

## Misconduct Costs of Banks — The Meaning Behind the Figures

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*The article deals with misconduct costs of banks, namely, the variety of costs incurred by the banks due to their failure to observe the legal and regulatory requirements imposed on them. In recent years, there has been a dramatic increase in misconduct costs of banks all over the world. Following the Global Financial Crisis of 2007-2009, the banking sector has experienced unparalleled regulatory fines and court rulings that have raised growing concerns regarding the banks' behaviour. Misconduct costs have become a serious concern for regulators, not merely in relation to the conduct of the banks per se — which reflects their ethical level; but also in relation to their capital adequacy — due to the huge amounts involved.*

*Our article is based on empirical research that examined misconduct costs of banks over a period of five years, and analyzed them against the regulatory and legal framework in which these banks operated. Our case study focused on the Israeli banking system, which is relatively small and concentrated. These idiosyncrasies enabled us to almost cover the whole sector (94%) and conduct an industry-wide analysis. The findings of the research indicate that the banks' misconduct costs are a case-specific issue, rather than a reflection of a general trend of the entire system. In addition, the lack of transparency of these costs was recognized as one of the main hindrances for transforming the banks' misconduct costs into an effective regulatory tool, aimed at improving the banks' behaviour and ethics. The conclusions and recommendations contained in the article are highly applicable to other jurisdictions, as well.*

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*Le présent article traite des divers coûts engagés par les banques en raison du bris par ces dernières d'exigences d'ordre légal et réglementaire. Au cours des dernières années, les coûts liés à l'inconduite des banques ont augmenté de façon drastique dans le monde entier. Suite à la crise financière mondiale de 2007-2009, une quantité sans précédent d'amendes réglementaires et de décisions judiciaires ont été rendues dans le secteur bancaire, ce qui a contribué à faire croître de façon notable les inquiétudes relativement au comportement adopté par les institutions bancaires. En effet, les coûts liés à leur inconduite sont devenus une grande source de préoccupations pour les autorités de réglementation, non seulement parce qu'ils*

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reflètent des comportements malhonnêtes de la part de banques, mais également parce que les montants faramineux impliqués ont fait naître des craintes liées à la suffisance des capitaux de celles-ci.

Cet article se fonde sur des recherches empiriques dans le cadre desquelles les coûts liés à l'inconduite des banques ont été examinés sur une période de cinq ans et analysés en fonction du cadre réglementaire et légal dans lequel évoluait chacune des banques concernées. L'étude de cas dont il fait état se concentre sur le système bancaire israélien en raison de sa grande concentration et de sa petite taille; ceci a permis de couvrir la quasi-totalité du secteur (soit 94 %) et d'effectuer une analyse à l'échelle de l'ensemble de celui-ci. Les résultats de la recherche indiquent que les coûts liés à l'inconduite des banques doivent s'analyser cas par cas et ne peuvent mener au constat d'une tendance généralisée dans le système. De plus, le manque de transparence relativement aux coûts engagés s'avère un des principaux obstacles à l'élaboration d'outils réglementaires tenant compte de ces coûts dont le but serait d'améliorer le comportement et l'éthique des banques. Les conclusions et les recommandations formulées dans le présent article ne sont pas limitées au système bancaire israélien, mais trouvent également application dans plusieurs autres juridictions.

## 1. INTRODUCTION

In recent years, there has been a dramatic increase in “misconduct costs” of banks all over the world. An international research reveals that in the period of 2009-2013, ten of the world's leading banks accrued fines and costs of almost £160 billion.<sup>1</sup> Results for the 20 major banks show an accelerated increase of their misconduct costs: from £205.84 billion in the period of 2009-2013, to £242.42 billion in the period of 2010-2014, and up to £252.25 billion in the period of 2011-2015.<sup>2</sup>

Following the Global Financial Crisis of 2007-2009, the banking sector around the world has experienced unparalleled regulatory fines and court rulings that have raised growing concern about banks' behaviour.<sup>3</sup> The Global Financial Crisis and the measures introduced to minimize its effects on the broader economy have brought to the fore discussions on a range of contentious policy issues, addressing the philosophy of regulation and the role of the state versus the role of markets in achieving desirable outcomes.<sup>4</sup> Against this backdrop, the

<sup>1</sup> “About Us” *Conduct Costs Project*, online: CCP Research Foundation <<http://conductcosts.cpresearchfoundation.com/about>> .

