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Israeli Banking - Present and Future Prospects¹

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I. Introduction

Banks are the central component of the financial system in most countries and are particularly important in emerging markets where non-bank financial institutions are less well developed. In both emerging markets and developed economies, banks play a critical role in the transmission of monetary policy to the economy. In addition, the efficient provision of banking services creates an environment that is conducive to long-term economic growth. In recent years economists have given increased recognition to the economic role of the banks and the broad importance of the payments and intermediary services provided by banks. At the same time, the banking industry around the world has been undergoing dramatic changes in structure and activities. There are several global trends in banking –

- ↖ government disengagement from the financial services business,
- ↖ increased concentration in the banking sector,
- ↖ spread of universal banking,
- ↖ increase of cross-national banking and foreign bank ownership,
- ↖ Substantial disintermediation as non-bank financial institutions become more

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active in financial markets.

Thus, this is an opportune time to examine these changes and to explore the future of banking.

An examination of the Israeli banking industry is particularly timely. In many respects it has always been where other countries are going now; Israel has always had a concentrated, universal banking system. In other aspects it has not yet been affected by some of these global trends, and is probably on the verge of some major changes. For example, government disengagement and successful privatization of the Israeli banks is underway but not complete. Although the nationalized Israeli banks were managed independently, once privatization is complete, significant changes in industry structure are likely to occur. Moreover, the growing interest of foreign banks in the Israeli financial sector is likely to affect the Israeli industry. Finally, progress towards financial liberalization and extensive changes in the Israeli regulatory environment that are under discussion will affect the future financial system.

The global trend towards highly concentrated universal banking systems is very strong. In recent years we have seen waves of mergers and acquisitions, particularly across national borders, that have increased concentration in both small and large countries. In emerging markets, acquisitions by foreign financial firms have become common place and in more than a handful of countries, a majority of bank assets is foreign owned. In Europe, monetary union provides a strong push towards a single banking market and cross-border activities have accelerated. In the U.S. historical restrictions on inter-state banking have all but disappeared, leading to a rapid reduction in the number of banks. In addition, arguments in favor of restrictions on bank activities are rarely heard and bank involvement in all aspects of the financial system (universal banking) is quickly becoming the global norm. Even in the U.S. legislation has recently repealed the Depression era restrictions on bank activities. Most countries are headed towards a financial system dominated by a small number of universal banks with significant international ownership.

In Israel the banking system as well as the whole financial market is dominated by a

handful of universal banks. The major characteristic that distinguishes Israeli banking from other countries is the relatively small involvement of foreigners in the banking system. The other distinguishing feature of the Israeli financial system is that the major banks face little competition from non-bank financial intermediaries and capital markets. In emerging market countries, there is often competition for deposit taking from postal savings institutions that continue to be important. In more developed countries, banks face competition from commercial paper markets or private placements by institutional investors as well as public bond and equity markets. Competition from institutional investors, pension funds, insurance companies and others, is less intense in Israel than in many developed countries. In addition, with the exception of the equity markets, capital markets are not particularly well developed.

These two distinguishing features of the Israeli financial system – the structure of banking and the role of the non-bank components of the financial sector – will be the basis for our discussion. The first section of the paper deals with the structure of the banking sector in Israel and the second section addresses the role of capital markets.

II. The Structure of the Israeli Banking Sector

The starting point for any discussion of Israeli banking is the 1983 banks shares crisis that led to government ownership of most of the banking sector. Although the government controlled the banks, the banking institutions were left in tact and there was little direct government intervention with bank management. The banks continued to be private sector institutions, albeit with government ownership of most shares, and the government expressed its desire to divest itself of share ownership quickly. However, privatization of the banking sector has been a painfully slow process. The government's commitment to disengagement from the banking system has simply been weak. Many other countries (such as Mexico, Argentina and Poland) with equally complex political constraints were able to privatize their banking sectors more quickly. However, substantial progress has been made in the last four years. In the near future we will be able to take government withdrawal from the banking sector for granted.

