Is there too much or too little bank regulation and supervision in Israel? An opinion based on international standards[1/]

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1/ The content of these slides should not be reported as representing the views of the IMF. The views expressed are those of the author and do not necessarily reflect the views of the IMF or IMF policy.

1.The International Standards: Where Do They Come From?

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- Basel Committee on Banking Supervision.
- IOSCO, IAIS.
- Other: OECD, countries' experiences
- IMF-WB: Financial Sector Assessment Programs (FSAP).

2. Why Bank Regulation and Supervision.

- Protection of small depositors. Asymmetric information. High unit cost of obtaining information
- Compensate for lack of market discipline. Deposit insurance with large coverage in many countries creates moral hazard. Bank creditors do not monitor risk. Risk may be underpriced.
- When risk materializes, cost for the country may be high (bank-bail out/dep.bail-out/financial instability)

Israel. Moody's Investors Service, Global Credit Research. October 2003

"Bank Hapoalim deposit ratings are placed at a2/Prime-1, the country ceiling for foreign currency bank deposits in Israel after factoring in some external support to the fundamental creditworthiness of Hapoalim from the Israeli authorities, in the event of need. Our firm belief that the Government of Israel would eventually step in to support Hapoalim is based mainly on the bank's size, market share and importance within the Israeli banking system".

"Given Leumi's size, we believe that it could still count on government support in a crisis, even after its full privatization. This view is also based on the bank's status within Israeli society (a status derived from the role it has played in the development of the State of Israel). A crisis at Bank Leumi could also become a systemic crisis and as such the government would be incentivised to assist the bank in the event of need. In the past the Israeli government has supported troubled banks regardless of whether they were privately or publicly owned. Over the long term, however, it is possible that the predictability of government support for the banking system will diminish...".

3. The Core Principles of Bank Regulations and Supervision

At T=0, Value of Bank XXX (Vb) = 0
(only known by the bank)

Assets		Liabilities	
Loan 1	**50**	**Deposits**	**90**
Loan 2	**40**		
Loan 3	**10**		
(loss loan 3)	*(10)*	**Equity**	**10**

At T=1, bank can use new $100 deposits (8% interest rate) to fund one of these two projects (both projects same expected return but one is much riskier):

Project	Bad State (p=0.05)	Good State (p=0.95)
1	-100	+121
2	+110	+110

Which project will the bank choose?
What do supervisors have to say about this choice?
What are depositors' preferences?

VB	Bad state (p=0.05)	Good state (p=0.95)
P1	-108	+21-8=13
P2	+10-8=2	+10-8=2

VB	Bad state (p=0.05)	Good state (p=0.95)
P1	0	13
P2	2	2

Depositor/ Large bank creditor	Bad state (p=0.05)	Good state (p=0.95)
P1	108	108
P2	108	108

Deposit Insurance	Bad state (p=0.05)	Good state (p=0.95)
P1	-108	0
P2	0	0

- Probability of default
- Size of the exposure
- Where the exposure has collateral or any other risk mitigation device
- Provisions
- Amount of capital
- Important issues here are:
  - **Risk-capital trade-off**
  - **What is the economic value of the bank**

- Provisions should be enough to cover average potential losses.
- Capital should be enough to cover "unexpected losses", i.e. losses that can have a small probability of occurrence
- Uncovered losses
- How to deal with high uncovered potential losses:

  - Setting limits that can reduce the "loss given default" (e.g. limits on large exposures) Loss given default depends on the original exposure and credit risk mitigators (such as collateral, default swaps, etc)

- For multiple positions, the relevant distribution is the distribution of changes of the value of the bank portfolio. The joint probability of default plays an important role. Consequently, large exposures may also result from the combination of several smaller positions that are exposed to common risk factors.

- No Israeli regulation prohibits to undertake risky projects
- No Israeli supervisor will tell a bank not to make a risky loan, instead the supervisor is asking for enough capital to make a risky loan
- General provisions cover expected losses.
- So, regulation does not hamper profits and growth in Israel.
- It may be difficult at present for banks to increase their capital base. However, it would also be too risky to expand at the cost of a “large uncovered tail”.
- The common ground to discuss both supervisors and bank concerns is in the short term: Do bankers and supervisors agree on the amount of risk that may be reasonable for Israel, given the amount of available bank capital?
- In the long term the question has to do more with how to increase capital or how to use credit mitigation techniques.
- Do banks and supervisors agree on how to measure risk?

4. From theory to implementation: what are the internationally accepted regulations in practice

Basle I implements the risk-capital trade-off in a very mechanical way. Capital = 8 percent of risk-weighted assets. Little risk sensitivity – Mechanic limits

Basle II: Capital requirements depend on probability of default, loss given default, exposure at default and maturity. Less mechanic limits. More risk measurement. Risk mitigation techniques provide capital relief.

5. A Quick Overview of the Accepted International Standards on Bank Supervision: Basel's Core Principles for Effective Banking Supervision

- Preconditions for effective supervision
- Licensing
- Prudential Regulations and Requirements.
- Methods of supervision.
- Information requirements.
- Formal powers of supervisors.
- Cross border banking.

In summary:

- The international standards call for a strong supervisor
- Strong does not mean arbitrary.
- Strong means that the supervisor needs to monitor that banks satisfy the risk-capital trade-off (and this has many dimensions). In case of doubt, it is up to the banks to produce the proof
- The implementation of Basle II will move the discussion between bankers and supervisors to risk measurement (as opposed to compliance with. mechanical rules). This approach implies necessarily more dialogue between bankers and supervisors.

6. Is There Too Much or Too Little Bank Regulation and Supervision in Israel?

Israel: Report on the Observance of Standards and Codes (August 2001 and March 2003) in www.imf.org/country/ISR/index.htm

“Israel has a competent and professional supervisory staff and a satisfactory legal and regulatory framework in which to supervise banks”

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Specific Recommendations:

Preconditions.

A detriment to effective supervision is that the BOI is subject to secrecy provisions which prevent an appropriate level of information sharing with domestic and foreign supervisors.

Prudential Regulations and Requirements.

Reporting to the supervisor of problem loans is limited to an annual return.

Prudential Regulations and Requirements.

More work is required to develop a more systematic framework for the assessment of country and transfer risks. The BOI should set out explicit requirements for these risks, including a requirement for banks to create and maintain adequate policies and procedures.

Methods of ongoing supervision*. The BOI is encouraged to consider the development of a quality assurance function. In assessing bank management, the BOI has begun to use the issuance of new licenses as the opportunity to impose a fit and proper regime. However, this needs to be expanded to cover all banks and extended to all directors and key members of management.*

7. Conclusions

- Israel has successfully passed the formal assessment of compliance with international best practices in bank regulation and supervision.
- Discussions between bankers and regulators are necessary and useful, and should focus on risk measurement and risk mitigation techniques.
- Consultation process