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## *Israel*

### **1. Executive Summary**

1. The financial market in Israel is supervised by three main financial regulators (The Banking Supervision Department in the Bank of Israel, The Capital Market, Insurance, and Savings Authority, and the Israel Securities Authority). The allocation of the relevant regulator who supervises each institution depends on the institution legal status and the business that is performed by the institution. In addition to these regulators, the Israel Antitrust Authority (hereinafter “IAA”), among other regulators, supervise certain aspects of the financial sector. While the financial regulators mainly focus on the stability and soundness of the financial sector, the IAA focuses on its competitiveness. These two different points of view often lead to tension between the IAA and the financial regulators that need to be discussed and resolved.
2. The characteristics of the activity in the financial sector influence greatly on the entry and switching barriers, which are considered high. The main entry and switching barriers are: (i) the need to comply with many regulation directives, (ii) economies of scale, (iii) asymmetrical information between different financial providers and between the customer and his current provider and (iv) the need to establish reputation in order to attract new customers.
3. In Israel, the financial sector market structure constitutes another major entry barrier. About 95% of the banking system's assets are controlled by five banking groups; the sole three credit card companies are subsidiaries of the three largest banks; and the two companies which are in charge of clearing payments, credit cards and transactions among the banks are co-owned by the largest banks.
4. In recent years, the IAA has greatly succeeded to reduce the entry and switching barriers derived from regulation and asymmetrical information, and to improve the financial sector market structure.
5. These successes are the direct result of the IAA’s ability to execute its authority while establishing strong relationships with the financial regulators and while inducing them to instill competition considerations among their other considerations.

### **2. Background- The financial sector in Israel and its regulation**

6. Financial intermediaries (banks, insurance companies and the stock exchange) are the backbone of financial activity in the capital market. Due to their characteristics, they are relatively prone to bankruptcy. Moreover, bankruptcy of a single but significant financial institution could have a ripple-effect that might devastate other financial institutions.
7. In order to secure the reliability and stability of the financial sector, regulators were established to supervise the financial intermediaries. Regulators pursue these aims by constructing directives which limit risks, make finance markets more competitive, and protect consumers.
8. In general, there are four main models of financial market supervision:

1. **The institutional approach** in which a firm's legal status determines which regulator is tasked with overseeing its activity from both safety and soundness and business conduct perspectives.
  2. **The functional approach** in which supervisory oversight is determined by the business that is being transacted by the entity, without regard for its legal status. Each type of business, even within the same financial institution, may have its own functional regulator.
  3. **The integrated approach** in which a single universal regulator conducts both safety and soundness oversight and conduct-of-business regulation for all the sectors of financial services business.
  4. **The twin peaks approach** in which there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function and the other that focuses on conduct-of-business regulation.
9. In some countries, the financial supervision is a combination of two or more models. This is the case in Israel. The Israeli supervision model is essentially institutional but also has some functional characteristics.
10. The activities in the financial sector are commonly divided to three main categories: banking, insurance and securities trading. To complement these three activities there are various consulting activities (e.g. financial, investment and mortgage consulting) and non-bank credit activity. All of the activities mentioned above are mostly carried out by the main financial intermediaries and are supervised by the three main Israeli financial regulators:
1. The Banking Supervision Department in the Bank of Israel (the Israeli central bank) is in charge of supervising the stability of the banking corporations, i.e. avoiding excess risks to their stability and protecting depositors' money, ensuring that the banking corporations are managed properly and maintaining fairness in bank-customer relations.
  2. The Capital Market, Insurance, and Savings Authority is an independent authority which supervises the insurance and long-term savings market in Israel and is tasked with setting a suitable insurance policy. Among other duties, the authority grants licenses and monitors the stability of insurance firms, pension funds, and insurance policies.
  3. Israel Securities Authority (hereinafter "ISA") whose function, by law, is protecting the interests of the investor public.
11. These regulators focus mainly on maintaining the stability and soundness of the financial sector and on appropriate disclosure.
12. Additionally, the IAA has the authority to supervise the competition aspect of the financial sector.
13. The most prominent participants in the Israeli financial sector are the banks. Alongside them are institutional bodies, which operate in the area of long-term savings and are mainly dominant in providing credit to large businesses.
14. The Israeli banking system is highly concentrated. It consists of five banking groups which control about 95% of the banking system assets. The remaining assets are held by three small Israeli banks and four foreign ones. Moreover, out of the five major banking groups, two groups dominate roughly 30% of the market, each. This market structure has not changed over the last twenty years.

