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KAHLON VS. FLUG

The finance minister wants competition, the BOI governor, stability. Who is right and can we enjoy both?

ISRAEL'S FIVE banks are dominated by two heavyweights, Leumi and Hapoalim, which control two-thirds of the credit market and consequently make enormous profits and pay their senior managers obscene salaries.

This cozy duopoly earns huge profits by charging commissions on nearly every minor transaction; I paid 6.50 shekels in commissions recently at my bank to pay a utility bill of 75 shekels. Such outrageous commissions are unheard of in modern banking systems abroad. I'm surprised the banks don't charge us for the air we breathe.

In 2015, the five banks had revenues of NIS 15 billion (\$3.9b.) from commissions, not much less than the NIS 24b. (\$6.24b.) they earned from interest.

The total profits of the five (Hapoalim, Leumi, Discount, Mizrahi-Tefahot and First International) in 2015 was NIS 8.24b. (\$2.14b.), up 27 percent from the previous year.

Leumi CEO Rakefet Russak-Aminoach

earned NIS 8.1 million (\$2.1m.) in total salary and bonuses, or 22,192 shekels every single day, including Shabbat, more than twice the average *monthly* salary of an Israeli wage earner (NIS 10,100). The other banks' CEOs received similarly astronomical payouts.

Kahlon is working to boost bank competition, lower the cost of borrowing and expand credit for small businesses

Finance Minister Moshe Kahlon wants to change this. During national elections last March, Kahlon's Kulanu party ran on

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a platform of lowering the cost of living by spurring more competition. Kulanu won 10 Knesset seats and Kahlon took over the Finance Ministry. Now, he and his ministry are working to boost bank competition, lower the cost of borrowing and expand credit for small businesses.

Kahlon and Bank of Israel Governor Karnit Flug last year announced the appointment of a new state committee charged with increasing bank competition. The head of the committee, Dror Strum, was formerly head of the Antitrust Authority and its members include Hebrew University Prof. Avi Ben-Bassat, a former Finance Ministry director-general; Amir Levi and Yael Mevorach, director and deputy director, respectively, of the Finance Ministry's budget department; Bank of Israel Deputy Governor Dr. Nadine Baudot-Trajtenberg; Prof. David Gilo, also a former head of the Antitrust Authority, and Prof.

Nathan Sussman, head of the Bank of Israel's research division.

The Strum Committee filed an interim report in February. One of its key recommendations was to force the banks to sell their credit card operations and separate credit cards from bank lending.

The five interim majority recommendations are: Forbid the banks to issue credit cards and create incentives for investment houses and other financial institutions to offer consumer credit, including consumer credit backed by personal pension accounts; make Discount Bank and First International sell their Visa Cal credit card business; transfer credit card supervision to the Finance Ministry; and allow insurance company subsidiaries to issue bonds and provide credit.

The Bank of Israel opposes all of them.

In the wake of this report, an important and fascinating debate has begun that rather

resembles a heavyweight boxing match.

In the one corner, weighing in at 8.24 billion shekels (total annual bank profits) is Dr. Karnit Flug, Bank of Israel Governor, who took up her post on November 13, 2013, and in the past two years has been quietly effective (see *The Jerusalem Report*, "A woman's job," December 16, 2013). She favors creating new credit-card firms, but strongly opposes banning the banks from credit-card operations.

In the opposite corner, weighing in at 10 Kulanu Knesset Members, whose votes are crucial for the 61-member coalition, is Finance Minister Moshe Kahlon, who has (according to a Channel 2 TV survey) a 37 percent approval rating. This is actually rather high, and a rare achievement for a finance minister a year into his term of office and following tough, unpopular budget cuts. Kahlon is trying to lower the cost of housing, food and banking services, always

All smiles before the clash: Bank of Israel Governor Karnit Flug and Finance Minister Moshe Kahlon announce the appointment of a committee charged with increasing bank competition, during a press conference at the Finance Ministry in Jerusalem, June 3, 2015

by spurring competition. More competition, more efficiency, lower prices – Economics 101.

Flug has a strong track record as a wise and efficient governor. Kahlon has a strong track record as a reformer. When he was communications minister in a previous government he drastically lowered the cost of cell phone communications by opening the industry to new players, and inspiring Prime Minister Benjamin Netanyahu's famous instruction to his other ministers, "Be like Kahlon!" (See

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The Report, "Be like Kahlon," July 16, 2012.) Very few of them listened.

The core of the debate is competition vs. stability among the banks. Kahlon wants more competition. Flug wants stability.

Competition may lower bank profits and cause instability. But stability may ensure the continuing duopoly that hurts consumers, borrowers, credit-card holders and small businesses.

Competition? Or stability? Could we possibly enjoy *both* competition and stability? In the background are the Strum Report recommendations and an impending decision about whether, and how, to implement them. Flug says they go too far. Kahlon says they don't go far enough.

Israel's banking sector is a vital part of the economy and its strength and well-being are of great importance.

So, who is right?