We will not dwell on the torturous history of bank privatization in Israel but will instead focus on the current and future status of the industry. First, we will discuss the extent of concentration and competition in banking. Second, we will discuss the sources of competitive pressures in the future – foreign banks and non-bank financial institutions.

a. Banking Sector Indicators

Table 1 shows some banking statistics for Israel and a group of 10 countries that we will use for comparison. The countries are all small (population less than 15 million) and well off (GNP per capital in excess of \$12,000 in 1997). (We eliminated the wealthiest small country, oil rich Norway.) Additional comparative indicators, including measures of bank operations, are in the 1998 Annual Survey of the Supervisor of Banks, Israel's Banking System. Overall, the available data suggest more similarities than differences between Israeli banks and banks in similar countries.

The Israeli banking industry is very concentrated with the five largest groups controlling 93% of bank assets and the three largest banks controlling 77%. Competition in banking system has intensified in the last decade. The change was not due to the entrance of new banks but rather the increase in the market share of the existing medium sized banks.

Banking in many of these countries is just as concentrated as in Israel; the Israeli concentration ratio is around the median value. However, the trend in Israel has been down while it has increased in many other places in recent years.

Interest rate spreads are often used to measure the efficiency of the banking system or the degree of competition. Bank scope data (Table 1) on the net interest margin shows that the spread in Israel is slightly larger than the median for the group of comparative countries. An alternative data source (World Bank, World Development Indicators) shows that the spread between lending and deposit rates in Israel in 1997 is about a percentage point higher than the median for the group. Nevertheless, both measures of the Israeli spread have fallen substantially during the 1990's.

A factor that inhibits significant change in the banking industry is that Israel is by some measures over banked. There is one bank branch for every 5,700 people and an ATM for

every 5,080. However, the data in Table 1 indicates that the number of persons per bank is comparable to other countries. A few large banks will continue to collect most deposits because any effort to build a deposit base in the relatively small Israeli market would be prohibitively expensive.

Table 1

Banking System Indicators

	Population per bank, Thousands	Concentration (Share of 3 large banks)	Deposit Money Bank Assets, ratio to GDP	Private Credit by Deposit Money Banks to GDP	Net Interest Margin (percentage points)
Year	1996	1997	1997	1997	1997
Austria	140	0.75	1.31	0.98	1.71
Belgium	67	0.83	1.37	0.65	1.67
Chile	-	0.42		0.54	3.88
Denmark	46	0.75	0.37	0.31	4.20
Finland	361	0.98	0.61	0.55	1.57
Greece	252	0.83	0.43	0.22	2.93
Ireland	83	0.67	0.38	0.32	1.14
Israel	260	0.77	0.92	0.71	2.78
New Zealand	235	0.59	0.97	0.94	2.49
Portugal	235	0.50	0.87	0.63	1.80
Sweden	260	0.83	0.45	0.38	2.46

Source: World Bank database constructed by A. Demirguc-Kunt and R. Levine, 1999.

b. Concentration and Competition in Banking.

Concentration in banking does not preclude competition. There can be a highly competitive banking industry without a large number of banking institutions. There are two sources of competition in banking: the threat of entry by new institutions and the provision of bank services and products by other institutions. Since banking is a multi-product industry, the threat of entry does not have to come from establishment of a new large comprehensive banking firm. Instead competition is likely to come from small banks or non-banks innovating or competing in particular product markets. New entrants,

foreign banks or non-bank financial institutions are likely to develop niche markets and new financial service products. The absence of extensive branch networks and deposits will not prevent them from competing for many fee based financial services that are the source of revenue growth in banking around the world.

The competition from non-bank financial sector institutions would include private and public capital markets, non-bank financial intermediaries and foreign financial markets and institutions. Capital market developments as a source of competition for banking are the subject of the second part of this paper. In this section, we discuss the banking sector itself.

There have been no formal restrictions on the entry of foreign banks and non-bank financial institutions into the Israeli markets since the mid-1990's. However, there has been little interest until recently in the Israeli market for several reasons. First, political risk of investment in Israel has historically been thought to be high. Second, and perhaps more important, Israel's isolation and the absence of significant economic relations with neighboring countries means that the international market centered in Israel is very small. The failure of foreign commercial banks to enter Israel is probably due to the failure of regulators to create an inviting environment. Finally, it was already noted that the extent to which Israel is 'over-banked' discourages foreign entry.

However, in other countries, foreign banks are willing to enter a crowded field when expanding financial markets create new business opportunities. Most of the comparison countries have a larger number of foreign banks operating than in Israel although their share of total bank assets is often as small as it is in Israel (about 3%).