15. Additionally, the sole three credit card companies are subsidiaries of the three largest banks.

16. The severity of the concentration problem is further emphasized by the fact that Automated Bank Services Ltd. (hereinafter “Shva”) and Automated Clearing House Ltd. (hereinafter “Masav”), which are in charge of clearing payments, credit cards and transactions among the banks are co-owned by the four and the five largest banks, respectively.

17. Due to the high concentration of the financial sector, the IAA has invested considerable time and resources in recent years, in order to reinforce competition in the financial sector, mainly by reducing entry and switching barriers.

### 3. Entry and switching barriers relating to the banking services sector in Israel

18. Most of the entry and switching barriers relating to the finance sector in general and in the banking services sector in particular, are derived from the characteristics of the activity in this sector.

19. First, the financial sector is **highly regulated** due to the need to maintain its stability. The regulation includes many directives regarding the financial institutions' capital ratio requirements, limitations on the ability to provide credit, compliance orders of the systems, etc. Although the Israeli financial sector was relatively unharmed by the financial crisis of 2008, the regulation directives, i.e. the regulation barriers, were increased as a result.

20. In general, the regulation directives in Israel are uniform to all competitors or potential competitors, even if one wants to operate in a limited form. This imposes a heavy burden on such potential competitors and prevents them from entering the market. For instance, the minimum capital requirement amounts to tens of millions Israeli shekel for every institution who wishes to supply credit, with no regard to the amount of credit it provides.

21. Second, the banking services sector is characterized by strong **economies of scale**. This is reflected by the substantial resources that one needs to invest in order to develop the designated and complex systems and the need for wide spread of branches, in order to reach a wide number of costumers. Also, economies of scale correlate with the need for risk diversification.

22. Third, **the information in the banking services sector is asymmetrical**. This barrier is reflected in two main ways. One, the fact that the current service provider holds all the information on each of its customers and can tailor-make an offer to fit a customer's needs while the potential competitor has no knowledge regarding the customer, and therefore cannot reach out to that customer with a persuasive offer. Second, the information between the customer and his current service provider is also asymmetrical. The rates of the financial services are mostly bundled, and therefore it is difficult, or even impossible, for the customer to compare between different providers.

23. Finally, in the financial sector, the customers are generally drawn to institutions with well-known **reputations**. Since this reputation is built over years, it is another barrier for potential new entrants.

24. In addition to these conventional barriers that characterize the financial sector in most countries, in Israel there is another significant barrier that arises from the market structure. As mentioned above, the central banking clearing systems are owned by Shva and Masav, which are owned by the large banking groups that also own the only three credit card companies. This structure enables the current entities in the market to create difficulties and even block potential competitors.

25. As will be detailed below, the IAA's recent activities contribute to the reduction of the entry and switching barriers derived from regulation and asymmetrical information, and to the improvement of the financial sector market structure.

#### 4. IAA's co-operation with agencies and regulators in the banking services sector

26. The IAA's involvement in the banking services sector is reflected in two main ways: (i) advocacy, which includes participation in governmental committees, performing governmental consultations and initiating market studies, and (ii) core antitrust activities, i.e. examining the competitive impacts of mergers and restrictive arrangements.

27. In recent years, the IAA was involved in several competitive activities in the financial sector, in which it co-operated with the financial regulators. As mentioned above, the financial regulators in Israel, as in other countries, are mainly focused on the stability and soundness of the financial sector and are less focused on the competitiveness level of it. Hence, it is a challenge to persuade them to include competition considerations among their other considerations. However, as will be elaborated below, the IAA experienced major success in this area in recent years.

### 5. Advocacy

#### 5.1. Participation in governmental committees

28. One of the foremost governmental committees of the recent years that dealt with the financial services sector was the Committee for Increasing Competition in Banking and Financial Services in Israel (hereinafter "Strum Committee"), which examined potential ways of increasing competition in the banking and financial sector.