We could bring the debate to a rabbi, though I fear he might listen to Kahlon and say, "you're right"; then hear Flug and say, "you're right"; and finally, when The Report protests, "learned Rabbi, they can't both be right!" he might respond, "you're right, too!"

I will present as fairly as I can Kahlon's case, partly using his own words (in quotation marks), and Flug's case (her own words, too, are in quotes).

Despite my efforts at objectivity, however, I'm afraid my own sentiments will be evident.

Readers, it is your call. Best of luck.

Finance Minister Moshe Kahlon: Let's start with my credentials. I'm the son of immigrants from Libya and grew up poor as one of seven children. I started a successful business importing car parts and have served as an MK since 2003. I know firsthand how people struggle to make ends meet.

I don't like to brag, but I got the lowly Communications Ministry in 2009 and soon spurred legislation that created three new virtual cell phone providers. The result? Rates were cut in half. I promised then, "I will continue to work to lower the cost of living by strengthening competition" – and I have ever since. I'm keeping my promise.

In the 2015 election, as Kulanu leader, my platform called for more competition in financial markets. Consumers are "getting screwed" by the three big banks. The committee chairman I appointed, Dror Strum, said the reforms his committee is proposing will help consumers and small-businesses gain better access to the huge NIS 300b. (\$75b.) credit market. We want Hapoalim and Leumi to sell off their credit-card business.

Excessive competition among the banks could lead to instability and could wreak havoc on the economy

I'm not certain the Bank of Israel wants *any* banking reform. Back in 2008, there were proposals to separate credit cards from the banks. Then-governor Stanley Fischer rejected the idea – and nobody was willing to tangle with him. Again, in 2011, the Trajtenberg Committee recommended more competition in banking. Again the Bank of Israel stonewalled. I think the only reason the Bank of Israel agreed to appoint the Strum Committee was public opinion. Dr. Flug understands the public wants reform. But she doesn't.

Let's make things very simple. The cellular market was NIS 30b. annually and competition there saved consumers billions. The annual household credit market is NIS 140b. If we take one-fifth off the cost, the public will save a huge amount – three times as much as was saved in the cellular market.

Let me be very clear. "I am not undertaking to accept all the Strum Committee recommendations. If I think there are things that should be changed, I will act to change them. I respect the committee and respect its conclusions, but if I find that I must change things, I am giving notice – I am not

bound to accept the conclusions."

Bank of Israel Governor Karnit Flug: Excessive competition among the banks could lead to instability in the financial system, which could wreak havoc on the economy. "In recent years, [the Bank of Israel's] supervision of banks has brought about significant steps to increase competitiveness, and the Bank of Israel is part of the effort to improve this sector.

"We must not forget the lessons of the most severe financial crisis in our generation, which was caused by irresponsible measures and inadequate supervision [of the financial services sector]. It is important to remember that in the past three years the balance of consumer credit has increased cumulatively by about 20 percent and credit to small businesses by about 30 percent.

"The issues which the Bank of Israel opposes [banning banks from owning credit-card companies] reflect, from the Bank's professional perspective, measures that are liable to negatively impact the public and serve as a marked risk to the stability of the economy. It is important that financial-system reforms are made with agreement, as a lack of agreement will hamper the ability to implement the recommendations in practice."

I think I can say this even more clearly. You, Minister Kahlon, cannot do your reforms without us, the Bank of Israel. So, you need our agreement and we do not agree to the reforms you are currently proposing.

The banks should be allowed to continue to issue credit cards, even after being forced to sell their credit card units. If not, this will create a monopoly of three companies issuing credit cards, compared to 10 credit card companies today. "It is easy to see that this will lead to an increase in the price of credit," not a decrease. "Leaving Visa Cal in the hands of Discount Bank and First International will strengthen their ability to compete [with Leumi and Hapoalim]."

And, by the way, move credit card supervision from the Bank of Israel to the Finance Ministry? "The fact that Israel weathered the crisis in 2008 relatively well emphasizes the need for professional and efficient supervision and illustrates

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the possible implications of not having such supervision. It is important that an apolitical entity not measured by its day-to-day popularity, will have responsibility for maintaining stability.

"The fact that in Israel we have not had to rescue any of the banks contributed to our rapid exit from the global crisis with minimal negative impact on growth, employment and standard of living. The experience of other countries illustrates the damage we avoided by maintaining the stability of the banking system and the damage that is likely if, as policy makers, we will not do so in future."

Kahlon: What? Bank of Israel and the size and clout of the Hapoalim-Leumi duopoly spared Israel the global 2008 crisis? Nonsense! Poppycock!

Big banks *cause* crises, they don't prevent them. Neel Kashkari spearheaded the controversial US bank bailout in 2008 and now heads the Federal Reserve Bank of Minneapolis. He recently said in Washington that "the biggest banks are still too big to fail and continue to pose a significant risk to our economy. Government and Congress should consider breaking up the big [American] banks to protect the system from another crisis." If it's true of America, it is true of Israel, too.

"I predict that in 10 years, there will be no banks" – because of technology. The Internet will be as disruptive for banking as it has been for taxis, hotel rooms and nearly everything else.

