

Chapter 4

The Institutional and Market Infrastructure

1. INTRODUCTION

A major component of financial stability is the resilience of the financial system, that is to say, the ability of the financial markets and institutions to continue functioning in a proper manner in the wake of threats to and shocks in the operating environment of the financial system or from those arising within the system. One of the crucial factors affecting the resilience of the financial system is the quality of the institutional and market infrastructure.

The term institutional and market infrastructure refers to all the conditions and structural factors impinging on the activity of the financial system and affecting its functioning and efficiency. Included in this broad definition of the term institutional and market infrastructure are the following: the structure of the financial institutions, including the reciprocal relations between them, relations whose intensity affects the intensity of system risks, i.e., the possibility that a number of financial institutions, of one or more types, will be simultaneously affected because of a joint external shock, or because of the spillover of problems from one institution to others (“contagion”); the arrangements connected to the payment and settlement¹ system, which could expose its users to systemic risks that are liable to spill over into countries and between countries; the regulation of financial activity (legislation, rules, regulations and by-laws) and supervisory mechanisms dealing with the financial system; the structure of incentives for all the players in the system (including taxation and guarantees); the rules of proper disclosure and the accounting rules that influence the transparency of the activity and the financial risks.

¹ Sometimes the term “institutional and market infrastructure” refers only to the payment and settlement system. The payment and settlement system in Israel includes the bank clearing house, the interbank clearing center, The Tel Aviv Stock Exchange, credit card companies, and various systems in the Bank of Israel, such as that for trading in liquidity, and that for trading NIS against the dollar.

This broad definition of the institutional and market infrastructure is highly compatible with the definition anchored in the 12 Key Standards for Sound Financial Systems adopted by the Financial Stability Forum as desirable principles and conditions for promoting financial stability (Box 4.2). The promotion of reforms and improvements in the institutional and market infrastructure is one of the major channels through which the authorities influence the resilience of the financial system.

This chapter analyzes the salient developments in the institutional and market infrastructure this year, developments that are likely to have significant implications for the resilience of the financial system. Section 2 focuses on the structure of the system of financial institutions, and Section 3 on reforms and changes in the regulation of the financial system as a whole as well as its components: the financial institutions, the financial markets, and the payments and settlement system. Section 4 deals with the implications of the major reforms on financial stability. As in other parts of the report, the emphasis in this chapter is on changes in the infrastructure, and not on an assessment of its level and on the array of factors determining this level.

2. THE STRUCTURE OF THE SYSTEM OF FINANCIAL INSTITUTIONS

- Toward the end of 2004 three insurance companies acquired control over three of the new large pension funds, which together dominate about 75 percent of the assets of the new funds. These acquisitions are likely to create far-reaching change in the control structure of long-term saving, change whose intensity will increase as the overall weight of the veteran funds, which are closed to new members, decreases.
- During 2004 the termination of independent activity of small banking corporations intensified, and today only one corporation of this kind remains. This development has contributed to consolidating the stability of the financial system, without adversely affecting competition within it.
- At the end of 2004, Bank Tefahot, the leading mortgage bank, merged into United Mizrahi Bank. This was preceded in 2003 by the merging of Bank Mishkan into Bank Hapoalim. In both cases, the resilience of the banking groups is expected to grow due to increased capital adequacy resulting from improved profitability, and due to increased efficiency of risk management—processes that contribute to consolidating financial stability.
- At the beginning of 2005 the Israel Discount Bank was privatized after more than two decades of government control, while the process of privatizing Bank Leumi was accelerated. The privatization of large banks in Israel presents a challenge to the Banking Supervision Department, in that it is bound up with the creation of new risks, resulting from the transactions of those banks with related parties.

a. Acquisition of the new large pension funds by the insurance companies

Toward the end of 2004 a fundamental change occurred in the ownership structure of the new and the general pension funds: three large new pension funds that for many years—until their nationalization and the appointment of directors on behalf of the government in 2003—were all controlled by the Histadrut, were sold to insurance companies. Three insurance companies acquired the three largest funds, which control 75 percent of the assets of the new funds: Menorah acquired Mivtahim Yoter (which at the end of 2003, held 51 percent of the assets of the new funds), Migdal acquired New Makefet (15.2 percent), and Clal Insurance acquired Meitavit (8.7 percent).

The immediate impact of the change in ownership of the new funds on the pension sector is relatively small, because of the limited size of their assets in relation to the total assets of the different pension funds—about 17 billion versus about 147 billion, respectively. However, the greater the growth in the proportion of the new (and the general) funds in the sector at the expense of the veteran pension funds, which are closed to new members and still constitute about three-quarters of the market, the greater will be the impact of the changes in the ownership structure on the pension sector. These ownership changes have already brought about a significant change in the

Table 4.1
Estimate^a of the Distribution of the Insurance Groups' Control of Long-Term^b
Savings Owned by the Insurance Groups Before and After the Purchase of the
Pension Funds in 2004

| | Migdal | Clal | Phenix | Harel | Menorah | Other | Total insurance | Total Long-Term Savings |
|--|------------------------|------|--------|-------|---------|-------|-----------------|-------------------------|
| | NIS billion | | | | | | | |
| Total long-term savings before purchase of the pension funds | 17.9 | 14.1 | 8.9 | 8.3 | 6.8 | 8.8 | 64.7 | 280.2 |
| Total long-term savings after purchase of the pension funds | 21.4 | 16 | 8.9 | 8.3 | 18.5 | 8.8 | 81.9 | 280.2 |
| | Distribution (percent) | | | | | | | |
| Total long-term savings before purchase of the pension funds | 27.7 | 21.8 | 13.8 | 12.8 | 10.5 | 13.6 | 100 | |
| Total long-term savings after purchase of the pension funds | 26.1 | 19.5 | 10.9 | 10.1 | 22.6 | 10.7 | 100 | |

^a Based on the distribution of insurance companies' assets at the end of 2003.

^b Long-term savings, as defined by the Bachar Committee, includes profit-sharing life insurance, the new general pension funds, provident funds and advanced study funds.

SOURCE: Based on data from the website of the Commissioner of the Capital Market, Insurance and Savings.

structure of control of the insurance companies in the long-term-saving market. The most salient development is the decrease in the level of concentration—a transition from a market in which two large companies are operating (and which constitute about half of the market; Table 4.1) to one of three large companies (about two-thirds). This has led to fundamental changes in the relative size of the leading companies in the market. Migdal is still the leading company in the area of long-term-saving, with a 26 percent market share among all the insurance companies (about 28 percent prior to the acquisition). As opposed to this, Menorah, which until the acquisition of Mivtachim was the fifth largest body in the insurance sector (11 percent), became the second largest, with a market share of about 23 percent, while Clal, which lost 2 percentage points of its market share as a result of the change (to about 20 percent), became only the third largest. This change is a consequence of Ministry of Finance policy not to permit the acquisition of large pension funds by large insurance companies. The effect of the changes in the ownership of the new pension funds on financial stability will be discussed in Section 4 below.

b. Termination of the independent activity of very small banking corporations

During 2004 and the beginning of 2005, the independent activity of a number of very small banking corporations that are not controlled by banking parent companies, was terminated. This is a continuation of a trend that has emerged in recent years, especially since the exposure of the large embezzlement of funds at the Trade Bank in April 2002. Since then, six small banking corporations have been shut down or merged with large banks (or are in the process of being shut down), and the total ownership of two additional small banks has been acquired by large banks² (Appendix 4.1). Of these corporations, only one very small independent financial institution has remained (Hesech).

This structural change, the essential nature of which became clear in the wake of the collapse of the Trade Bank, is a result of a number of simultaneously operating factors: (1) A more active, directed policy of the Banking Supervision Department in recent years to encourage very small, independent banking corporations to merge with large banks or to leave the sector; (2) Increasing awareness on the part of the controlling shareholders of the independent small banking corporations of the feasibility of these moves, in light of the expected fall in profitability of the corporations under their ownership, the increased risks, and the difficulty of managing them according to current supervisory requirements and those expected in the coming years (see below); (3) Favorable environmental conditions, especially in the past two years, which have facilitated orderly and planned mergers and closures, in close coordination with the authorities, without creating shocks in the financial system.

² It was also decided to gradually close and revoke the license of one “middle-sized” bank – the “Industrial Development Bank.” Furthermore, the licenses of two financial institutions owned by the large banks have been revoked: “Leumi Finance Company,” and “Bank Leumi for Industrial Development.”

The large banking institutions enjoy clearly structured economies of scale and diversity, expressed, among others, in a relatively good distribution of risks in the financial mediation process and relatively low operational costs, which enable them to activate expensive risk management mechanisms and the control over these mechanisms, without losing their relative cost advantage. These advantages, which are also expressed in their capital adequacy, contribute to strengthening their financial resilience.³

These relative advantages have increased in recent years, and are expected to continue and to stabilize in view of the long-term trend of declining financial margins, alongside the expected growth of the costs and the intensification of the risk involved in banking activity. This is a result of the accelerated development of sophisticated, complex, and expensive financial instruments against the background of the constant improvements in technology on the one hand, and on the other, because of the need for new and expensive tools for managing the control over those risks, among others, in view of the more stringent supervisory requirements for these tools, for example the expected implementation of the regulations of Basel II.