Some recent developments do suggest that changes are possible. For the first time, some major foreign commercial banks are starting operations in Israel (Citibank and Republic Bank are opening branches this year). The announcement of Citibank's plans was supported by intensive talks between bank officials and the Governor of the Bank of Israel on flexible criteria for establishing activities in Israel. There are rumors that Citibank might buy an Israeli bank and there have been discussions between Citi and the Arison group that controls Bank Hapoalim. It has been suggested that Bank Hapoalim

wants a strategic foreign banking partner so it can widen its overseas activities, especially to provide financial services to Israeli firms abroad. Also, the bank would like to establish a local derivatives market and Citibank's experience would be of assistance.

Thus, successful foreign entry will be based on business plans that differ from the existing large banks. They are likely to develop fee based financial services businesses and to avoid the development of wide branch networks. With the changes in technology underway, branch networks might be unsustainable and their existence might be a burden to banks like Leumi and Hapoalim.

Foreign banks can have a particularly strong effect on banking sector competition because they can bring both new product innovations and technology from major financial sectors. (Technology imports might be less important for Israel because the banks around the world are major customers for the Israeli software industry. Still foreign entrants can speed and make possible the diffusion of new technology.) Equally important is the potential effect of entry by foreign non-bank financial institutions that we will discuss later on.

The entry of foreign banks and other financial institutions needs to be placed in some international perspective. Banks usually enter a foreign market as they follow their home country customers. The isolated Israeli market may, until very recently, have been too small for this type of activity. Broader cross-border banking activity was not very common until very recently. For example, the EU removed all formal barriers to cross border banking about ten years ago. However, there was virtually no change in banking structure until the introduction of the Euro reduced the exchange rate risks and signaled a firmer political commitment to a single market. Elsewhere around the world, regulators have often restricted foreign bank entry. Paradoxically, the first instances of significant foreign entry occurred in some of the formerly planned economies of Central Europe. The wave of cross-border bank mergers that started in the EU in the last few years has begun to spread. Many European banks have been growing by buying banks in other countries with strong market links to the home country. For example, the Spanish banks have expanded into South America and the Dutch and German banks are active

throughout the transition economies. Political resistance to foreign bank expansion is not unheard of. Recently, Brazil rejected some efforts of foreign banks to enter Brazilian banking.

Another source of competition introduced to the banking system in recent years was due to the liberalization of rules concerning participation in foreign financial markets. Capital controls on Israelis were removed over a period of several years and virtually gone by 1998. These changes influenced the financial environment for Israeli firms and their use of foreign sources for financing increased rapidly. The impact of the liberalization on households was much smaller because there are still taxes that make capital outflows of Israelis not worthwhile. The removal of these taxes (which has been recommended this month by Ben-Bassat committee) will make Israelis' financial investment abroad more profitable- which will of course increase competition to the banking system.

c. The Traditional and Non-traditional Activities of Banks.

Although universal banking has become the worldwide norm, there are wide differences in the degree to which bank activities are restricted. Table 2 provides a summary of restrictions on bank activities in the most important non-traditional activities – insurance, real estate and securities. It also indicates whether there are restrictions on direct bank investments in non-financial firms and in the ownership of banks by non-financial firms. The summary indicates that the degree of restrictions in Israel is somewhat greater than in many comparable countries.

Although the Israeli approach to organizing the banking industry has always emphasized the universal nature of the banks, significant restrictions on bank activities have been an element of regulatory policy. Restrictions on bank activities are a form of competition policy. That is, a motivation to restrict bank activities is to reduce the power of the banks and to foster competition. An alternative approach is to foster the development of non-bank institutions and capital markets that will provide competition even if the banks have wide powers.

Although capital market development will be very important as restrictions on banks are

removed in Israel, the financial system will remain bank-based. In fact, the difference between bank based and market based financial systems are diminishing around the world. In Israel and elsewhere, the development of other financial institutions and instruments will increase the competition with the banks and lead them to react by increasing non-traditional activities - as we already see in many places around the world.