29. The Committee was assembled from representatives of the IAA, Bank of Israel, the Ministry of Finance and the academia.

30. The IAA urged the following main recommendations, believing they will significantly improve market structure, lower the entry barriers for new entities and strengthen the bargaining power of customers.

31. In respect of market structure, Strum Committee recommended on separating the control of the credit card companies from the large banks and changing the ownership structure of Shva.

32. Regarding the regulation barrier, the Committee recommended on adding a series of regulatory directives aiming to ease the entry of new banks and other new financial institutions and also recommended on formulating conditions for access to the payment systems, taking into consideration the scope and the type of activity of the entity who wishes to connect to these systems. In addition, the Committee recommended on

establishing regulation on all payment services entities based on international regulation, with emphasis on European regulation in accordance with the PSD principles. The purpose of this regulation is to set uniform requirements for these entities, to encourage competition in the field of payment services in Israel and to allow the entry of new competitors into the market.

33. As to the asymmetrical information barrier, the Committee recommended that banks will be obligated to update their financial services rates on a regular basis, in a central website. This will enable customers to compare between financial services. Moreover, the banks will be obligated to allow an API linkage by an authorized entity (who will be subject to the regulation) to the accounts of every customer who has given its consent, and will not limit the ability of any such authorized entity to make such a connection in order to "shop" on behalf of the customer.

34. Following its recommendations, the Law for Increasing Competition and Reducing Concentration in the Israeli Banking Market was enacted.

## 5.2. Governmental consultation

35. In August 2016, the IAA received a request from a member of Knesset<sup>1</sup> to examine the mortgages sector. The Knesset member claimed that since June 2015, the interest rates on mortgages have simultaneously risen in all the banks, without a change in the prime interest rate or any other apparent reason. Hence, according to the request, this increase is a cause for concern for possible coordination between banks in the mortgage segment.

36. Following the request, the IAA opened an examination of the mortgages sector, which included meetings with representatives of the Bank of Israel and representatives of mortgage advisors, as well as examining numerous documents relating to the activity of the banks in the field of housing mortgages.

37. The conclusion that emerged from the IAA's examination was that the increase in the interest rates recently offered to the public by mortgage borrowers is closely linked and followed the intensified regulatory requirements of the Banking Supervision Department in this area and it is not a result of co-ordination between the banks.

38. However, the IAA found an additional finding concerning the banks' conduct with regard to the mortgage advisors, as will be detailed below.

39. The work of external mortgage advisors contributes greatly to competition between the banks in this field. The assistance of mortgage advisors makes it easier for borrowers, especially those with no knowledge in this area, to compare between the proposals of the various banks, which can lead to improve the terms of the offered mortgages. The banks' internal documents received by the IAA showed that even the banks themselves recognize this effect of the mortgage advisors.

40. The results of the IAA assessment demonstrate that, in the last two years, and especially since the second half of 2016, few banks have been taking steps to reduce their work with external mortgage consultants, while understanding that other banks operate in a similar manner. Their desire to reduce the percentage of loans granted as part of a process carried out by an external mortgage advisor is due to the lower profitability of

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<sup>1</sup> The Israeli parliament.

such loans. The banks adopted a variety of practices that hinder the work of mortgage advisors and concern both the identity of the consultants with whom the banks work and the process of working with the authorized consultants. Due to the fact that mortgage advisors promote competition in the mortgage market, the IAA believed that the conduct of the banks against them is liable to harm competition between the banks in this area.

41. The main findings of the IAA's assessment were presented to the Banking Supervision Department, and the recommendations were reflected in a draft directive issued by the Banking Supervision Department on June 12, 2017, regarding mortgage advisors. According to the draft directive, banking corporations will be required to establish a policy regarding the interaction with customers' representatives and the work processes with them. The policy will be submitted to the Banking Supervision Department examination to ensure that the customer could be properly represented. In addition, the draft set a general principle which determines that banking corporations would not refuse to act with customers' representatives at any stage during the process of supplying mortgages, except when the representative is not complying with the aforementioned policy.