The closure of the small banking corporations, or the merger of small banks, especially the independents, into the large banks, acts therefore to increase the resilience of the banking system, and with it, the stability of the financial system as a whole. It achieves this stability by enabling those corporations to benefit from professional tools and knowledge, infrastructure services, computerization, and the control mechanisms that exist in the large banks, and thus to reduce the risk of their falling and the systemic risk embodied in these falls—the danger of contagion. In addition, the supervisory authorities can divert resources that have been freed as a result of the mergers and the closures to other supervisory needs. These processes, however, will not fundamentally influence the concentration and the competition in the branch, in light of the insignificant size of those corporations in relation to the other banks in the system. The trade-off between competition and financial stability does not exist in these circumstances, and financial stability thus increases without adversely affecting competition (see Box 4.1).

c. Merging mortgage banks within the banking parent companies

A different type of merger was that in which mortgage banks were merged within the banking parent companies. At the end of 2004, Bank Tefahot was merged into United Mizrahi Bank. This merger was preceded at the end of 2003 by the merger of Bank Mishkan into Bank Hapoalim. Here we are not talking about small and independent banking corporations, but rather large banks, the leaders in their field, which are controlled by commercial banks. The two mortgage-bank mergers into

³ For an extensive discussion on operational economies of scale, see the Annual Survey of Israel's Banking System, 2003, by the Supervisor of Banks.

Table 4.2
Mergers of Mortgage Banks with their Parent Banking Corporations - Basic Data
prior to the Mergers, end-2003

| | Total assets | Equity | (NIS billion, on a consolidated basis) | |
|----------|--------------|--------|--|---------|
| | | | Share of total banking system ^a | |
| | | | Assets | Capital |
| | | | (percent) | |
| Hapoalim | 258.9 | 14.3 | 31.1 | 32.4 |
| Mishkan | 26.9 | 1.4 | 24.3 | 21.2 |
| Mizrahi | 78.9 | 3.9 | 9.5 | 8.8 |
| Tefahot | 32.2 | 2.0 | 29.2 | 30.9 |

^a For Hapoalim and Mizrahi, total banks and their subsidiaries. For Mishkan and Tefahot, total mortgage banks and their subsidiaries.

SOURCE: Banking Supervision Department .

parent companies are essentially different in view of the different sizes of the banking parent companies in relation to the banks merged within them. Thus, on the eve of the merger of Mishkan into Bank Hapoalim, the assets of Bank Hapoalim were ten times greater than those of Bank Mishkan, while the assets of United Mizrahi Bank were only two-and-a-half times greater than Bank Tefahot (see Table 4.2). Despite the difference between the two mergers, certain similarities exist between them with regard to financial stability: in both cases, the resilience of the banking groups is expected to grow by increasing the capital adequacy as a result of the increased productivity, parallel to increased efficiency in the management of risks, both of which contribute to consolidating financial stability.

The operating environment of the mortgage banks has become more dangerous in recent years owing to a number of factors, chiefly the continuing slump in the real estate sector; the trend of declining credit earmarked for new homeowners, and a decline in the commissions charged on the credit provided; and uncertainty about income from insurance payments, against the background of increased competition with the insurance companies. Also, the continuous shortage of long-term linked sources, together with the relatively slow penetration of the mortgage banks into the unlinked mediation sectors, have negatively affected their potential profitability.

Until now, the mortgage banks have coped successfully with the changes in demand, among others, thanks to handsome current income on the basis of past performance as well as streamlining procedures. Thus the average annual return on equity in mortgage banks between 1997 and 2003 reached 10.5 percent, as opposed to 8.8 percent in the five large banking groups. However, the continuation of these trends would have been liable to harm the performance of the mortgage banks, and thus their resilience. Their merger within the banking parent companies has helped to curb these negative trends by reducing expenditures as a result of integrating the computer systems and the amalgamating the head-office staffs in the two banks, and by joint management of the sources, the uses and the financial risks. Furthermore, the direct reflection of the

negative trends in the business environment of the mortgage banks in the performance of the mortgage banks, had they continued to operate as separate bodies within the banking groups, was liable to damage the public's confidence in the groups. The merger of these banks within parent companies prevented the realization of this risk.

An additional improvement in the resilience of the groups will be achieved if the ambition of the parent companies is realized of increasing the profitability of the banking groups by increasing the volume of their income through leveraging the mortgage customers into expanding the activity of the parent bank in the retail banking sector, which is considered relatively profitable.⁴

d. Privatization of the banks

The most salient development in the area of holdings and ownership connections in the financial sector is the sale of the controlling core (26 percent) of Bank Discount to the Bronfman-Schron consortium at the beginning of 2005.

The sale of the Bank Discount group ended more than two decades in which the control of the third largest bank in the system was in government hands. In exchange for 26 percent of the banks' shares in the first stage, the acquiring group undertook to pay NIS 1.3 billion, 250 million of which would be paid in the future. Furthermore, the consortium was given the option to purchase a further 25 percent of the bank's shares in the future.

With the sale of Bank Discount, Bank Leumi remained the only bank under government control.⁵ At the end of February 2005, the state, which until that time held about 34.8 percent of the shares of Bank Leumi, sold 6.5 percent of its shares to Deutsche Bank, which then distributed them among investors. 28.3 percent of Bank Leumi shares, a controlling interest, are still held by the state, and one of the possibilities currently under discussion is that the state will sell its shares to the public through the Tel Aviv Stock Exchange during 2005.

International experience shows that one of the major ways in which privatization influences the privatized bank's resilience, is the extent of the government's involvement in the bank's activities, and how this involvement is expressed. Thus, the privatization of a bank whose activities the government was largely involved in, and in a way that undermined its resilience, could contribute toward consolidating its financial stability. This would mainly be a consequence of setting up a professional board of directors and management motivated by business considerations, and serving, when necessary, as a clear address for the supervisory authorities for taking steps to consolidate the stability of the bank. On the other hand, the privatization of a large bank

⁴ The assimilation of a mortgage bank in a group could, however, cause harm to the reputation the group enjoyed prior to the merger because of its distinctive activity prior to the merger, harm that depends, *inter alia*, on the relative weight of the bank within the group.

⁵ The "Industrial Development Bank," the "Israel Bank of Agriculture" and the veteran pension funds have also remained in government ownership.

points to increasing the risk of related parties, a risk that flows from transactions that the privatized banking corporation enters into with parties connected to it, especially in the area of credit. In the wake of privatization, the fear arises that private entities with wide business interests outside the bank, will exploit the special contacts they have with the bank in order to obtain credit devoid of business considerations, and under less stringent conditions than are acceptable for similar transactions for people without connections.

In reality, the government did not play a dominant role in managing the banks that were nationalized two decades ago, and they generally functioned as if they were under private ownership. This reality was supported by the Bank Shares Arrangement Law, which prevented the government from interfering in the management of the banks. In any event, the privatization of the banks increases their flexibility in raising capital, which in turn contributes to their resilience. However, the major risk embodied in the privatization—the risk of related parties—is particularly relevant in the Israeli economy in which business and financial activity is concentrated in the hands of a limited number of groups or families. The privatization of the large banks thus constitutes a real challenge to the bank supervision apparatus, despite the limitations and the regulations that regulate the transactions of related parties.

The plan to sell Bank Leumi through the TASE, and not to a controlling core defined in advance, as has been the case until now, presents the supervisory authorities with new challenges of ensuring that mechanisms exist for enabling control over the way the privatized bank is managed, in the absence of owners who would constitute an address for control requirements. Until now, the Banking Supervision Department has used a series of tools to ensure the stability of the bank after its privatization, including the creation of a defined and identified controlling core whose components have passed stringent tests of financial robustness and integrity as a condition for obtaining the control permit. If a controlling core is not ultimately created in Bank Leumi after its privatization, this might necessitate the adaptation of the supervisory tools that have been used until now to ensure the stability of the banking corporations that have changed owners.

Box 4.1

The Interrelationship Between Competition and Financial Stability

The intensification of competition among financial institutions, for example by reducing concentration,¹ is considered one of the important ways of

¹ The prevalent outlook is that if concentration is increased, competition is reduced. There are those, however, who claim that concentration contributes to increasing competition. See, for example, E. Schargrodsky and F. Sturzenegger (1998), "Regulation, Concentration and Competition in Financial Intermediation." Business School, Universidad Torcuato Di Tella.

ensuring an efficient allocation of resources in the economy over time, which contributes directly to growth.

Up to ten years ago, the accepted assumption was that intensifying competition among financial institutions would undermine financial stability, an assumption based, among others, on empirical findings. The newer theoretical literature, however, especially from the mid-1990s onward, as well as the empirical research, shows that the interrelationship between competition and financial stability is circumstance-dependent, and thus far more complex than a simple trade-off. Researchers are unanimous that they have only touched the tip of the iceberg, and that considerable research on this subject is still required before it is possible to make unequivocal statements on the nature of the relationship.

The prevalent view in traditional articles is that there is indeed a trade-off between competition and stability. These articles, which are generally based on the monopolistic profits approach (charter value), claim that the banks' market power leads to a reduction in the risk they take, because the excess profits they can accumulate at a given risk level are higher than under competitive conditions. Under these conditions, intensifying competition creates an incentive to increase the risk.

One of the most important and quoted articles presenting the monopolistic profits approach is that of Keeley (1990).² Keeley presents a theoretical framework and empirical evidence to back his claims that the deregulation in the US banking system in the 1970s and 1980s intensified competition and weakened financial stability by reducing monopolistic profits. Owners of banks or managers working on their behalf had a clear interest in assuming additional risks in order to improve yields, which they did by offering assured funds as part of insuring the deposits. A similar claim is raised in this context by Mishkin and Edwards³ (1995), who feel that the taking of excess risk that was observed during the 1980s among US banks was a reaction to the erosion of their profits in light of the competition from the financial markets with regard to both credit and deposits. The excess risk the banks assumed did in fact lead to a dramatic increase in the collapse of banks in the US against the background of increasing competition during the 1980s.