Table 2

Non-traditional activities of banks

	Overall Evaluation of bank Powers	Securities	Commercial bank investment in non-financial firms	Real estate	Non financial firms investment in commercial banks	Insurance
Austria	Very wide	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Permitted
Belgium	Somewhat restricted	Permitted	Restricted	Restricted	Unrestricted	Permitted
Canada	Somewhat restricted	Permitted	Restricted	Permitted	Restricted	Permitted
Denmark	Wide	Unrestricted	Permitted	Permitted	Unrestricted	Permitted
Finland	Wide	Unrestricted	Unrestricted	Permitted	Unrestricted	Restricted
Greece	Somewhat restricted	Permitted	Restricted	Permitted	Restricted	Permitted
Ireland	Wide	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Prohibited
Israel	Somewhat restricted	Permitted	Restricted	Unrestricted	Restricted	Restricted
Portugal	Wide	Unrestricted	Permitted	Restricted	Unrestricted	Permitted
Sweden	Somewhat restricted	Unrestricted	Restricted	Restricted	Restricted	Permitted
United states	Restricted / Somewhat restricted	Restricted	Restricted	Restricted	Restricted	Restricted

Unrestricted: the bank can directly engage in all activities.

Permitted: the bank can engage in all activities, but some of them not directly but through a holding company

Restricted: less then all activities are allowed through a holding company.

Prohibited: the bank is prohibited engaging in this activity directly or through a holding company.

Source: J. Barth, D. Nolle and T. Rice, "Commercial Banking Structure, Regulation and Performance: An International Comparison", In *Modernizing Financial Systems*, ed. D. Papadimitriou, St. Martins Press, 2000.

Israeli information added by authors

III. The Development of Capital Markets in Israel

The reason for our interest in capital market institutions is that a competitive banking environment, particularly in a small country that will tend to have a concentrated banking sector, comes from the robust development of other capital market institutions. Capital market instruments and institutions are the primary source of competition for the banking sector. Development of capital markets and a richer variety of capital market instruments available to the private sector will effect the dominant role of the banks. In fact, we believe that the under development of the capital markets in Israel is the most significant factor in holding back overall the financial sector and it has a major influence on the lack of competition to the banking sector

The role of the capital markets is more important than the extent of concentration in the banking sector itself. Non-banks providing banking services and intermediation by capital market institutions are the sources of a competitive financial sector. Development of such institutions does more to foster competition than regulatory restrictions on the activities of the banks that dominate the financial sector.

Capital market institutions have been growing in recent year in many countries with a history of universal banking. In many small European countries non-bank avenues for investments by individuals did not exist until recently. In recent years, there has been substantial disintermediation in countries like Spain and Belgium resulting in sharp declines in he banks' share of total financial assets and rapid increases in the growth of other financial intermediaries. For example, financial assets of all institutional investors (insurance companies, pension funds, investment companies, etc.) increased from 44% of GDP in 1990 to 63% in 1996 in Belgium and from 16% to 45% in Spain. These countries have experienced increased competition in the banking sector, reduced spreads and consolidations in the industry.

In Israel there has not been a similar disintermediation process or any rapid growth in the

importance of non-bank intermediaries. The assets of institutional investors (pension funds, insurance companies and provident funds but excluding mutual funds) to GDP declined from 88% in 1990 to 78% in 1996 due to withdrawals from provident funds. A unique aspect of the Israeli financial structure is that financial intermediaries and institutional investors are mostly bank-controlled entities or bank managed; about 83% of provident funds and 60% of mutual funds are affiliated to the banks. Thus, there is little competitive pressure from disintermediation in the sense seen in other countries.

In countries with well-developed capital markets, banks are only one part of a broad spectrum of institutions that contribute to the process of financial intermediation between investors and savers. An enterprise's financing arrangements fall along a continuum that starts with the entrepreneur and extends to the large public firm that raises capital in a variety of ways, ranging from the issuance of publicly traded equity to internationally syndicated loans and private placements. Well-developed capital markets include many modes of financing and different types of institutions that can be grouped into three broad categories:

Entrepreneurial finance. Entrepreneurial financing starts with the efforts of start ups to utilize self-financing, e.g., the personal saving of the entrepreneurs' friends and family. It includes government 'incubator' projects and the inter-firm provision of trade credit. Finally, it culminates with the first of the capital market institutions that we will discuss – the venture capital industry.