<sup>2</sup> “Conduct Cost Results” *Conduct Costs Project*, online: CCP Research Foundation <<http://conductcosts.cpresearchfoundation.com/conduct-costs-results>> .

<sup>3</sup> Taku Dzimwasha, “20 Global Banks Have Paid \$235bn in Fines since the 2008 Financial Crisis” *International Business Times* (24 May 2015), online: <<http://www.ibtimes.co.uk/20-global-banks-have-paid-235bn-fines-since-2008-financial-crisis-1502794#>> .

<sup>4</sup> Robert Baldwin, Martin Cave & Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice*, 2d ed. (Oxford: Oxford University Press, 2012) at 2-3 [Baldwin, Cave & Lodge].

concept of misconduct costs as a legal, regulatory and policy tool deserves a comprehensive analysis.

The goal of this article is to provide several insights into the meaning behind the figures of the banks' misconduct costs, as well as to the future role of these costs. In addition, the article will propose several policy recommendations for transforming the banks' misconduct costs into an effective and improved regulatory tool, aimed at improving the banks' behaviour.

"Banks' Misconduct Costs" is a catch-all term for a variety of costs that are generated by conduct that failed to observe the legal and regulatory requirements imposed on banks.<sup>5</sup> Many questions are raised regarding banks' misconduct costs, and in particular — regarding financial sanctions imposed by regulators, their level and their composition. For example: Are the costs representing a fair reflection of the bank's wrongdoing? Are they effective? Should they operate at the criminal level or at the civil level?

Beyond compliance and the formal duty to follow the law and the regulatory provisions, misconduct costs are directly connected to the question of how safe the banks and the banking system are. The level of misconduct costs directly affects the profitability of banks and, in certain cases, may even endanger their stability. As a result, misconduct costs have become a serious concern for regulators, not merely in relation to the conduct of the banks per se, but also in relation to capital adequacy.

Misconduct costs are also directly connected to the ongoing debate as to how ethical the behaviour of banks is. Misconduct costs reflect unsatisfactory levels of behaviour, not only as a breach of legal and regulatory provisions, but also — and not less important — of ethical norms of behaviour. Can we trust banks with our money? Banks rely on public trust. While trust takes years to establish, it can be lost in one moment, due to a failure caused by the implementation of questionable ethics, values or behaviour. Banks keep telling us that they want to restore public trust. They also tell us that they are determined to improve their culture, be more ethical in their behaviour and adopt a more sustainable business model as part of their social responsibility. Facing these declarations, misconduct costs serve as a useful and efficient tool for assessing a bank's ethical standards and culture.

Misconduct costs are one of the most important tools for evaluating bank's behaviour. They design the bank's style of management, affect its relationships with various stakeholders, and, inevitably, help shape its reputation. The amounts, types and dates of a bank's misconduct costs may provide us with valuable information about how this bank behaved in a given period. Moreover, misconduct costs can give us a picture, not only of a specific bank, but of the entire banking sector in a country, and — based on international analyses — even of the global banking system. An analysis over a period of a few years may

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<sup>5</sup> See the exact definition in section 2 below.

give us an indication on whether banks are improving or not, emphasizing the importance of a comprehensive analysis of the banks' misconduct costs.

The transparency of misconduct costs is also an important issue: Should banks disclose their misconduct costs to the public? Should this information be included in the banks' financial reports or sustainability reports? The disclosure of misconduct costs is essential for the purpose of equipping the public with information on key public policy issues: How well-behaved are our banks? However, while some of the misconduct costs are publicly published and easy to detect, other costs are less transparent and are much more difficult to follow. Even when misconduct costs are apparently disclosed to the public, some of the costs tend to remain tucked away in obscure parts of lengthy accounts, while others are included in categories of general expenses and bear general terms. Disappointedly, we will usually not find the data presented coherently in the banks' financial or sustainability reports. As a result, it is almost impossible to obtain the full and accurate picture of the total misconduct costs of banks.