As opposed to the above, more modern literature on banking offers different scenarios, according to which stronger competition does not

² Keeley, M. (1990), "Deposit Insurance, Risk and Market Power in Banking." *American Economic Review*, 80, 1183-1200.

³ Edwards, F and Mishkin, F. (1995), "The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy." *Federal Reserve Bank of New York, Economic Policy Review*, 1, 27-45.

necessarily undermine stability. Furthermore, even in cases where a negative connection exists between competition and stability, it is possible to take policy measures, such as instituting risk-adjusted insurance premiums on deposits that will weaken the trade-off between competition and the stability of the banking system, while still enabling enjoyment of the other advantages of competition.

Nagarajan and Sealey⁴ (1995), for example, show that the impact of competition on stability is dependent on the way in which the monopolistic profits are determined, and especially the way in which supervisory policy influences these profits. When margins are high, an expression of a decline in competitiveness, they are a **result** of supervisory policy that increases the incentive to take risks, which then adversely affects financial stability. Thus increasing competition does not necessarily adversely affect financial stability.

In general-equilibrium models, efficiency implies perfect competition and financial stability. In other models, intensifying competition improves financial stability. In general, finding the correct balance between competition and financial stability necessitates defining an analytical framework in which cost and benefit can be identified in welfare terms of levels of competition and stability. From the perspective of welfare economics, the relevant question is what are the efficiency levels of competition and financial stability. The overall conclusion emerging from different models in the economic literature is that the answer depends on the model. This is not a surprising conclusion, for in a second best world concentration is likely to be preferable to perfect competition, and absolute stability is likely to be socially undesirable (Allen and Gale, 2003).⁵

Boyd and De Nicolo (2005)⁶ show that the intensification of competition between banks reduces the interest rates on loans to entrepreneurs, raises the profitability of the ventures, and thus weakens the incentive to take risks. In this case the increased competition raises financial stability by reinforcing the financial robustness of the business sector.

A clear indication of the lack of trade-off under certain conditions between financial stability and competition can be gleaned from the Israeli experience in recent years in the context of the disappearance of small, independent banks from the banking system. This process, which gathered momentum since the collapse of the Trade Bank in April 2002, has been

⁴ Nagarajan, S. and Sealey, C.W. (1995), "Forbearance, Deposit Insurance Pricing and Incentive Compatible Bank Regulation." *Journal of Banking and Finance*, 19, 1109-30.

⁵ Allen, F. and Gale, D. (2003), "Competition and Financial Stability." Wharton Center Working Paper, No. 3, 26.

⁶ Boyd, J and De Nicolo, G. (2002), "Bank Risk-Taking and Competition Revisited," Working Paper, Carlson School of Management, University of Minnesota.

handled in a controlled manner without causing shocks to the financial system, and has contributed to consolidating stability without harming competitiveness. (See the detailed discussion in Section 2 above.)

The difficulty of identifying the trade-off in practice between increasing competition and changes in stability presents a challenge to the authorities entrusted with maintaining stability in the financial system but who also greatly influence the level of competition within it, to determine an appropriate policy mix, especially at a time that reforms are being instituted whose aim is to intensify competition in the system. The authorities tend to place the prevention of financial crises at the top of their list of priorities, given the substantial and tangible costs of financial instability, and the difficulty of estimating the costs of the lack of competition and of inefficiency. This implies that the authorities tend to prefer stability to competition, even if the trade-off in practice is unclear. Despite this, it would appear that a judicious course of action could achieve both goals simultaneously.

3. REFORMS AND REGULATORY CHANGES IN 2004⁶

- At the end of 2004 the committee dealing with reforming the capital market (Bachar Committee) published its recommendations. The reform was approved by the government at the beginning of 2005, and legislative memoranda have already been circulated for its implementation. The reform aims to reduce the concentration in the capital market, the major recommendation being to separate the provident funds and the mutual funds from the banks.
- In 2004 the Ministry of Finance and the Israel Securities Authority continued to initiate legislation and regulation with the aim of removing barriers and encouraging the development of the nonbank credit market. Among the steps taken: removing the barriers to the issue of asset-backed bonds, and the passing of a law concerning the prospectus for the issue of commercial papers or non-convertible bonds; a change in the method of revaluating non-tradable assets of institutional investors; the publication of rules for approving rating companies and strengthening the infrastructure for establishing real-estate funds.
- In November 2004, a law was passed to ensure the stability of the TASE Clearing House and the Maof Clearing House by strengthening their legal status and by eliminating some of the vagueness that existed in certain situations.

⁶ A list of changes introduced by the various supervisory authorities during 2004 is presented in the appendix.

a. Reforms and regulatory changes in the overall financial system

(i) The major recommendations of the committee dealing with reforming the capital market (Bachar Committee)⁷

In September 2004, the committee dealing with reforming the capital market (Bachar Committee) presented its report to the Minister of Finance. The committee was asked to recommend the steps that should be taken to increase competition in the Israeli capital market. The recommendations aim to reduce, within a few years, the concentration in the capital market and to diminish the conflict of interest that is built into the activities of the financial intermediaries. The government discussed the recommendations on November 14, 2004, and decided to delegate the directors general of the Prime Minister's Office and the Ministry of Finance to examine the comments of the ministers and the public regarding the reform, and to develop a format for its execution. On January 3, 2005, the Prime Minister and the Minister of Finance approved the proposed format. In February 2005, memoranda of the bill for implementing the committee's recommendations were published.

The following legislative memoranda were distributed:

1. A legislative memorandum for increasing competition and reducing concentration and conflict of interest in the capital market in Israel, 5765-2005. (The memorandum included amending the Banking-Licensing Law, amending the regulations dealing with providing investment consultation, amending the Joint Investments in Trust Law, and amending the Supervision of Insurance Transactions Law.)
2. A legislative memorandum on the supervision of financial services (provident funds), 5765-2005.
3. A legislative memorandum on the supervision of financial services (dealing with providing consultation and the marketing of pension products), 5765-2005.

The following are the major recommendations that have been approved and that are in the process of legislation or implementation:

- **Complete separation of the provident funds and the mutual funds from the banks:** The process will be gradual; the provident funds will be sold within three years from the date the law is passed, and the mutual funds—within four years. Furthermore, it is recommended to consider providing incentives to encourage foreign entities to acquire the provident funds and the mutual funds, similar to the situation pertaining to other investments in the economy. In order to reduce capital market concentration, a permit will not be granted for acquiring a provident fund or an insurer if, following the acquisition and with regard to long-term saving, the market share of the purchaser, the holders of a controlling interest and bodies under their control exceeds 15 percent. With regard to mutual funds, the market share will not exceed 20 percent.

⁷ For an analysis of the significance of the change on financial stability see Section 4.

- **Limiting accompanying parties from serving as leading underwriters and limiting the underwriter from selling securities to itself and to related institutional parties:** The implementation of the recommendation will enable banks to continue operating in the area of underwriting, but will prevent them from operating as costing underwriters in those cases in which a potential conflict of interest exists in the course of providing the credit. Similarly, the proposed limitation will ensure that other underwriters that do not belong to the banking group but are likely to become involved in the area of wholesale credit, will not be exposed to these potential conflicts of interest.
- **Consultation provided by banking corporations regarding life insurance and pension products:** Banking corporations that have completed the sale of all their holdings in provident funds and are not stakeholders in the insurer (including the pension fund) will be permitted to consult about life insurance and pension products. If the equity capital of the banking group to which the banking corporation belongs exceeds NIS 10 billion, the corporation will also be required to sell all its holdings in the mutual funds.
- **Model for compensating those involved in consultation** (the distribution model): With regard to **financial products and securities**, it is proposed to allow consultants to directly charge the producer of the products a uniform, fixed, and supervised distribution commission. With regard to **pension products** (insurance, pension, and provident funds) to be sold for the first time by the banking system, it is proposed to prohibit the distributors from charging their producers distribution costs. This model will be reexamined in five years time.
- **Provident fund law:** A law will be legislated to regulate the licensing, supervision, and enforcement rules for provident funds, as well as completing the existing arrangements for easing members' movement between funds, and the investment policy of the funds.
- **A thorough and comprehensive examination of the supervisory structure of the capital market** in Israel: This examination will assess, among others, the benefit of a comprehensive view of the capital market, as opposed to the risk of concentrating considerable power in a single body.

The report of the Bachar Committee also includes recommendations for the following complementary steps: (1) The inter-ministerial team that developed the recommendations will act as a steering committee accompanying the legislative process. (2) The team will examine and formulate recommendations for further intensification of competition in the capital market, through examination and regulation of rules for: (a) Commercial papers; (b) Money market funds, including the possibility of drawing checks on NIS funds; (c) Selling and repurchasing of securities—Repo; (d) Distribution of mutual funds by someone who is not a member of the TASE; (e) Easing the transition between banks; (f) Insuring deposits; (g) Nostro and market-maker investments by the banks; (h) Introducing securitization programs into the banking system.