42. It is worth mentioning that the banks and the Banking Supervision argued that the reduction in the work with external mortgage consultants was done in order to ensure the reliability of the advisors and to ensure that customers will receive high level advisement. This purpose was recognized by the IAA to some extent as a legitimate cause for imposing limitations on the external mortgage consultants. The two conflicting purposes were discussed lengthily between the Banking Supervision and the IAA until agreement was reached on the principles that will strengthen the presence of mortgage advisors in the banks while, on the other hand, ensuring the reliability of these advisors. Meaning, the directive manage to promote competition without undermining the soundness of the activity.

43. The draft was fully implemented on October 31, 2017.

### **5.3. Initiated market studies**

44. Recently, the IAA, cooperating with the ISA, conducted a study examining the competition between various entities which enable retail customers to trade securities and other financial instruments such as shares, bonds, exchange traded funds and mutual funds. Since the Israeli capital market is experiencing a period of regulatory and structural changes and since technological development presents new products and services, the IAA has decided that this is the right timing to promote recommendations so that the new capital market being formulated these days will be more open and competitive.

45. Currently, the vast majority of retail customers (97%) that have securities trading accounts manage their accounts through a bank, while the rest of the retail customers conduct trading through a non-bank stock exchange member (hereinafter: "NBSM"). According to the IAA research, the fees charged for securities trading and management by banks to retail customers are, on average, much higher than those charged by the NBSM. The fee differences can be as high as three-fold, and this can translate into a difference of thousands of shekels a year for many customers. Despite the significant price differences, there has been no increase in the NBSM market share in recent years.

46. The IAA, together with the ISA, are currently formulating a series of recommendations aimed at removing barriers in the brokerage market and encouraging competition. These recommendations are formulated after mapping and analyzing trading

services in the Israeli capital market, based on data collection and after consultation with the various market players. The recommendations are formulated in a way that will pursue the ISA aim to protect the interests of the investor public while inducing competition. For instance, because of different regulation imposed on banks and NBSM, banks are considered more stable than NBSM and therefore, attract more customers. One recommendation is to establish protection schemes for NBSM that will strengthen their stability in comparison with the banks in the eyes of the customers and hence, will strengthen their competitive ability.

## 6. Core antitrust activities

### 6.1. Restrictive arrangements

47. As mentioned above, Automated Bank Services Ltd. (or Shva) is a private company owned by four of the largest banks in Israel. Shva is a joint clearing services company that operates in accordance with the license and permits granted by the Bank of Israel. In addition, since Shva is a co-operation between competitors, it is considered a restrictive arrangement that does not fall under any block exemption. Therefore Shva is obliged to obtain an exemption from the IAA for its activity.<sup>2</sup> Shva provides services to various financial institutions, including banks, monetary institutions, and credit card companies. Shva operates systems which enable collection of transactions in credit cards from terminals in merchants; transfer of approvals to credit card transactions; clearing between acquirers and issuers of credit cards; and the transfer of approvals for cash withdrawal operations.

48. Shva shareholders, the banks, are engaged in activity in the area of credit cards by holding the sole three credit card companies operating in Israel. The first IAA restrictive arrangement exemption decision was issued on June 18, 2002 and was subject to a number of behavioral directives. Since then, a number of additional exemption decisions have been issued, the last of which was issued on September 24, 2017.

49. The execution of transactions in credit cards is carried out by an agreement system between four parties: an issuer, an acquirer, a merchant and a consumer. The issuer issues a credit card to the consumer; the consumer uses the card as a means of payment; and the merchant provides the consumer with goods or services. The merchant transfers the details of the transaction to the acquirer and the acquirer, who is bound by the agreement with the issuer, undertakes to transfer the money in respect of the transaction to the merchant on the date agreed upon according to the type of credit card. At the same time, the issuer undertakes to transfer the consideration for the transaction to the acquirer. The consideration is collected from the consumer at a mutually-agreed time.