Bank lending. Even with fully developed capital markets, banks are the single most important financial institutions. This is often because credit rating by banks and the relationships between firms and their banks are important sources of information to capital markets and other financial institutions.

Capital market financing. There are a wide variety of capital market institutions that take part in the process of financial intermediation. They include non-bank financial institutions such as merchant banks and institutional investors, and both private and public bond and equity markets. Our interest here is the growth of capital market financing in Israel and the absence of some capital market institutions.

As capital markets develop, the banking sector's share of total credit declines for the simple reason that lenders have other places to go. In the last ten years there were some large changes in the sources of funds for Israeli firms. First, government sources were reduced dramatically and "directed credit" is now relatively small. Second, local stock market (equity) sources have increased in some years, and from 1995 there was a major increase in funds raised by firms in stock markets abroad. Third, in 1999 there was a dramatic increase in venture-capital funds raised, especially for high-tech firms. Although these trends have increased the forces of competition in the local financial market, banks continue to dominate as the primary source of funds. There is some clear segmentation to the capital markets. Larger firms can go abroad for funds while banks dominate the domestic markets. There are some challenges to bank dominance: in some years firms have used the equity markets to raise working capital and recently, the rapidly growing venture capital industry is very important for high tech firms.

Most importantly, there are still some conspicuously absent components to the Israeli capital markets. The absent components are related to another important factor: the involvement of the government with institutional investors that has inhibited the development of capital market institutions and instruments. This involvement enables the banks to retain market power and influence over firms, particularly those without access to foreign sources of financing.

We will briefly examine the major components of the spectrum of capital market sources in order to understand the forces that are competing with the banks and those that can develop in the future.

a. Venture Capital. The venture capital industry is extremely well developed in Israel and in recent years has increased its role as a source of financing to small and medium-size enterprises. There are 60 VC funds operating now in Israel. Unofficial sources indicate that in 1999 VC sources to high-tech firms were about \$1 billion. The venture capital industry is far more active and developed in Israel than in other small economies.

The VC industry started to develop with the establishment of "YOZMA" – a VC fund sponsored by the government. This fund established ten VC funds (partly with foreign

capital) that are all functioning. This government initiative led to other VC funds and there are now 45 private VC funds and 5 additional public funds. The industry has been relatively free to grow and can thrive without any formal regulatory or market mechanisms.

A major difference between the local VC industry and those operating in the U.S and most of the European countries is the limited participation of institutional investor's e.g. pension funds and insurance companies in Israel. Pension funds, as a result of regulatory changes, have become the largest source of venture capital funding in the United States, Ireland and Denmark. In those countries pension funds as a percent of venture capital funding was higher they 30%.

The increase in funds raised by this industry has already led to a competitive response by the banks. The large banks already announced that they are establishing VC funds.

b. Non-Bank Banks. In many countries non-bank financial intermediaries such as mutual funds, insurance companies, pension funds, and investment banks are important in financing enterprises, and they have been growing dramatically over the past two decades or so. This trend has actually crowded out the banking sector and increased the competition in financial markets. The increasing importance of institutional investors as holders of assets mean that their impact on the functioning of financial markets is high and growing, and in most European countries, they play a key role in the domestic financial systems. In those countries they engage in financial market activities as:

- ◀ Collectors of savings, in particular from households
- ◀ Suppliers of funds in the market for securities and other financial assets
- ◀ Participants in the primary and secondary markets for bonds and equities and in the derivatives markets.

The increase in institutional investor's share of financial market was pronounced in their growing role of corporate governance. As major shareholders their role in take-overs is a central one in many markets. They also have a role in increasing the liquidity of secondary markets.

In Israel there are hardly any non-bank financial institutions that compete with the banks. There are no non-bank deposit institutions like the U.S. thrift industry, the British building societies and the European postal savings institutions. In addition, the banks manage most of the mutual and provident funds, so the funds are not a competitive force. The pension funds and insurance companies are not bank affiliated, but there are restrictions on their portfolios that prevent them from financing investments via credit or from participating in the corporate bond markets. Unlike pension and insurance companies in the European countries, in Israel these institutions mostly collect savings and transfer them to the government by buying non-tradable government subsidized bonds.

