the product market circumstances and the manner of regulated entities' operations.