50. In Israel, there are only three companies which are credit card issuers and they all act also as acquirers. As mentioned above, the three credit card companies are all held by banks. On April 4, 2017, the Bank of Israel granted an acquirer license to an additional

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<sup>2</sup> According the Israeli law, no person shall be party to a restrictive arrangement, unless he has obtained court approval or an exemption pursuant to the law. Parties may file a motion with the IAA for exemption from the duty to receive court approval for the restrictive arrangement. The IAA will examine whether the restrictions in the arrangement substantially limit the competition in a significant portion of the market, whether the main point of the restrictive arrangement is to limit competition and whether it contains restrictions which are not necessary to achieving its main goal. The IAA may stipulate conditions for the exemption.

company. The three credit-card companies are linked by cross-acquiring agreements regarding the cards issued by them, which enable each of them to clear the credit cards issued by the other companies. Shva has a significant role in performing cross-acquiring between the acquirers and the issuers.

51. Shva operates as a switch that enables the transfer of requests for the approval of transactions in credit cards, and constitutes a central clearing interface for transactions executed with credit cards, which enables the settling of accounts and the transfer of information between the acquirers and issuers. Money transfers between the acquirers and issuers are carried out through the money transfer system operated by Automated Clearing House Ltd. (or Masav), another company co-owned by the banks.

52. In addition, Shva acts as a processor for credit card transactions, provides the acquirers with terminal management services in the merchants, and performs additional technical activities for the acquirers and issuers.

53. Also, Shva tests the merchants' terminal software to verify their compatibility with the protocol and the connection to the system and is a manufacturer of such software.

54. Communication between these parties is done through the communication protocol, which allows all parties to communicate in the same language.

55. In the past, Shva developed a communication protocol that was updated over the years in order to adapt to the needs of the developing market. The protocol that was formulated over the years was complex and unique and was tailored to the standards of the existing credit card companies. This situation led to a technological difficulty in connecting a new issuer or acquirer to the systems. Moreover, lack of information regarding the characteristics of the technological interface created difficulties for entities seeking to compete with existing players in the credit card industry.

56. As part of the last exemption, Shva was required to develop a new protocol, which will be adapted to international standards, and will increase the security of transactions in a credit card and enable the entry of additional companies.

57. The Shva ownership structure was deliberated by the Strum Committee. Following the recommendations of the Committee, the banks were directed to sell part of their shares in Shva so that no shareholder will hold more than 10% of its shares. The purpose of this action was to achieve a more decentralized ownership of the corporation.

58. However, even after the acquisition of shares by other entities, Shva is expected to continue to be a restrictive agreement between competitors.

59. The main concern arising from the activity of Shva is that it will prevent entrance or raise the entry barriers that new competitors in the credit card industry are facing, in each of the segments in which Shva and Shva shareholders operates.

60. During the discussions with The Bank of Israel, the Bank raised its concerns that as a result of Strum Committee recommendations, the financial sector would undergo many changes and if the IAA will impose structural directives on Shva at this time, it could undermine the stability of the sector. Hence, the Bank of Israel asked the IAA to extend the last exemption for a few years.

61. The IAA, on the other hand, believed that because of the expected changes in the financial sector, the two regulators should seize the opportunity and with their combine authorities take action that will further encourage competition in the market. In the IAA's

opinion, carrying out an action now rather than postponing it for a number of years will actually lead to greater certainty in the market.

62. In light of the aforesaid, the IAA has succeeded to persuade the Bank of Israel to support an outline to extract the communication protocol from Shva. According to the outline, the communication protocol is to be transferred to a nonprofit association, comprised by all the entities operating in the payment card market, including new incumbents. This non-profit association will be supervised as a controlled payment system by the Bank of Israel Payment Systems Department.

63. To the IAA beliefs, transfer of the communication protocol to the ownership and management of all its users will facilitate the activities of entities seeking to compete with Shva or its shareholders as well as the entry of new players into the payment card market.

## 7. Conclusion

64. In light of the entry and switching barriers and in view of its concentrated market structure, the Israeli financial sector has been at the center of governmental activity in recent years. While the financial regulators mainly focus on the stability and soundness of the financial sector, the IAA focuses on its competitiveness. These two different points of view often lead to tension between the IAA and the financial regulators that need to be discussed and resolved.

65. During its recent activities, the IAA have greatly succeeded to reduce the entry and switching barriers derived from regulation and asymmetrical information, and to improve the financial sector market structure.

66. These successes are the direct result of the IAA's ability to execute its authority while establishing strong relationships with the financial regulators and while inducing them to instill competition considerations among their other considerations.