This article is based on empirical evidence that was collected in Israel as part of the "Conduct Costs Project", initiated by the London School of Economics and headed by Prof. Roger McCormick.<sup>6</sup> The project collected and analyzed the misconduct costs incurred by the leading global international banks, as well as some major national banks, in the UK, US, France, Portugal, Australia and Israel since 2008.

The authors of this article constitute the Israeli research team. Our research focuses on the misconduct costs of the five leading Israeli banks during the period of 2009-2013. It analyzes their misconduct costs against the background of the regulatory and legal frameworks in which the Israeli banking system operates, and offers an innovative look at the figures and their meaning.

The structure of this article is as follows: section 2 focuses on the concept of misconduct costs by defining and explaining its meaning. Section 3 presents the Israeli banking system, its unique structure and characteristics. In addition, it provides a general overview of the Israeli regulatory and judicial entities, which are authorized to impose financial sanctions on banks. The next two sections focus on our research regarding banks' misconduct costs in Israel: section 4

<sup>6</sup> The Conduct Costs Project is an Associated Research Project of the CCP Research Foundation — Conduct, Culture, People. It is "inherited" from the work which was carried out at the London School of Economics (LSE) Conduct Costs Project and continues and expands that work. The LSE Conduct Costs Project created a proprietary dataset evidencing (based on publicly available information) the financial consequences of misconduct of banks. The Conduct Costs Project involves the calculation, compilation and analysis of banks' conduct costs with a view of making comparative assessments of bank's performance on cultural and ethical issues. Furthermore, beyond this "cultural" indicator are risk management benefits from this data. When leveraged with banks' internal metrics, the comparative nature of the Project's data presents the opportunity to defend a bank's risk profile, its conduct risk management, culture and, potentially, its regulatory capital requirements. See: "Conduct Costs Report 2015", CCP Research Foundation, at 3, online: CCP Research Foundation <<http://ccpresearch-foundation.com/noticeboard?item=30635-conduct-costs-report-2015>> .

explains the methods of research and the empirical findings, while section 5 analyzes the empirical data collected. Finally, section 6 concludes our analysis and presents recommendations. Although our research focuses on the Israeli banking system, its lessons are highly applicable to many other jurisdictions and banking systems.

## 2. WHAT ARE MISCONDUCT COSTS?

The term “misconduct costs” is a rather illusive term. It has neither an exact definition nor a binding or closed list of costs that are included in it. Generally speaking, the term “misconduct” means any infringement of a legislative, administrative or regulatory provision and the term “misconduct costs” embraces all the costs and expenses paid out or borne as a direct result of misconduct.

For the purposes of this article, the term “misconduct costs” embraces all the costs borne by a bank in connection with any of the following:<sup>7</sup>

1. Regulatory proceedings, specifically (but not exhaustively):
  - a. Fines or comparable financial penalties imposed on the bank by any regulator;
  - b. Any sum paid to a regulator or at the direction of a regulator in settlement of proceedings of any kind;
  - c. Any sum paid to, or set aside to be paid to, any third party or parties to the extent required by any regulator; and
  - d. Any sum paid, or set aside, for the purchase (or exchange) of securities or other assets to the extent required by a regulator and (if such information is available) to the extent that such sum exceeds the open market value of such securities or other assets as at the date of purchase.
2. Any costs, losses or expenses which are directly related to an event or series of events or conduct or behaviour of the bank or a group of individuals employed by the bank, for which any fine or comparable penalty has been imposed, or any censure issued by a regulator.
3. Any sum that has become payable as a result of, or in connection with, any breach of any code of conduct or similar document entered into, or committed to, at the request of, or required to be entered into or committed to by, any regulator or any public, trade or professional body.

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<sup>7</sup> We adhered to the definition of the Conduct Costs Project. See: “Conduct Costs Definition”, online: CCP Research Foundation <<http://conductcosts.cpresearchfoundation.com/conduct-costs-definition>> .