Box 4.2**The Twelve key Standards for Sound Financial System¹**

The international financial crises that erupted in the 1990s underscored the need to intensify international cooperation between supervisory bodies and international organizations in order to strengthen the stability of the overall international financial system. For this purpose, the finance ministers and the governors of the central banks in the G7 countries initiated the establishment of a committee, which recommended establishing the Financial Stability Forum (FSF). The forum started operating in 1999 under the auspices of BIS (Bank for International Settlements), with the participation of representatives of international organizations and representatives of 11 leading countries. The aim of the forum is to promote international financial stability, that is to say, to improve the functioning of the international markets and reduce the chances of contagion from the financial systems of the various countries (transfer of shocks). The aim would be achieved through the exchange of information between authorities and through international cooperation, and especially by means of adopting international standards developed since the 1980s (when the Basel principles for supervision of the banks were formulated) by international bodies specializing in these areas.

The forum adopted the 12 Key Standards for Sound Financial Systems, which cover a wide range of issues concerned with financial stability, whether directly or indirectly, based on an approach that sees appropriate macroeconomic policy, a strong financial system infrastructure, and proper regulation and control as essential conditions for ensuring stability. Most of the standards are general principles or guidelines for the infrastructure underlying financial stability, while a few are more detailed—especially principles for supervising the banks, among them directives concerning the capital adequacy of the banks (including determining capital thresholds).²

The standards aim to establish minimal principles and conditions that each country should strive to meet in order to promote the stability of the local financial system, according to its special circumstances, thereby contributing to the stability of the global financial system. It appears that the

¹ This box is based on an article on the subject containing a summary of each of the standards, written by Noa Ben-Ya'akov of the Bank of Israel. The article (in Hebrew) can be found on the Bank of Israel site (www.bankisrael.gov.il).

² See footnote to Table 4.3 below.

expanding and deepening of the process of adopting international standards is a consequence of globalization and the intensification of financial integration throughout the world, together with the development of the financial markets and the removal of barriers between banking and other activities, as a result of the worldwide spread of financial liberalization. These processes have intensified the dependence between the financial systems in different countries and between different channels of financial activity at the local and the international level. We see in the determination of international standards an attempt to deal with the risks arising from these processes.

Even though formally the standards are only recommendations, the countries cannot ignore them and attempt, in practice, to comply with them, owing to their growing status among international financial institutions as a criterion for the state of economies and financial systems. Thus, the IMF and the World Bank recommend complying with these standards, view them as guidelines in their ongoing work with the countries, systematically examine the extent to which the countries comply with the standards, and even publish their findings in special reports, such as the Report on the Observance of Standards and Codes—ROSC. The extent to which the countries comply with the standards has become one of the criteria used by international rating companies as well as financial institutions and other potential investors in determining the country's rating, the risk attributed to it, and even the volume of investments they make in it.

The importance of the standards also emerges from the literature on the issue. Thus, for example, in an article examining the connection between adhering to the international standards and the spread and grading³ of emerging economies, the writers conclude that the greater the country's adherence to the standards, the lower the risk of the creation of shocks, and the more stable the financial system.

The above attests to the importance of implementing the international standards, especially for Israel, a small economy and open in financial and non-financial terms, which strives to integrate in international markets, and competes in emerging economies for foreign investments. The implementation of all the standards in Israel requires a long and complex adjustment process, and cooperation between different authorities.

³ Christofides Charis, Christian Mulder and Andrew Tiffen (April 2003), 'The Link Between Adherence to International Standards of Good Practice, Foreign Exchange Spreads, and Ratings'. IMF Working Paper, (WP/03/74).

Table 4.3
The Twelve Key Standards for Sound Financial Systems^a

| Name of the standard | Subjects and goals of the standard |
|--|---|
| 1. Macroeconomic policy and data transparency | |
| Monetary and financial policy transparency | Increasing transparency related to the goals and performance of monetary policy, so that information is provided to the public on an understandable, accessible and timely basis. In this way the central bank and the financial agencies boost their credibility and the efficiency of the policy, and thereby, stability. |
| Fiscal policy transparency | Increasing the transparency of the government's fiscal policy, particularly with regard to the budget, enhances credibility, which will be reflected in lower borrowing costs and stronger public support for sound macroeconomic policy |
| Data dissemination | Arranging the dissemination of macroeconomic and financial data to the public in the following dimensions: coverage, periodicity, timeliness, accessibility and quality of the data. |
| 2. Institutional and market infrastructure | |
| Insolvency | Defining the legal basis essential in cases of insolvency of corporations, including banks and financial institutions. |
| Corporate governance | The principles are aimed at improving the legal, institutional, and regulatory framework for corporate governance and providing investors and corporations etc. with the ability to influence the behavior of the corporation. |
| Accounting | The standard contains 40 principles detailing how different transactions should be recorded in companies', the government's and the central bank's financial statements. |
| Auditing | The standards are used worldwide as criteria for setting high auditing standards. They help comptrollers to meet the growing and changing requirements for financial reporting, and provide guidance in specific areas. |
| Payment and settlement | This standard sets out core principles for the design and operation of payment and settlement systems that ensure their stability and contribute to the stability of the domestic and international financial institutions and markets. It also provides guidance on how the principles can be implemented, including the role of central banks in ensuring that the principles are observed and in monitoring the operation of the system. |
| Market integrity | The legal and organizational framework for monitoring, preventing and repressing money laundering and the financing of terror. |
| 3. Financial regulation and supervision | |
| Banking supervision | The Core Principles for Effective Banking Supervision (the Basel Committee) relating to the status of banking supervision, its authority, and its method of operating, including minimum requirements from the banks to ensure their stability. |
| Securities regulation | Principles of the regulation of securities activity to protect investors, to ensure the efficiency, fairness and transparency of the markets, and to reduce systemic risks. |
| Insurance supervision | Principles related to the status of Insurance Supervision, its authority, and its method of operating, to ensure the stability of insurance companies. |

^a References to the standards in full and descriptions of the issuing bodies can be found on the website of the Financial Stability Forum (FSF): www.fsforum.org

(ii) Approving rating companies

The role of rating companies is to determine the level of risk that an investor in bonds is exposed to of not receiving the principal and the interest in a series of bonds. The process of reforming the capital market, which includes the development of the nonbank credit market, underscores the importance of rating companies for the proper functioning of the market and its financial stability. In March 2004 the Ministry of Finance published rules for approving a rating company in terms of Regulation 41a of the Income Tax Regulations (Rules for the Approval of a Provident Fund) which defines rating as debt rating in Israel or an approved foreign country, determined by a company approved by the Supervisor of the Capital Markets as a rating company. A company wishing to obtain the above approval is required to present a request in writing to the Supervisor of the Capital Markets and to operate according to a list of rules. In terms of the rules, the company will be incorporated as a company pursuant to the Companies Law, and will be located in Israel; the company will deal solely with the rating of a debt or a corporation, unless otherwise authorized; the company will operate according to a knowledge agreement as well as with instruction and support from a recognized overseas rating company for at least five years; the company will be independent and will operate without any conflict of interest; the rate of holding of institutional bodies in the rating company is limited to 10 percent, and the rate of holding of all institutional bodies—to 49 percent. Rules have also been determined for the board of directors and the rating committee. The company will publish an annual report, and the Supervisor of the Capital Markets is entitled to revoke the approval given to the company to operate as a rating company if one of the rules is violated.

b. Regulatory changes in the financial institutions*(i) Changing the method of revaluating the assets of institutional investors*

As decided by the Ministry of Finance, from April 2005 the institutional bodies, the provident funds, the pension funds and the insurance companies will be required to change the method of revaluating the non-tradable assets at their disposal (deposits, loans, and non-tradable bonds). The change entails a transition from revaluation according to the adjusted value of the assets, to revaluation according to their fair economic value based on the interest rates provided by the Shaarei Ribit company. This company was chosen in an international tender for supplying non-risk interest rates and risk premiums especially for this need.

Institutional investors are currently required to revalue differently the value of their investments in tradable bonds (according to market value) and the value of their investments in non-tradable bonds (according to the adjusted value).

The use of the adjusted cost method does not express the real economic value of non-tradable assets, which therefore biases the calculation of the profits or the losses. A lack of uniformity of receipts is thus created for members and various policyholders, and no appropriate base exists for comparing between the institutional bodies. This lack of symmetry in the revaluation method of the value of the institutional investors'

assets also leads to preferring investment in non-tradable bonds to investment in tradable bonds. The tendency of the large institutional investors to prefer, for reasons of accounting presentation, investment in the non-tradable debt market distorts the allocation of sources of credit in the economy. Furthermore, it creates an unreasonable situation in which investors demand a premium in exchange for tradability, which seriously undermines the development of the tradable debt market in Israel. The change will enable members to receive value according to the market, and will prevent distortions in the distribution of the value of the assets between members.

(2) Applying the obligation of daily revaluation of provident fund assets and regulations for easing the transition

As decided by the Ministry of Finance, starting from April 3, 2005, the assets of the provident funds will be revaluated daily, as opposed to monthly, as has been the case until now. The monthly revaluation created distortions in calculating both the member's yield and the fund's yield. A consequence of the monthly revaluation is the use of the fund interest mechanism. The fund interest is credited to the members' deposits during the month, and sometimes causes a cross-subsidy between the members' savings and the presentation of an artificially higher return. Daily revaluation of the provident fund's assets eliminates the existing distortions and guarantees the members a more precise calculation of their rights. Applying a daily revaluation obligation will also facilitate the mobility of provident fund members between funds. According to the new regulations, a member will be able to move from one fund to another within 7 business days and to withdraw his money within 4 business days.

c. Reforms and regulatory changes in the financial markets

(i) Removal of barriers to the development of a corporate bond market

In recent years the authorities have been actively encouraging the development of a corporate bond market. Considerable progress was achieved in 2004 in removing the barriers to the development of the market, according to the recommendations of the committee for examining the granting of concessions for the prospectus of bonds and commercial papers. The committee's recommendations also dealt directly with lowering costs. In January 2004 a stamp-tax exemption was approved for bonds issued in series⁸ and traded on the TASE or issued to an institutional investor. This exemption is also given with regard to documents issued by packaging companies.⁹

This exemption is designed to provide an incentive for the establishment of packaging companies that will assume some of the credit risk, which will result in the increasing supply of credit sources.