For a decade there are talks about deregulation of pension and insurance activities in Israel. It is likely that the restrictions on their portfolio composition will be removed soon in the near future, so that they will be subject only to minimum capital and liquidity ratio requirements and not portfolio restrictions. Liberalization of this kind, if it is accompanied by a reduction in the supply of government non-tradable bonds, can drive these institutions to engage directly in financing enterprises and in time to become a force competing with the banks.

The recommendation of the Ben-Bassat committee on the separation of provident funds from the banks can also be a force in the same direction of creating non-bank-affiliated financial institutions. However, the recommendation to foster competition by limiting each bank's share in the market to 10 percent is not enough. Competition will only develop when portfolio restrictions are liberalized and the government's dominance on the supply side is reduced as well.

Additional competitive pressures can come from the non-bank financial sector providing financial services. In the U.S. where until very recently bank activities were severely restricted, the banks faced competition from brokerage and other financial service firms that were able to provide virtually all the financial services of a bank and were often able to innovate without regulatory constraints.

In addition to the foreign bank interest in Israel described earlier, a large number of foreign non-bank financial institutions have recently started activities in Israel. Several

European and U.S. investment and merchant banks have small operations in Israel. In the last year and a half, eleven institutions registered with the Bank of Israel because they wanted to use the name “bank” and there are many other financial institutions operating in Israel or planning to. For example, Merrill Lynch is planning to open an office to provide information to Israeli firms and customers and is likely to develop broader activities. Newspaper reports indicate that the Lehman Brothers representative in Israel made transaction that amount to 5 billion dollars last year. The activities of foreign financial institutions are likely to be a strong inducement for change in Israeli finance.

c. Corporate Bond Market. Another major source of corporate finance in many developed countries is the debt market: long-term corporate bonds and short-term commercial paper. The latter is a very close substitute for bank credit. However bond markets in Israel are very small and commercial paper is non-existent. The data below show that this is clearly a missing link in Israeli capital markets. Private bond market capitalization is about 3% of GDP in Israel while it is over 15% and often as much as 50% in most of the other countries examined.

There are some barriers to the development of bond markets in small countries. For example, a commercial paper market requires sufficient depth to provide a secondary market, a reasonably large number of issuers and some standardization of the instrument (through reliable ratings and bank lines of credit). Small financial markets rarely have the depth that is sufficient for this market to develop. It is difficult to say whether a commercial paper market could be viable in Israel. Some large companies have CP issues abroad and that might inhibit the development of the domestic market.

Policy makers have made some efforts to facilitate the development of commercial paper. In 1998, the “Arrangement Law” (a supplement to the budget act) included a provision to help commercial paper issuance. Firms that sell bonds with duration of a week to a year to “classified investors” (e.g. banks, mutual and provident funds, insurance companies) will not have to issue a prospectus. In addition, such bonds can trade on the stock exchange with fewer requirements than other commercial debt. These developments are steps in the right direction; they reduce barriers to issuance or CP ‘supply.’ The major

remaining hindrance to the development of the CP market is the ‘demand’ barriers. The high-yield non-tradable government bonds that are issued to pension and insurance funds reduce the demand for corporate bonds. The government has already made tender offers for the exchange of some non-tradable bonds, but there is still a long way to go before these issues disappear.

Table 3

Market Capitalization As % of GDP in 1997

	Stock Market Capitalization	Private Bond Market Capitalization
Austria	17	33
Belgium	45	53
Chile	10	-
Denmark	29	106
Finland	59	27
Greece	24	1
Ireland	25	4
Israel	41	3
New Zealand	38	-
Portugal	24	20
Sweden	114	57

Source: World Bank database constructed by Demirguc-Kunt and R. Levine, 1999.

Although, an active non-bank short-term debt market requires enough depth for trading to occur, long term debt instruments can exist in fairly small markets. In the U.S., corporate bond markets are often fairly illiquid since there are large numbers of heterogeneous instruments. Moreover, the biggest part of the market in terms of funds raised is through private placements, a phenomenon that is absent in Israel. The market exists because there are large institutional investors that demand bond instruments. These include pension funds, insurance companies and mutual funds. These institutions also hold government bonds in their portfolios. The competitive markets price the assets and lead institutional investors to hold both private and public debt in their portfolios. The key issue here is that the public sector competes openly for funds from these investors. There are no special issues for such investors with preferred terms or guaranteed returns or other special arrangements that crowd out the private sector, contrary to the situation in