4. Any loss of income or other financial loss attributable to a requirement imposed by a regulator to place money on deposit with a central bank or other institution at below the market rate of interest, being a requirement imposed in connection with a breach of law or regulatory requirement.
5. Any sum paid in connection with any litigation (whether ordered to be paid by a court or tribunal or in settlement of proceedings) where the litigation involved allegations of material wrongdoing or misconduct by senior officers or employees of an institution which were not refuted.
6. Any other sum, cost or expense, not falling within any of the sections above, that was paid pursuant to an order or requirement of a regulator and which is a result of any breach of any regulatory requirement or law.

It should be noted that the above list includes not only “obvious” misconduct costs, such as fines, financial sanctions, or any payment, compensation or expense imposed by any regulatory or judicial authority, but also includes significant losses incurred to banks due to severe misbehaviour of any of its employees, managers or directors, or due to inadequate risk management that led to improper conduct. Misconduct costs also include costs of remediation programs designed to correct the misconduct, legal expenses, fees for other professional services provided to banks in relation to their misconduct, etc.

From the above taxonomy, we conclude that misconduct costs stem from two sources: a regulatory source and a public source. The regulatory source is a set of regulatory enforcement tools and measurements taken by regulators in order to enforce binding norms on supervised banks.<sup>8</sup> The public source, on the other hand, is based on public initiatives such as individual complaints to the bank’s ombudsperson or to the regulator, lawsuits against banks, and class actions. In other words, misconduct costs represent two different types of enforcement: regulatory enforcement and public enforcement.

Misconduct costs that stem from regulatory enforcement are an essential element in “command and control” regulation. The essence of a “command and control” regulation is the imposition of strict rules of conduct on the activity of the supervised institutions, which is usually carried out by issuing binding directives, accompanied by the threat of applying various kinds of sanctions in cases of breach of rules. Under this regulatory approach, the regulator takes a clear stand both in designing the norms of behaviour and in determining and imposing penalties for their violation. The regulator commands the industry to meet specific standards and controls its behaviour through the threat of various sanctions.<sup>9</sup>

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<sup>8</sup> Neil Gunningham, “Enforcement and Compliance Strategies”, in Robert Baldwin, Martin Cave and Martin Lodge, eds., *The Oxford Handbook of Regulation* (Oxford: Oxford University Press, 2010) 120 at 152.

<sup>9</sup> Baldwin, Cave & Lodge, *supra* note 4 at 106-107. For the weaknesses of this system, see:

Regulatory misconduct costs are also a major element in other techniques of regulation such as “mandatory self-regulation”.<sup>10</sup> Under this regulatory method, the regulatory function of standard-setting is performed by the supervised firms themselves, following a demand by the regulator and subject to his supervision. The regulator usually makes do with determining the general framework or the objectives of the desired norms, and instructing the supervised institutions to pour contents to these norms according to their own discretion (or, sometimes, subject to several basic restrictions). The regulator sets the principles while the supervised institutions define the rules and the decision-making procedures. Nevertheless, the regulator supervises the implementation of the self-determined norms, and has the power to impose sanctions in the event of a breach. In other words, while the supervised institutions have full control over the very existence of the rules and the design of their contents, the enforcement thereof — including the power to impose financial sanctions — is still the prerogative of the regulator.<sup>11</sup>

In contrast, it is doubtful whether regulatory misconduct costs could serve as an enforcement tool in voluntary self-regulation, as it is based on the goodwill of the supervised institutions and on the absence of intervention or supervision by the regulator (although it is sometimes conducted in coordination with, or with the facilitation of, the regulator). Under voluntary self-regulation, the supervised institutions volunteer to perform regulatory functions by themselves. The supervised institutions have full control over the very existence of the rules, the design of their contents, and the enforcement thereof. The emphasis is on gaining a moral commitment, and on using information, education, technology sharing, and perhaps peer group pressure, as means of enforcement. Strong self-

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Christine Parker, *The Open Corporation: Effective Self-Regulation and Democracy* (Cambridge: Cambridge University Press, 2002) at 8-12; Baldwin, Cave & Lodge, *supra* note 4 at 107-111.