⁸ At least 10 bond certificates issued under identical conditions. The exemption is also granted to convertible bonds in shares.

⁹ Companies whose sole purpose is that of acquiring or renting assets in the context of issuing asset-backed bonds. The exemption is given for all the documents issued as part of the activity of these companies for the actual issue of bonds, and also for the agreements for acquiring loans, for guarantees to ensure payments, for a trustee agreement, for an underwriting agreement, for an agreement with a rating company, for a deed of trust, and for the management and collection of the payments.

A number of additional legislative amendments were completed during the year, including amending the definition of the term tradable security in the Securities Law—cancellation of the limitations on the use of this financial instrument; changing the format of the issue to a shelf prospectus in terms of which during the year from the day the prospectus is published it will be possible to offer commercial papers whose date of maturity is not later than a year from the date of their issue, so that the last possible date of maturity is two years from the date of publication of the prospectus. The prospectus will include the types of commercial papers, the total maximum debt, and the mechanism for determining the interest. The quantity and the method of presenting orders, the interest rate, the allocation date and the date of maturity will be published in a further allocation. Also, the time period for publishing the prospectus has been shortened to three business days, and the disclosure in the prospectus has been reduced. Ultimately, the prospectus will be a short document whose main function is to describe the securities issued and their conditions, and a description of the sources of repayment at the proposer's disposal. One of the aims of the changes is to create opportunities for the bond market to develop according to market demand without preference for a specific route, whether in the stock exchange or outside it, or a preference for structured bonds over others.

(ii) Reform of trade in government bonds – transition to market makers' trading

In July 2004 the government approved an amendment to the Government Loans Law, which includes a comprehensive reform of the government bond market, and in December the amended law was approved by the Knesset. The reform involves the appointment of a group of large and stable financial institutions in Israel and abroad as principal market makers that will operate in the primary and the secondary market. All the market makers will be able to participate in the government bond auctions, against a commitment to purchase a certain volume of bonds each year (the primary market) and against a commitment to quote (propose) buying and selling prices in large series of government bonds for a number of hours during the day and at intervals to be determined in advance (the secondary market). The primary market makers will also be permitted to borrow government bonds from the borrowing reservoir (Repo facility) that will be set up by the Ministry of Finance with the help of the TASE clearing house, and will enjoy exclusive access to the new designated trading system (the Eser system—an acronym of primary market makers). This system will operate transparently; the quotes within it will be available to the active participants in the bond market, and it is thus reasonable that they will become an important benchmark for pricing bond market transactions. Market makers will also be able to acquire an additional amount in auctions (surplus allocation), the volume of which will be determined in advance. The reform will be implemented gradually. In the first stage, continuing for about two years, it will only apply to *Shahar* bonds, which constitute about 30 percent of the stock of government bonds traded, and about 45 percent of the new issues.

The aim of the reform is to intensify competition in the domestic bond market by introducing additional international financial entities into it, and by creating a

commitment on the part of some of the largest foreign banks to undertake continuous activity in Israel's capital market and to market government bonds. The investor base in government bonds will thus be widened by means of granting institutional and large private investors throughout the world the opportunity to buy and trade Israeli bonds directly and simply. This will reduce the concentration in the capital market in general and the bond market in particular.

(iii) Real Estate Investment Trusts (REIT)

In January 2004 the Committee for the Examination and Regulation of REITs in Israel presented its report. A REIT is a corporation that holds and manages profit-yielding real estate¹⁰ and enjoys special taxation status, on condition that it meets certain conditions, the major ones being that it holds profit-yielding real estate and that it regularly distributes the profits to investors. Some of the REITs deal with real-estate financing, for example purchasing loan portfolios (mortgages) from banks or insurance companies, that is real-estate-backed loans. Some of the REITs are traded on the TASE, which enables the public to participate in large profit-yielding real-estate projects at low transaction costs and with a risk spread in their investment portfolios. At the same time, the instrument diversifies the financing possibilities in the real-estate sector and improves the allocation of capital in the economy. The committee's major recommendations dealt with the status of REITs—disclosure, transparency, trading on the stock exchange, and taxation. In August 2004, a legislative memorandum was presented for implementing the committee's conclusions, and in February 2005, it was approved by the ministerial legislative committee.

(iv) The Committee for the Reexamination of the Reporting Model of the Company's Business in the Prospectus and its Derivatives (Barnea Committee)

On June 15, 2004 the Knesset's Finance Committee approved amendments to the securities regulations, while at the same time the Knesset approved an amendment to the Securities Law—amendments introduced on the basis of recommendations of the Barnea Committee whose purpose was to **improve the financial reporting of the traded companies**, and to bring the reporting rules closer to those of the American reporting. The approach underlying the amendments is that of creating continuity in the financial reporting of the public companies. A major component of the amendments is that of equalizing the scope of disclosure required in the periodic reports to the scope of disclosure required in the prospectuses, and that the major information included in the prospectus will be regularly updated in the periodic reports. Equalizing the scope of disclosure is expected to facilitate the publication of periodic prospectuses. In addition, the Securities Law was amended in order to ensure equality in the level of responsibility regarding misleading details between prospectuses and other reports pursuant to the Securities Law. According to the amendments it will be possible under certain conditions to include information required in the securities regulations by

¹⁰ Rental residential apartments, office buildings, commercial centers, shopping centers, hotels, storerooms, homes for the elderly, etc.

referring to the same details published by law in another report. The purpose of this is to alleviate the information load of prospectuses. The amendments apply from the periodic reports of 2004.

(v) Equalizing the taxation rates on foreign securities to the tax on Israeli securities (2005)

The approved equalization of tax rates between foreign and Israeli securities, which was planned for the beginning of 2007, has been brought forward to the beginning of 2005. The decision to equalize tax rates was made as part of the overall tax reform whose implementation regarding domestic securities began at the beginning of 2003. Starting on January 1, 2005, the tax rates deducted at source for capital gains from the sale of foreign securities, including shares, options, warrants and tradable bonds, has been reduced from 35 percent to 15 percent, which is similar to the tax imposed on capital gains from the sale of Israeli securities. The tax rates deducted at source on foreign mutual funds and on capital gains from the sale of non-tradable bonds (as defined by the legislator) was reduced to only 25 percent. Parallel to the tax reduction on capital gains, the tax rate deducted at source on interest paid on tradable bonds issued after May 8, 2000, was also reduced to 15 percent (for non-tradable bonds—35 percent). The tax rate deducted at source on interest paid on tradable bonds that were issued prior to May 8, 2000 remains at 35 percent. The tax rate on dividend was reduced to 25 percent.

(vi) Reducing the tax on basket certificates (EFT) imitating international indices

An amendment to the income tax regulations came into force in July 2004, according to which securities' basket certificates imitating international indices that are traded on the TASE, will be taxed at 15 percent, similar to the tax on domestic securities. The time gap that was created until the tax rates for foreign securities were also equalized, was one of the factors leading to the rapid development of this instrument in the second half of 2004. (See Chapter 3.3.)

d. Reforms and regulatory changes in the payments and clearing system

(i) Reform for adjusting the system to international standards

Preparations continued during 2004 for the reform of Israel's payments and clearing system, which includes adjusting the existing systems to updated international standards, and the establishment of a new system of payments and clearing during the day, RTGS, in which large payments will be cleared in real time. All payment systems in local currency will undergo changes, and will ultimately be directly connected to the new payments system. The new payments system will reduce the risks for the entities using it, especially the Bank of Israel.

The major implications of the reform concern both the finality of the banks' balances at the Bank of Israel, and the business hours of the banking day. The implementation of the principle of the finality of the balance necessitates the cancellation of all the

accounting records in which the value date is retroactive. With this in mind, it has been decided during 2005 to cancel the retroactive interbank transfers prior to activating the RTGS system.

For years the banking day in Israel has ended at 15:00. In order to match the operating hours of the RTGS system to the activity hours in a calendar business day, it has been decided to extend the closing time of the banking business day to 18:30, a change that will be implemented in November, 2005. At the same time, the method of clearing checks will be changed to electronic, as is the case in most of the banks, thereby eliminating the possibility of manual and magnetic clearing. Because of the shortening of the clearing time, the banks will be able to present check files to each other, including simulation of the checks.

(ii) The Stock Exchange Clearing House

Changes in the system of payments and clearing that have important implications for financial stability were executed in 2004 in the Tel Aviv Stock Exchange Clearing House. These changes are a continuation of the changes initiated by the Supervisor of Banks in this area with regard to the banking system.

In April 2004 the TASE took an important step toward strengthening the stability of the Maof (derivative assets) Clearing House—the establishment of a securities control system in real time. Continuously and in real time the system calculates the securities required from the members of the derivatives clearing house in the course of trading. The system operates throughout the trading day, and reexamines whether each transaction executed in the derivatives market meets the updated securities demand of the members of the Maof Clearing House. Until the change was introduced, the securities were only calculated once a day, at the end of trading, a situation that increased the risk that a clearing-house member would not have securities against his position in his account. The change also included securitization of the required securities, and currently the Maof Clearing-House members have to deposit bonds as security in a special account opened in the TASE Clearing House. In the past, the securities also included a personal guarantee.