Israel.

d. Equity markets and IPOs in Israel and abroad. Most of the small countries that we think are comparable to Israel (excluding Netherlands and Sweden) have a dominant banking system and a relatively small capital market. Israel stands out, despite the dominant role of banks; the Israeli local stock market has grown dramatically in recent years. Market capitalization, 41% of GDP in 1997, is right in the middle range for the small open economies that we examined. The increased trend of Israeli firms raising capital on the Tel-Aviv stock exchange has been a large competitive force to the banking system, especially in years of stock market boom. Nevertheless there are still problems that keeps the equity market from becoming a major source of competition to the banks:

Supply: For most firms, an overwhelming fraction of the shares are held by a few large shareholders. On average the five largest shareholders hold about 75% of the firms' equity compared to 20-40 percent in the other countries.

Demand: The fact that institutional investors have restrictions on their investments, as we mentioned before, makes their participation in the market very small.

A major change in corporate finance in the last five years was the dramatic increase in the number of firms - mostly high-tech - that raised capital abroad in the U.S. and Europe. The number of Israeli firms listed in the U.S. is larger than the sum of all other foreign firms in the U.S, beside the Canadian firms. The capitalization of Israeli firms trading in the U.S. is more than \$60 billion and almost as large as the capitalization of the Tel Aviv Stock Exchange. Companies, particularly hi-tech IPOs prefer the cachet of an American listing as well as the cheap capital available in the U.S. Viability of capital markets in Israel would suggest that dual listings should be encouraged. However, controversy about the adequacy of U.S. securities regulations and accounting standards has stymied such developments.

This kind of access to foreign capital markets has two main affects: on the one hand it increases the financing options of firms and the elasticity of demand to bank loans: reducing the local banks monopolistic power. On the other hand it can prevent domestic

capital market development and therefore reduces the role of local markets in the financial system. It is possible that the most profitable and attractive Israeli firms will finance their activities internationally leaving the local markets and banks for smaller local companies.

Foreign Financing. Israeli foreign exchange markets including the capital account was liberalized in the 1990's. Many of the restrictions on raising capital from foreign banks and depositing money there were released. Nevertheless it is interesting to note there has not been a large increase in this kind of source of finance. Most of the firms increased the share of their foreign-currency credit by raising it from local Israeli banks. Nevertheless there are indications (see Ribon & Yosha, 1999) that the foreign currency liberalization had a large influence on the local banking system: it especially increased the elasticity of the demand function for local credit and reduced bank interest rate margins.

Capital market institutions around the world have been experiencing globalization in much the same way that banks have. Although regulations and industry structure are usually country specific, there has recently been a large increase in cross-border activities of insurance companies, investment companies for privatized pension schemes. Mutual fund sales and management are still predominantly local in Israel. However, in 1997 Generali, the Italian insurance conglomerate bought a local insurance company, Migdal, from Bank Leumi. In addition, as Israeli firms are already active abroad, they are likely to develop relationships with foreign financial firms. It is inevitable that international financial firms will compete with local markets. Thus, the ability of local financial institutions to create alliances with foreign markets and institutions is a key to growth.

Access to foreign capital markets by Israeli firms can prevent domestic capital market development and also take profitable business away from the banks. It is possible that the most profitable and attractive Israeli firms will finance their activities internationally leaving the local markets for smaller local companies. As noted above, a large number of firms have made equity issues in the U.S. or Europe and there are examples of commercial paper and bond issues abroad as well.

Capital Markets: Conclusion. All in all, we have argued that the development of capital

markets will provide competition to the banks. Filling the gaps in the capital market spectrum is difficult in a country like Israel where the banks are already active in most existing financial markets. Nevertheless, change in the regulation of insurance companies and pension funds that are likely to be introduced in the near time will lead to changes. The non-bank intermediaries will be able to do more lending and to hold more diversified portfolios, which might gradually increase their competition with banks. In addition, non-bank securities underwriters and a growing venture capital and private placement industry could increase the influence of non-banks in corporate finance. The fact that the banks already dominate distribution networks for any new portfolio products will make some of these changes gradual. Moreover, if entry is allowed and encouraged by policy, then the markets are contestable which will foster competition.