<sup>10</sup> Mandatory self-regulation is sometimes recognized by other names. See, for example: Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992) who coined the term “enforced self-regulation” [Ayres & Braithwaite]. Other scholars include it in the category of co-regulation. See for example: Ian Bartle & Peter Vass, “Self-Regulation and the Regulatory State: A Survey of Policy and Practice” Research Report 17, Center for the Studies of Regulated Industries, University of Bath, (2005) 19-30, online: <[http://www.bath.ac.uk/management/cri/pubpdf/Research\\_Reports/17\\_Bartle\\_Vass.pdf](http://www.bath.ac.uk/management/cri/pubpdf/Research_Reports/17_Bartle_Vass.pdf)> [Bartle & Vass]; Linda Senden, “Soft Law, Self-Regulation and Co-Regulation in European Law: Where Do They Meet?”, (2005) 9:1 *Electronic Journal of Comparative Law*.

<sup>11</sup> This model characterizes a large number of the Proper Conduct of Banking Business Directives of the Israeli Supervisor of Banks, in the different areas that they relate to. The various directives require each bank to determine for itself a “framework of action”, “policy”, “internal procedures”, “written document”, etc., in line with the Supervisor’s basic requirements as set out in the directive. For elaboration, see: Ruth Plato-Shinar, *Banking Regulation in Israel: Prudential Regulation versus Consumer Protection* (The Netherlands: Wolters Kluwer, 2016) at 76-77 [Plato-Shinar, “Regulation in Israel”].

enforcement is rare.<sup>12</sup> The absence of compulsion, formal enforcement and sanctioning in this regulatory approach are exactly the elements that render self-regulation such an attractive alternative, from an industry perspective, to more interventionist forms of government regulation. Simultaneously, these elements are exactly the elements that render the imposition of misconduct costs unsuitable for self-regulation.

Regulatory agencies have considerable administrative discretion with enforcement tasks. They can deploy two very different enforcement styles or strategies: “deterrence strategy” and “advise and persuade strategy”.<sup>13</sup> Deterrence strategy constitutes a confrontational style of enforcement and emphasizes the role of sanctioning in cases of rule-breaking behaviour. In contrast, an “advise and persuade” or “compliance” strategy emphasizes cooperation between the regulator and the supervised institutions, rather than confrontation, and conciliation, rather than coercion. The regulator and the supervised institution work together in order to mitigate and resolve rule-breaking situations.<sup>14</sup> While misconduct costs are less suitable for the “advise and persuade strategy”, they do play an important role in the deterrence strategy, serving not only to sanction past violations, but also for deterring against future violations.

### 3. THE ISRAELI BANKING SYSTEM

#### (a) The Structure of the Banking System<sup>15</sup>

The banking system in Israel consists of five major banking groups,<sup>16</sup> in addition to three small banks,<sup>17</sup> all of which are public companies whose shares

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<sup>12</sup> On self-regulation in general, see: Bartle & Vass, *supra* note 10 at 19 (“pure self-regulation”); Baldwin, Cave & Lodge, *supra* note 4 at 137-164. A complicated question, which extends beyond the scope of this article, is whether provisions of voluntary self-regulation, such as codes of ethic, generate a cause of actions for customers and individuals who suffered damage from the breach by a bank, thus imposing compensation and other misconduct costs on the bank.

<sup>13</sup> Baldwin, Cave & Lodge, *supra* note 4 at 120-152.

<sup>14</sup> See Keith Hawkins, *Environment and Enforcement: Regulation and the Social Definition of Pollution* (Oxford: Oxford University Press, 1984); Bridget M. Hutter, *Compliance: Regulation and Environment*, (Oxford: Clarendon Press, 1997).

<sup>15</sup> Bank of Israel: Banking Supervision Department: Israel’s Banking System — Annual Survey 2015, at 7-18 (31 August 2016), online: Bank of Israel <<http://www.boi.org.il/en/NewsAndPublications/RegularPublications/Pages/skira15.aspx>> [Israel’s Banking System 2015].

<sup>16</sup> These groups are: Hapoalim (headed by Bank Hapoalim Ltd.), Leumi (headed by Bank Leumi Le-Israel Ltd.), Discount (headed by Israel Discount Bank Ltd.), Mizrahi Tefahot (headed by Mizrahi Tefahot Bank Ltd.), and First International (headed by The First International Bank of Israel Ltd.).