In November 2004 the Knesset approved the Clearing Houses Financial Stability and Securitization of Securities Law, which is designed to ensure the stability of the TASE Clearing House and the Maof Clearing House. According to the change, a member of the stock exchange who purchased securities on the exchange that are cleared in the clearing house is not entitled to receive them until they have been fully paid for at the clearing house. This has eliminated uncertainty in certain situations.

A further change determines that if the payment is not executed, the clearing house becomes the owner of the securities. The law also regulates the rights of the clearing houses over securities that their members transfer to the TASE Clearing House as collateral. The rights of the TASE Clearing House will take preference over liens for the benefit of third parties, subject to its control over securities. The change will also enable the clearing house to realize securities without a legal injunction, if it so requires.

4. The Implications of the Reforms for Financial Stability

- The reforms in recent years have brought about a revolutionary change in the financial system: a long-term-savings sector is emerging (insurance, pension and provident funds), private and separate from the banking sector. Furthermore, a credit market for the private sector is also emerging—outside the banks (tradable and non-tradable) and sophisticated.
- The reforms affect different aspects of financial stability in opposing directions. One of the future influences, which presents a challenge to the authorities, is the transfer of risks to the long-term-savings sector, in the wake of which the value of the public's asset portfolio will be exposed to greater fluctuations than in the past.
- In order to cope successfully with the significant challenges to the stability of the financial system that the reforms create in the transition period, the authorities have to take preemptive steps regarding regulation and supervision. It is especially important to strengthen the enforcement of cautious and proper management of credit risks in the long-term-savings institutions (the new insurance groups).

a. Introduction

In recent years many reforms and structural changes relating to the financial activity in the economy¹¹ have been executed (or are in the process of execution), which cumulatively are expected to fundamentally change the Israeli financial system in general, and long-term saving in particular. A factual description of the two major reforms in this area in 2004—the sale of the new pension funds to the insurance companies in the wake of the reform in the pension funds and the recommendations of the Bachar Committee, especially the separation of the provident funds from the banks—are dealt with above. In this section, we will attempt to assess the major implications of these two reforms in conjunction with other changes—such as the reform in the taxation of the capital market; completion of the liberalization in foreign currency; and new regulations and arrangements in long-term saving, in revaluation of assets, investments, designated bonds, the structure of commissions and customers switching from bank to bank—on the stability of the financial system, and especially on the stability of the long-term-savings institutions (insurance, pension and provident funds).¹²

¹¹ A description of the reforms in 2003 can be found in the Financial Stability Report for 2003 at www.bankisrael.gov.il, and a description of the reforms in 2004 can be found in the present report.

¹² The present discussion does not deal at all with the reforms themselves, but rather assumes they will be fully implemented as was decided, and focuses on their implications for financial stability. The discussion does not deal with the implications of the reforms that relate to the supply of financial services, such as underwriting, consulting, and marketing.

b. The major changes in the financial system

It would appear that these reforms will fundamentally change the structure of the financial system: the working assumption of the following analysis is that the recommendations of the Bachar Committee will be implemented and that the five large insurance companies will make the most of the concentration limitations recommended by the committee, and will acquire most of the assets of the provident funds. Five financial groups will thus be created (insurance groups), similar in size, which will focus on long-term saving,¹³ alongside the banking groups, which will focus more on classic banking activities. Based on this assumption, the share held by insurance companies in long-term savings will grow from 29 percent to 78 percent. A further result is the reduction of concentration among the financial groups, which is reflected in contraction of the gaps between the five large insurance groups themselves—in terms of the sum of assets controlled and managed—and between them and the five large banking groups. It should be mentioned that the banks' share of the public's total financial assets in the banking groups and the insurance groups will decline as a result of the reform from 86 percent to 73 percent, while at the same time the insurance companies' share will double to 27 percent. The new structure, against the background of other changes and reforms, will increase competition among the insurance groups themselves for the public's long-term savings (the sources)¹⁴ and its investments (the uses), and between them and banking groups—particularly over credit.

This working assumption might not be realized, in that other financial institutions, including foreign entities, will acquire a substantial part of the provident funds' assets. In such a case, a third, significantly sized sector will arise in the financial system—the investments sector, which will include, in addition to the provident funds, the mutual funds that the banks are required to sell, and the portfolio-management companies. The number of financial groups in the system will grow appreciably, despite the fact that the non-banking groups will be smaller. The following analysis will restrict itself to the original assumption, and will not consider the investments sector in detail (see the final comment in this section).

We are currently witnessing the beginnings of a revolutionary process in the credit market for the private sector (for businesses and households): the channel of credit (tradable and non-tradable) from the long-term-saving institutions (see Chapter 3, Section 5), and the channel of tradable credit (bonds and commercial securities of

¹³ The concentration limitation determines a maximum rate of 15 percent of total long-term savings for each group. Based on the current distribution of saving between insurance, banks and others (Table 4.1) and on the assumption of maximum exploitation of the limitation, following the implementation of the reform, the insurance branch will control 78 percent of long-term savings (and will acquire NIS 137 billion out of the 171 billion held by the banks), and each of the five large insurance groups will control about 19 percent of the saving controlled by the sector (NIS 42 billion).

¹⁴ The array of reforms and changes creates a new incentive structure for the long-term-savings institutions, and changes the relative profitability of the long-term-savings channels (insurance, pension and provident funds) from the public's point of view, but it is difficult to assess the overall impact on its composition.

companies, and bonds backed by assets and by loans) from households (mostly by means of mutual funds) are being added to the channel of bank credit, accompanied by significant growth in the number of lenders and in the diversity of instruments (including derivatives). This revolution results from a combination of many changes, among them the contraction in the volume of designated bonds issued to the pension funds, the greater freedom given to institutional investors to choose the composition of their investment portfolio (in the investment rules) and to grant credit, and the changeover in the public sector from unfunded to funded pensions—all of which increase the supply of sources in the credit market. The revolution is also a result of increased severity of the single borrower limitation at the banks on the one hand, and the separation of the provident funds and the mutual funds from the banks and the creation of five insurance groups of similar size in the future on the other—all of which increase the number of large lenders in the market. Finally, all the above, together with the cancellation of tax discrimination on various financial assets, the cancellation of the stamp tax, concessions in the prospectus for issuing commercial securities, ongoing revaluation of institutional assets according to fair value, permitting customers to move between long-term-saving institutions, and the introduction of market makers—work toward encouraging competition between the financial entities and to enhancing the market.

c. The major implications for financial stability

The overall influence of the reforms on financial stability is analyzed below from two viewpoints. First, we compare the extent of stability of the financial system in two circumstances: the final situation of the financial system following the full implementation of the reforms and the adjustments on the part of all the players involved in it and surrounding it (“the future system”) as opposed to its situation prior to the implementation of the reforms (“the previous system”). And second, we analyze the impact on financial stability of the adjustment processes of the players in the transition period from the previous system to the future system. As will be explained below, the challenges facing the authorities are critical for maintaining financial stability. Comparing the future system with the past system sharpens the contribution of the different aspects to financial stability.¹⁵

(i) Comparison between the future and the previous financial system

A comparison between the future and the previous financial system shows that the reforms will bring about fundamental changes in the operation of the financial system, some that will increase its stability and others that will weaken it, without being able to determine in advance their overall impact on the stability of the system.

¹⁵ A comparison of this kind is not easy, despite the particular focus on financial stability. This, among others, is because of the complex connections between financial stability and other factors such as competition, concentration, the structure of the system, efficiency, and conflicts of interest.

(a) The increased financial stability is reflected in two important ways:

Reducing systemic risks: The reforms contribute to increasing the resilience of the system—primarily because they remove a significant part of the financial activity from the banking sector, namely the part dealing with provident funds and mutual funds, and because they sever the ownership connections between the banks and the insurance companies—two actions that reduce the risk of contagion from these financial institutions to the banks. The risk of contagion arises from an undermining of the public’s confidence in the banks following a blow to the financial institutions connected to them if their reputation is tarnished, and especially the provident funds, whose very existence is dependent on confidence. The danger of a run on the provident funds by members is a result of the high rate of liquidity commitments of the funds to their members. The assessment that these moves increase resilience is based on the conception that the systemic risks in the banking sector are the highest in the financial system, among others, because only in this sector do assured and liquid liabilities coexist, which creates the risk of contagion to the banks and between them (“run on the banks”). The systemic risks in the banking sector are also highly significant, because of the centrality of the banks in the economy—and especially in credit to the business sector and in the payments system, a blow to which severely impacts on their non-financial activity. According to this conception, the transfer of activity that is not part of classic banking activity from the banks to other institutions, and intensifying the division between them, strengthens the overall resilience of the financial system.¹⁶

New risks of contagion will, however, be created in the future system from the new pension funds to the insurance companies, due to a combination of conditions: the new leading pension funds are now owned by the insurance companies, which are private entities, as opposed to being indirectly owned by the Histadrut and enjoying government support. As a result of the pension reform, members’ rights are no longer guaranteed, but rather are susceptible to fluctuations according to the value of the assets of the fund. The pension products are complex, and the wider public cannot clearly grasp the essential differences between them. Despite this, it seems that the new risks of contagion are less than those between the provident funds and the banks.