IV. Prospects for Israeli Banking and Capital Markets

Israeli banking will continue to share many of the trends found around the world – universal banks in a concentrated banking system. However, the nation’s financial structure can still change dramatically if foreign participation is encouraged and if impediments to the development of capital markets are removed. Both of these developments go a long way to imposing competitive pressures on a small number of universal banks. *The changes that will occur in the banking system will be due to capital market developments that reduce the importance of banks in financing.* Among the developments underway are: raising capital abroad (from foreign banks as well as capital markets), growth of mutual and provident funds foreign investments, growth of commercial paper and bond markets, the increased activity of foreign banks and intermediaries in Israel.

It is clear that the banking sector is rapidly moving towards zero government ownership, a welcome and long overdue development. However, true government disengagement from the banking sector extends beyond ownership. The government should be less involved with planning and overseeing industry developments. For example, regulators should set standards for bank ownership and avoid the politicization has made the

approval process so long and drawn out.

The term “universal” bank is probably on its way to extinction. Even banks in the U.S. that faced broad activity restrictions in the past are well on their way to becoming universal. Banking systems will differ around the world in the degree of restrictions. In small economies like Israel, restrictions on banks are often viewed as a form of competition policy. However, such restrictions on bank universality of activities should not be viewed as a permanent substitute for the development of non-bank institutions and foreign competition. Competition policy should focus on the development of non-bank financial institutions and capital markets. Both regulatory restrictions and government participation in the capital markets often inhibit these developments. The gaps in the capital markets will not be filled by restricting the banks but instead by encouraging entry of other institutions.

In the past, banking policy has emphasized restrictions to foster competition rather than institutional development. It is now time to place the emphasis on institutional development. For example, the Brodet committee reforms in 1996 prohibited the banks from controlling a non-bank entity, and by the end of 1998 they had to reduce their holdings in such firms to a maximum 20 percent of their equity. A better approach than such portfolio restrictions would be improvements to corporate governance and an enlarged role for institutional investors.

Foreign ownership of Israeli banks should be encouraged. In fact, it will occur as soon as less restrictive labor rules enable a new owner to easily restructure a bank. Foreign ownership will facilitate international flows of funds, help integrate Israel with European and U.S. capital markets and encourage improvements in bank management. Openness to foreign ownership is the key to making Israeli banks part of the global financial markets.

Government disengagement from the banking sector will only be complete when the government liberalizes capital markets. More open and complete capital markets are likely to develop in the near future and these institutions will provide competition to the banking sector. There are two aspects of capital market liberalization:

The first has largely been accomplished in recent years. It is the capital account liberalization that allows free entry by foreign investors in the Israeli capital markets and removes any restrictions on Israelis making portfolio investments abroad.

Reduced government interference with institutional investors. As pension funds are allowed a broader range of investments, new capital market instruments will develop a trend that is also on the way and should be encouraged.

There are some important missing links in the continuum of financial and capital markets in Israel. In particular, there are no money markets other than the inter-bank market and there are no corporate bond markets. It is not obvious that such markets will develop but existing regulatory impediments should be removed. The development of new markets would be easier if there were more mutual and provident funds that were independent of the banks. This is an instance where some regulation to create some fire walls between portfolio managers and banking business could be advisable. In addition, easier entry of non-bank funds would be helpful. It is possible that non-bank entities are slow to develop because the Israeli public views that the bank related entities are in some sense insured by the government. A clear definition of the extent of government intervention would be helpful.

Globalization of financial markets poses a threat to local banks in Israel and in small open economies around the world. Large and successful enterprises are likely to have increased access to world markets. This is already happening in Israel since a large number of firms access equity markets, commercial paper markets and loan markets in the U.S. or Europe. A trend towards offshore financing could inhibit the development of local markets that would be detrimental to the local economy. Thus, policy makers and banks in Israel should be eager to develop more complete domestic capital markets. The banks may resist such developments that appear as a threat to their dominant position in credit markets. However, it is not in their long run interest to do so.

It is difficult to forecast exactly what developments will occur first in the Israeli financial sector. However, one thing can be said for sure. That is, the Israeli banking industry faces a period of rapid and profound change as new financial market instruments and

institutions challenge its dominant role. If the banks respond to the challenge and develop into an efficient and competitive component of the capital markets then they will serve an important role in the growth of the Israeli economy.

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