<sup>17</sup> These banks are Union Bank Ltd., Bank of Jerusalem Ltd., and Dexia Israel Bank Ltd.



are traded in the Tel-Aviv Stock Exchange. Apart from the Israeli banks, four foreign banks operate in Israel, with one branch each.<sup>18</sup> The activities of these foreign banks are extremely limited, both in absolute terms as well as in relation to their total assets.

The Israeli banks provide a wide range of financial services, including corporate and commercial banking, retail banking, housing loans and credit card services. In addition, they are active in the capital market and engage in securities trading, both on behalf of customers and for their own portfolios (*nostro*). They also provide pension and investment advice services.<sup>19</sup> The law prohibits the banks from managing provident funds, pension funds and mutual funds, and from holding companies that engage in such activities.<sup>20</sup> The law also prohibits the banks from engaging in insurance activities,<sup>21</sup> from controlling insurance companies and insurance agencies,<sup>22</sup> and limits holdings in an insurance company which constitutes “a significant financial institution”.<sup>23</sup> A very new law introduced in January 2017 compels the banks to sell the credit card companies under their control.<sup>24</sup>

The large Israeli banks are also active abroad through branches and subsidiaries. However, this activity has not succeeded in creating significant and stable profit centers for the banks, despite their widespread deployment abroad and the notable investment made in this activity. The attempts by Israeli banks to penetrate foreign markets have not been particularly successful and the proportion of assets of their overseas offices in relation to the total banking system’s assets has gradually declined.

Israel successfully survived the 2007-2009 Global Financial Crisis without significant damage to its economy and financial system. The financial institutions — including the banks — displayed resilience, maintained their stability, and none of the institutions collapsed. The economy experienced a short crisis, but the damage was relatively mild compared to other developed countries.<sup>25</sup>

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<sup>18</sup> These banks are Citibank N.A., HSBS Bank plc, Barclays Bank plc, and State Bank of India.

<sup>19</sup> The permissible areas of activity for banks are determined by the Banking (Licensing) Law, 5741-1981, s. 10 [Banking (Licensing) Law].

<sup>20</sup> Banking (Licensing) Law, *supra* note 19 at ss. 10, 11. This is the result of the Capital Market Reform of 2005. On this reform see Plato-Shinar, “Regulation in Israel”, *supra* note 11 at 23-24.

<sup>21</sup> Banking (Licensing) Law, *supra* note 19 at s. 10.

<sup>22</sup> *Ibid*, at s. 11. However, banks are allowed to have control in insurance agencies that only market property insurance and life insurance as incidental services to the provision of housing loans by the bank. See *ibid*, at s.11(b)(2).

<sup>23</sup> Banking (Licensing) Law, *supra* note 19, at s. 24(a).

<sup>24</sup> Law to Enhance Competition and to Reduce Concentration in the Israeli Banking Sector (Legislative Amendments), 5777-2017.

<sup>25</sup> Kobi Braude, Zviya Erdman & Merav Shemesh, “Israel and the Global Crisis 2007-09”

One of the characteristics of the Israeli banking system is its high level of concentration. As mentioned above, the Israeli banking system is dominated by five large banking groups, whose assets value amounts to almost 94% of the total assets of the system. Approximately 58% of the assets are held by the two largest groups — Bank Leumi and Bank Hapoalim.<sup>26</sup> This centralized structure constitutes an oligopoly (or more accurately — a duopoly) where a small number of companies control the vast majority of the activities in the sector.

The concentration in the Israeli banking system is rather high. In 2015, the Herfindahl-Hirschman Index (HHI index), which measures the concentration in the system as a whole, and is calculated according to the total assets of the banks, was 0.22. The Concentration Ratio (CR<sub>2</sub>), which measures the market share of the two largest banks within the system's total assets, amounted to 0.58. An international comparison shows that the concentration in the Israeli banking system is significantly higher than the EU average.<sup>27</sup>

Another characteristic of the Israeli banking system is the low level of competition between the banks. This observation mainly rests on the Structure Conduct Performance (SCP) Paradigm, according to which the greater the level of concentration in the system, the greater is the market power of its players, and the lower is the level of competition.<sup>28</sup> A low level of competition was also found according to the Contestable Market Theory. According to this theory, competition can exist, even in a concentrated market, under the condition of a real threat of competition, pressurizing the existing players to behave competitively. Such a threat does not exist in the Israeli banking system.<sup>29</sup> Finally, the Pazar-Rosse H-Statistic value for the Israeli banking system in

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(September 2011), online: Bank of Israel < [http://www.bankisrael.gov.il/deptdata/mehkar/crisis/crisis\\_2007\\_2009\\_eng.pdf](http://www.bankisrael.gov.il/deptdata/mehkar/crisis/crisis_2007_2009_eng.pdf) > .