Enhancing the markets and competition: The reforms create alternative channels for executing financial transactions, for example, financing for the business sector from pension and provident fund institutions or from the issue of tradable bonds, which reduce the firms’ dependence on banks and increase the availability of the

¹⁶ According to this conception, a financial conglomerate—which is a bank that operates in all the banking and financial channels (and at times the non-financial) without limitation—is less stable from the viewpoint of systemic risks than a bank that deals only with classic banking activity, even if it benefits from a wider spread of sources of profit and risk within it. The reason for this is that the realization of large risk and losses in one company affects other companies in the conglomerate, owing to the connections between them, and is liable to also harm the public’s confidence in it and lead to the collapse of the conglomerate. As a rule, the risks of contagion between financial and banking activities within a conglomerate are very high.

sources. The reforms also encourage the deepening and the enhancing of the securities and derivatives markets, which contributes to stability through a mechanism for determining prices and the public information embedded in them, and through the trade in risks that facilitates their management and dispersion. The reforms contribute to the dispersion of credit risk, and especially for the large borrowers in the economy, among a large number of lenders, thereby reducing the vulnerability of the financial system in the event that a large firm collapses.

It is acceptable in financial systems to assume that competition comes at the expense of stability; in certain circumstances, however, an intensification of competition could contribute to stability. (See the Box on Competition and Financial Stability in this chapter.) Admittedly, the reforms in Israel intensify competition, but in view of the fact that prior to the reform the level of competition in certain financial activities, for example the credit market for small businesses and household savings, was very low, it can be assumed that increasing competition will not harm financial stability. As opposed to this, intensification of competition will contribute to efficiency, to strengthening the financial robustness of the business sector (reducing the cost of financing and increasing its availability) and to correct pricing and management of risks, thereby contributing to stability.

In certain activities, however, in which competition is already at a high level, especially credit to large companies, increasing the competition between the banks and the insurance companies, and among insurance groups themselves, is liable to lead to increased risks for the banks. This scenario could come about if, for example, insurance groups manage to rapidly increase their credit portfolios by purchasing bonds backed by mortgage portfolios from the banks, and by means of credit to large, quality companies that are interested in reducing their dependence on bank credit.¹⁷ The credit risk in the banks will be a function of the impact that the separation of the provident funds and the mutual funds from the banks has on contracting their sources of profit and their ability to disperse risks, as opposed to the opposite impact of increased activities (sale of insurance and pension products, and pension consultation). In the final analysis it would appear that the major negative impact of increasing competition in the credit market is on the stability of the insurance groups in the transition period (see below).

(b) The weakening of financial stability is reflected in two ways:

The public's confidence in the system: In the wake of the reforms the proportion of assured-yield assets in the public's asset portfolio will decline, parallel to an increase in the proportion of assets exposed to market risks and fluctuations in value,

¹⁷ It is possible, at least in the transition phase, that the banks will realize their advantage over the insurance companies in credit risk management, and will sell them more risky credit than the average. In this case, increasing the competition will reduce the credit risks in the banks at the expense of the insurance companies.

including savings and the rights accruing at retirement.¹⁸ These changes will intensify fluctuations in the values of the public's assets, the effect of which is to undermine the public's confidence in the insurance groups. This change is especially significant if the confidence of the public in the stability of the insurance groups is lower than its confidence in the stability of the banks, because of the far-reaching regulation in the banks and the covert insurance of the deposits—and in the stability of the Histadrut pension funds, in light of its major representative strength in the economy. Experience also points to the fact that in practice the government guarantees the deposits in the banks and provides backing for the Histadrut pension funds, while there is no similar unequivocal experience regarding savings in the insurance groups. Furthermore, under certain conditions, large fluctuations in the value of the public's financial assets are liable to create or intensify fluctuations in consumption and real activity in the economy by means of the wealth effect and to undermine the financial robustness of firms, thereby intensifying the damage to financial stability.

Structured conflicts of interest: Conflicts of interest are perceived as a problem of fairness and consumerism. However, when conflicts of interest are exploited in a way that harms the wider public, its confidence in the financial system is liable to be undermined—a scenario that already took place in the bank-share crisis in the early 1980s and in the extending of credit in order to purchase mutual funds in the early 1990s. On the one hand, by separating the provident funds and the mutual funds from the banks and by reinforcing the differentiation between consultation and marketing in the financial activity, the structured conflict of interest in the banks' operations is diminished. On the other hand, however, structured conflicts of interest will increase within the insurance groups, especially between management of the Nostro portfolio in insurance¹⁹ and the management of investments for holders of profit-sharing life insurance policies, members of pension and provident funds, and between managing the investments for different types of members. Despite this, in comparing between the two situations, the conflict of interest in insurance is less critical than in banks, the reason being the greater importance the banks have in the system, as explained above. Furthermore it is possible that the increased competition between the insurance groups will actually reduce the exploitation of the structured conflicts of interest.

(ii) The transition period

Liberalization and reforms in the financial system contribute to the development of the economy, and many examples exist of planned and staggered processes that are

¹⁸ This claim is not an attempt to contradict the important fact that the pension reform took care of the significant threat to the stability of savings and rights, the actuarial deficit, which arose from guaranteed rights to members that were not sufficiently covered by insured assets.

¹⁹ The Nostro portfolio in insurance includes the equity capital, the general insurance, the risk component in life insurance, and the part of life insurance that ensures a yield not backed by designated bonds.

implemented successfully and without crises. Experience in Israel and worldwide, however, shows that significant processes of liberalization and reforms in financial activity lead to prolonged processes of adjustment, sometimes accompanied by crises. In general, these adjustment processes are not smooth and synchronized, because they are bound up with learning processes and considerable creativity on the part of the players, often on a trial and error basis. Under certain circumstances, these processes are liable to be reflected in disruptions in the financial system and in the excessive fluctuation of prices of financial assets, which in some cases could even lead to a crisis. Thus, for example, Israel's foreign-currency liberalization in 1977, which was executed dramatically against a background of problematic underlying conditions in the economy and without appropriate readiness on the part of the authorities, caused intensified capital movement and the acceleration of inflation, which ultimately necessitated the need to back down from the liberalization. Another example is the far-reaching financial crisis in Korea in 1997, whose roots are inherent, among others, in financial liberalization during the 1980s and 1990s that was not accompanied by a strengthening of the regulatory system. International experience in this area can be gleaned from the financial stability literature,²⁰ which emphasizes the increased vulnerability of the financial system in the wake of liberalization processes, and recommends a staggered implementation of liberalization steps in addition to strengthening the regulation and supervision of the financial system in order to ensure its success.

An analysis of the impact of the reforms in the transition period reveals that the authorities in Israel face a demanding challenge of preventing any possible harm to financial stability during the period. Admittedly, the basic conditions in the economy and the level of regulation and supervision are better than in the past, and also the reforms are being implemented in a staggered manner. Despite this, it appears that the cumulative reforms are creating fundamental changes in financial asset yields and risks, in the incentives structure and the rules of the game, as can be seen in the activities of various financial institutions, in the securities markets, and especially in the credit market. These changes could lead to long processes of adjustment in the public's behavior (individuals and companies), in its assets portfolio and its liabilities. During the period in which these players are making adjustments, the probability of harm to financial stability increases, which is likely to be reflected in reduced public confidence in the insurance groups, in an undermining of their stability, in a decline in the value of the public's financial assets, and in disruptions in the functioning of the financial system. This situation has a greater chance of occurring if the adjustment processes are not synchronized and are unsatisfactory.

The reforms in Israel in recent years require significant processes of learning and adjustment on the part of the various players in the financial system, especially regarding credit risks in light of the substantial changes in the credit market for

²⁰ See for example: Mishkin (1997), "The Causes and Propagation of Financial Instability: Lessons for Policymakers", Federal Reserve Bank of Kansas City, Issue August, pp. 55-96.

the private sector. The insurance groups have to establish a system for marketing, managing, and controlling credit and credit risks (including securitization and credit derivatives), and will have to acquire superior professional knowledge and assimilate it in the organization and in the decision making process. The public (the business and the household sectors) will probably learn to exploit the new possibilities, but only after having acquired the knowledge that will enable it to evaluate the profitability of various channels, especially the complex long-term-saving products, in terms of costs, yields, and risks for the various investment channels. A particular difficulty concerns households' internalization of the risks, and adapting their behavior to the greater fluctuations than in the past of financial assets, and especially pension rights, which are no longer assured. The banks too will be required to adapt themselves to a more competitive environment, especially in the management and pricing of credit risks.²¹

d. Challenges for the authorities

The various supervisory authorities have to deal with the possible negative influences on the stability of the **future** financial system, the source of which lies mainly in the growth of credit risks in the banks and in the intensification of structured conflict of interest in the insurance groups. The most significant challenges, however, to financial stability, as mentioned above, are likely to appear in the **transition period**. In order to deal successfully with these challenges, the authorities dealing with the stability of the financial system, and especially with the stability of the insurance groups, have to increase the resilience of the financial system by already taking complementary steps at this stage. In fact, the Bachar Committee was aware of these challenges and declared its intention to take steps in the area of infrastructure and the regulation of the financial system, and indeed some changes have already been included in the legislative memoranda for implementing the reform, while others are being planned. Successfully coping with the challenges necessitates, however, taking many immediate steps, both in the area of infrastructure and regulation, and in the area of supervision and information to the public.²²

Regarding the infrastructure and the regulation: Increasing the independence and the enforcement authority of the supervisory bodies over the insurance groups,

²¹ The very process of separating the provident funds and the mutual funds from the banks also presents a challenge to the authorities. Thus, for example, the way of financing the acquisition of provident and mutual funds could, under certain conditions, intensify the credit risks and the contagion in the system.