How this debate is resolved will have huge impact on the economy for years to come. Meanwhile, offstage, Israel's economic growth is perceptibly slowing, while attention is focused on the rising wave of terrorist attacks.

Despite the global Great Recession, which began in 2008, Israel's Gross Domestic Product (GDP) grew 5.5 percent in 2010 and 5 percent in 2011 but in 2015 GDP only grew 2.5 percent, compared with 2.6 percent in 2014. GDP per capita increased only 0.5 percent as population growth was about 2 percent.

Israel's economic growth is generally export-driven. The weak global economy

caused a 3.1 percent decline in exports of goods and services in 2015, after a 1.5 percent increase in 2014. Imports rose 0.6 percent last year, down 3 percent from 2014, so that, overall, Israel's foreign trade sector, normally a growth engine, was a growth retardant in 2015. Economic growth would have been low or zero had it not been for a surge of consumer spending.

The total value of home loans (mortgages) is now about NIS 300b. (\$78b.) and the Bank of Israel is worried about the banks' health in case a recession or sharp drop in housing prices brings mortgage default and bank losses, as happened in the US.

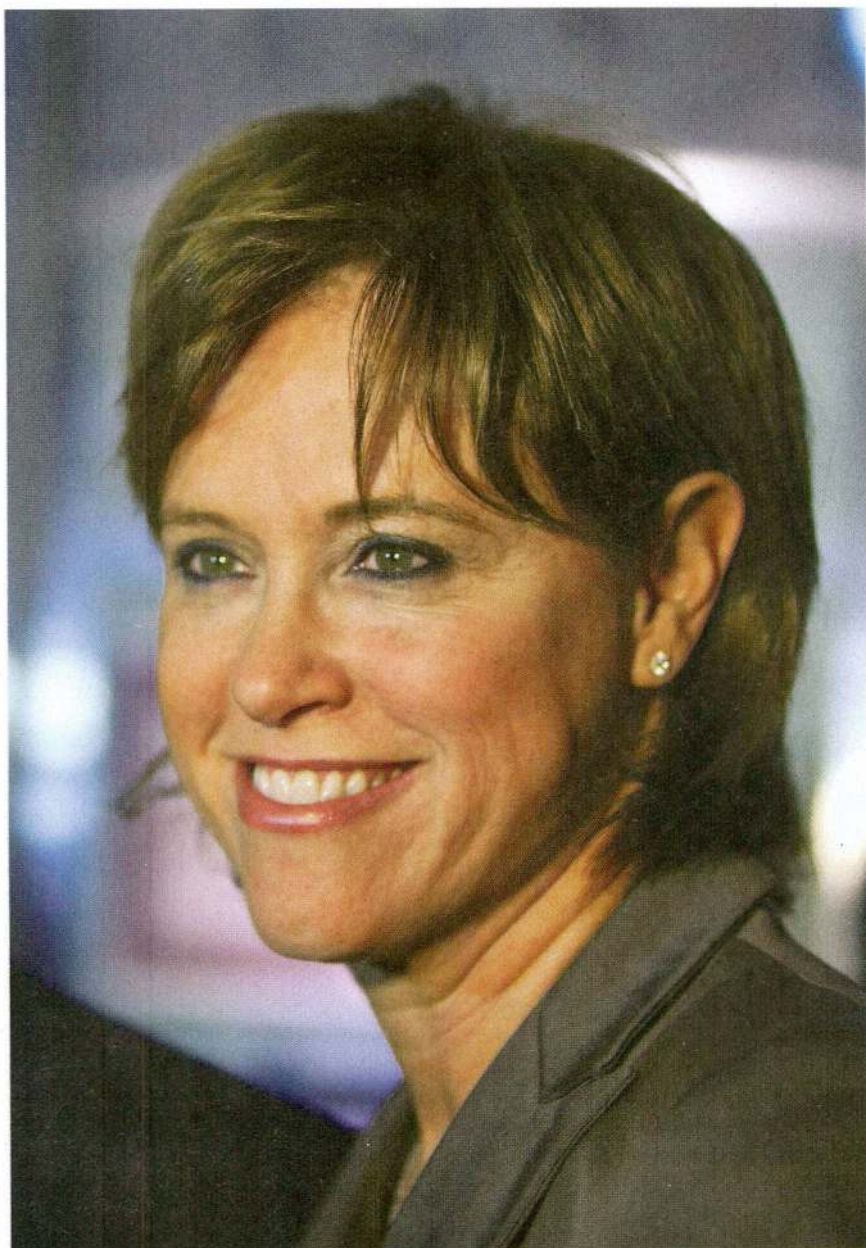
Competition? Or stability? Let us hope

Daily wage of 22,192 shekels:
Leumi CEO Rakefet Russak-Aminoach

our policy makers, led by Kahlon and Flug, resolve this key issue in a prudent and pragmatic manner. We need both competition *and* stability – there must be a way.

Postscript: On March 16, the Knesset voted to limit the pay of top executives in banks and insurance companies to a maximum of NIS 2.5m. shekels (\$650,000) annually. ■

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