<sup>26</sup> Israel's Banking System 2015, *supra* note 15 at 8.

<sup>27</sup> *Ibid.*, at 17.

<sup>28</sup> See, for example: "Report of the Team to Examine Increasing Competitiveness in the Banking System" (March 2013), online: Bank of Israel < <http://www.boi.org.il/en/BankingSupervision/Survey/Pages/competition.aspx> > . The Committee to Enhance Competitiveness in Common Banking and Financial Services, "Background Survey for the Interim Report: The Situation of Competition in the Target Sectors and the Required Measures" (2016) available in Hebrew, online: Ministry of Finance < <http://mof.gov.il/Committees/competitivenessCommittee2015/MidReport2.pdf> > [Enhance Competitiveness]. Bank of Israel, "Examination of the Prices of the Banking Services — Recommendations of the Work Teams" (January 2007), available in Hebrew, online: Bank of Israel < [http://www.boi.org.il/he/Research/Pages/neumim\\_neum226h.aspx](http://www.boi.org.il/he/Research/Pages/neumim_neum226h.aspx) > [Recommendations].

<sup>29</sup> David Rotenberg, "The Competitiveness in the Banking Sector: Theoretical Aspects and Empirical Evidence from Israel and Abroad", Banking Supervision Department Research Unit, Working Paper (2002), available in Hebrew, online: Bank of Israel < [http://www.boi.org.il/he/Research/Pages/papers\\_dp0502h.aspx](http://www.boi.org.il/he/Research/Pages/papers_dp0502h.aspx) > ; Enhance Competitiveness, *supra* note 28 at 8-13 (in respect of retail credit); Recommendations, *supra* note 28, at 6-12.

various years, was found to be lower in comparison to other western countries, indicating a lower level of competition.<sup>30</sup>

In light of the concentration of the Israeli banking system and the lack of competition between its members, the costs of misconduct receive special importance, being a means to curb the banks' enormous clout and ensure that the banks do not abuse their power to the detriment of their customers.

### (b) The Banks' Supervisory Entities

As mentioned, this empirical research refers to various Israeli regulatory and judicial entities, which imposed fines and other misconduct costs on Israeli banks during the period of 2009-2013. Hereinafter is a short introduction to the relevant regulatory agencies and their power to impose misconduct costs.

#### (i) The Supervisor of Banks

The main regulator in charge of the banking system is the Supervisor of Banks (the "Supervisor of Banks") at the Bank of Israel, which is the central bank of Israel.<sup>31</sup> The Supervisor of Banks heads the Banking Supervision Department and is appointed by the Governor of the Bank of Israel.<sup>32</sup>

The mandate of the Banking Supervision Department (the "Department") is based on several laws.<sup>33</sup> However, the Department's regulatory goals were not determined by the law. Rather, they are defined by the Department itself, according to its own definition of its role, which could be found in its annual reports.<sup>34</sup> Its roles include maintaining the banking system's financial stability ("prudential regulation"), consumer protection, and promoting competition.<sup>35</sup>

One of the most important enforcement tools available to the Supervisor of Banks is the civil-administrative financial sanction. Financial sanction involves a payment to the State coffers of sums that could amount to millions of Israeli Shekels (ILS). There is a long list of breaches that can lead the Supervisor of

<sup>30</sup> Enhance Competitiveness, *supra* note 28 at 8-9; Recommendations, *supra* note 28, at 8-9. The Parliamentary Inquiry Committee on Bank Fees: Final Report 16-17 (June 2007), available in Hebrew, online: Knesset <[http://www.knesset.gov.il/committees/heb/docs/bank\\_inq.pdf](http://www.knesset.gov.il/committees/heb/docs/bank_inq.pdf)>.