²² Some of these steps are based on the international standards for financial stability (see Box 4.2), and on an assessment of the extent to which Israel complies with them, *inter alia*, on the basis of reports of the IMF and the World Bank. Some of the standards, as well as some of the steps enumerated here, only present guiding principles without going into details.

for example by increasing administrative independence and widening the authority to collect information; by institutionalizing and formalizing the cooperation between the supervisory bodies, both in the transfer of information between them, and in coordinating the ongoing supervision of the institutions they are jointly responsible for; and institutionalizing the coordination between the supervisory bodies and other bodies involved in formulating policy vis-à-vis the financial system, in order to maintain systemic stability. Among the required regulatory steps will be harmonizing the capital requirements against credit risks and against quasi-banking activity of the insurance companies, as well as readiness for crises; legislating a provident fund law as soon as possible; regulating supervision over the various entities operating in the field of securitization transactions, for example, defining the authority and the supervisory tools for enforcing the regulations dealing with the prevention of conflict of interest between the rating companies and sellers and buyers; defining the desirable structure of the insurance groups, such as clearly delineating the separation between the management companies of the investment portfolios for pension, provident funds, and insurance, as opposed to life insurance and general insurance; determining regulations for managing credit risks in the insurance groups, similar to those applying to the banks; and determining rules for executing and recording securitization transactions and credit derivatives, and reporting on them.

Regarding supervision: Adapting the capital adequacy requirements in the insurance groups to their new activity, and especially to the growth in credit risks, and ensuring that the groups are capable of managing the credit risks prior to approving the extension of credit and enforcing management norms. In order to ensure the above, the supervisory authority requires the ability to monitor, analyze, evaluate and supervise the insurance groups on site, similar to the existing capability in supervising the banks. There appears to be a need to upgrade the system of the insurance groups' reporting to the supervisory authority in order to provide comprehensive information in real time, which is needed for monitoring and evaluating their stability.

Regarding information to the public: Increasing public awareness of the risks in the asset portfolio, especially the new uncertainty in the value of pension rights following the cancellation of the guarantee; publication of risk and performance indices of the various institutions (and not only yields and commissions), and expanding the disclosure of risks and their management, and of capital adequacy in the financial reports of the insurance groups.²³

²³ In the alternative assumption mentioned at the beginning—that a significantly large investment sector will come into being—the challenges facing the authorities will be greater because the change in the extent of enhancement of and competition in the financial system, and especially the credit market, will be more extreme, and because the need for coordination between the supervisory authorities over the different sectors will be greater.

APPENDIX 4.1
MERGERS, CLOSURES AND ACQUISITIONS OF VERY SMALL
INDEPENDENT BANKING CORPORATIONS, JANUARY 2002 TO
FEBRUARY 2005

2002

April In April, a provisional liquidator was appointed for the Trade Bank

2003

February In February, Bank Hapoalim purchased the complete holdings in the Maritime Bank and in June the Maritime Bank was merged within Bank Hapoalim and its license revoked.

2004

March In March 2004, the license of Bank Polska Kasa Opieki Tel Aviv (Bank Pekao) was revoked, and it became a subsidiary corporation in the Bank Hapoalim group. This was after Bank Hapoalim had purchased full ownership in the bank in December 2003.

March In March 2004, the process of closing the Global Investments Bank was completed and its license revoked. This was the culmination of a process that began a year previously, in close coordination with the Banking Supervision Department, in which the bank gradually and in a controlled manner settled its liabilities and its assets and closed its clients' accounts.

June In June 2004, an agreement was signed for the purchase of Investec Bank by The First International Bank.

2005

February In February 2005, the Euro-Trade Bank announced its intention to cease operating as a bank, to hand back its banking license, and to continue operating as a non-bank private investment house.

February In February 2005, a deal was concluded to transfer the operations of the Gahalet financial institution from the Tel Aviv municipality to Bank Otsar Ha-hayal.

February In February 2005, an agreement was signed to sell the banking operations of the Haoved Haleumi Savings and Loan Fund, Netanya to Bank Otsar Ha'hayal.

APPENDIX 4.2

MAJOR DIRECTIVES AND CHANGES BY THE SUPERVISORY AUTHORITIES²⁴ IN 2004

Bank of Israel: Banking Supervision Department

- February Draft directives for measurement and disclosure of problematic debts and provision for bad debts were sent to the banking corporations. Essentially they are designed to match the terms and definitions used in Israel to those accepted in the leading systems worldwide, according to the recommendations of the international committee on banking supervision (Basel Committee).
- September Publication of draft directives concerning the management of credit frameworks in current accounts and current loan accounts, the aim being to cease frequent and continuous deviations from the approved credit framework in these accounts.
- October Draft guidelines were submitted to the banks regarding credit rating ahead of implementation of the Basel II principles in Israel. Basic standards were determined in the document for constructing a rating system in order to assess savings components and to execute valid examinations of the system and the assessments. Advanced systems based on these standards are unlikely to be introduced into Israel in the coming years.
- Draft directives for proper banking administration were published, which are designed to regulate the overall activities of the credit-card companies in the area of risk management and various areas of consumerism.

Ministry of Finance: Capital Markets, Insurance and Savings Department

- January Implementing the reform in the insurance branch, including expanding the transparency and the disclosure in insurance policies, and changes in the structure of commissions in the branch.

²⁴ Bank of Israel, the Ministry of Finance, and the Israel Securities Authority. The list also includes changes initiated by the Tel Aviv Stock Exchange.

- Terminating the issue of bonds designed for the new pension funds. Bonds will be issued to the fund only if their balance does not exceed 30 percent of its assets.
- February A new instruction was published that will require government companies to include declarations by the directors in the financial reports as to their correctness.
- April Starting from May 1, 2004, policyholders will have a more flexible choice of the coverage they require in comprehensive vehicle insurance (coverage of property damage to the vehicle, and property damage of a third party). This choice has been facilitated by an amendment in the supervisory regulations of insurance transactions.
- In light of the reform in the pension sector in 2003, new regulations have been published that regulate the operation of the new pension funds as actuarially balanced yield funds.
- August The Supervisor of Insurance, in conjunction with the Supervisor of Banks, distributed a proposal for regulating the sale of insurance by mortgage banks.
- September New directives have been published simplifying the transfer of members between the new pension funds. The new directives increase the disclosure to policyholders prior to their transfer to another pension fund.
- November The government approved the recommendations of the Bachar Committee for reform of the capital market, the essence of which is the separation of the provident funds and the mutual funds from the banks. (See Section 3 of this chapter.)
- The Shaarei Ribit company was chosen to establish and operate the interest rates pool for the provident funds, the insurance companies and the pension funds. The interest rates will serve to capitalize the cash flows of the non-tradable assets.
- The Knesset's Finance Committee approved the proposal to amend the State Loan Law to include a comprehensive reform of the government bond market in order to regulate the activity of market makers in bonds. In January 2005, the amendment passed its second and third readings in the Knesset.

Ministry of Finance: Israel Tax Authority

July A regulation was determined according to which a tax of 15 percent will be imposed on investments in Exchange Traded Funds that track international indices traded on the TASE. This regulation will apply retroactively from January 2004.

Ministry of Finance: Accountant General's Office

October The Accountant General approved the reform of providing risk insurance to exporters through The Israel Foreign Trade Risks Insurance Corporation (IFTRIC). The reform aims to encourage the entry of additional Israeli banks into the exporting funding circle, thereby expanding competitiveness and reducing the exporters' financing costs.

The Israel Securities Authority

March An instruction was given to the commercial banks to relate to structured products as if the Investment Consultation Law applied to them.

June The Finance Committee approved the legislative amendments that anchor the recommendations of the Barnea Committee by law, the aim of which is to improve the financial reporting of tradable companies.

July The Israel Securities Authority published an instruction that requires companies to improve reporting on benefits received by senior office holders, stakeholders, and holders of controlling interest.

August A legislative memorandum was presented in the wake of the conclusions of the Committee for the Examination and Regulation of REITs in Israel. According to the memorandum, the funds will be traded on the TASE, and will be company-tax exempt on part of the income that will be distributed as dividend.

The Israel Securities Authority presented a proposal to amend the Mutual Funds Law in order to permit the offer of foreign mutual funds in Israel.

- The Knesset approved an amendment to the Securities Law that regulates the change in the method of underwriting and the way in which securities are offered to the public.
- September The Israel Securities Authority appointed a public committee to examine the corporate governance of public companies in Israel. The committee's objective is to advise the Authority in defining control principles in public companies.
- October A directive was approved that requires public companies to report on the activity of their internal auditors.
- November The Finance Committee approved an amendment to the Securities Regulations that facilitates the issue of commercial securities, including issues by means of a shelf prospectus according to the recommendations of the committee headed by Adv. Reuven Bachar.

The Tel Aviv Stock Exchange

- January Trading on the conservation list was inaugurated, as well as limited trading in securities of companies that do not meet the conservation rules.
- March Market makers were introduced in euro-rate derivatives on the TASE.
- April The TASE Maof Clearing House began operating a securities control system in real time for trade in derivatives. Continuously and in real time, the system calculates the collateral required from members of the Maof Clearing House in the course of trading.
- May The TASE launched a new platform for institutional investors (excluding mutual funds) to trade in non-tradable bonds without a prospectus.
- September The TASE directorate approved the inauguration of trade in new Exchange Traded Funds (ETFs) indexed to additional assets such as commodities and to an international index of hedge funds.