<sup>31</sup> For elaboration on the Bank of Israel see: Daniel Maman & Zeev Rosenhek, *The Israel Central Bank: Political Economy, Global Logics and Local Actors* (London: Routledge, 2011).

<sup>32</sup> *The Banking Ordinance*, 1941, s. 5 [Banking Ordinance].

<sup>33</sup> The main laws are: Banking Ordinance, *supra* note 32; Banking (Licensing) Law, *supra* note 19; the *Banking (Service to Customer) Law*, 5741-1981 [Banking (Service to Customer) Law]. Additional laws confer authority upon the Supervisor in specific areas, such as: *Prohibition on Money Laundering Law*, 5760-2000 [Prohibition on Money Laundering]; *Cheques without Cover Law*, 5741-1981; *Sales (Apartments) (Assurance of Purchasers of Apartments) Law*, 5735-1974, that applies to construction loans.

<sup>34</sup> Avi Ben-Bassat, *Regulation of the Capital Market* (The Israel Democracy Institute: 2007) 24, in Hebrew.

<sup>35</sup> See, for example, the Israel's Banking System 2015, *supra* note 15 at 105-108.

Banks to impose financial sanctions on a bank,<sup>36</sup> including a breach of Proper Conduct of the Banking Business Directive promulgated by the Supervisor of Banks; failure to correct a deficiency in accordance with the Supervisor's instructions; a breach of a directive, rule or decree issued by the Governor of the Bank of Israel, or; a breach of certain provisions of laws.

Before the imposition of a sanction, the bank is afforded a hearing opportunity to voice its arguments. However, the Supervisor is ultimately the one who decides on the matter. The Supervisor's decision to impose a financial sanction is appealable to the Magistrates Court. Such an appeal, as far as we could determine, has never been filed.

If a breach of the provisions of the Bank of Israel Law is established, the authority to impose the financial sanction rests with the Governor of the Bank of Israel.<sup>37</sup> In addition to imposing a financial sanction on the bank itself, the Governor is also authorized to impose a financial sanction on the CEO of a bank who failed to monitor or take all reasonable measures to prevent a breach.<sup>38</sup>

The Supervisor of Banks also holds the authority to impose a "civil fine".<sup>39</sup> In practical terms, there is no difference between a financial sanction and a civil fine. Both cases involve a payment of a substantial amount of money to the State's coffers, without a criminal conviction. Originally, the intention was that financial sanctions would be used against a breach of directives that do not constitute a criminal offense, while civil fines would be used against violations that also constitute a criminal offense.<sup>40</sup> Therefore, it was prescribed that payment of a civil fine would not detract from a person's criminal responsibility for the violation.<sup>41</sup>

Additional powers were conferred to the Supervisor of Banks in cases where a bank has committed a criminal offense pursuant to the Banking (Service to

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<sup>36</sup> Banking Ordinance, *supra* note 32 at s. 14H; Banking (Service to Customer) Law, *supra* note 33 at s. 11A; Prohibition on Money Laundering, *supra* note 33 at c. E, where the sanction is imposed by a committee headed by the Supervisor ("the Sanctions Committee"). The same applies under the *Prohibition on Terror Financing Law*, s. 48(e); *Sale (Apartments) (Assurance of Investments of Purchasers of Apartments) Law*, 5735-1974, s. 4B(b) that applies to Construction Loans. It should be noted that a financial sanction can be imposed on the banks by other regulators as well, in their domain of supervision. One example is the Israel Antitrust Authority, by virtue of chapter G1 to the *Restrictive Trade Practices Law*, 5748-1988. Another example is the Israel Security Authority, under the *Securities Law*, Chapter H3, or under the *Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law*, 5755-1995 c. G1 or s. 38H [Regulation of Investment Advice Law].

<sup>37</sup> *Bank of Israel Law*, 5770-2010, s. 58.

<sup>38</sup> *Ibid.*, s. 70.

<sup>39</sup> Banking (Licensing) Law, *supra* note 19 at s.50B.

<sup>40</sup> See the explanatory notes to s. 2(12) of the Bill to Encourage Competition and to Reduce Concentration and Conflicts of Interest in Israel's Capital Market (Legislative Amendments), 5765-2005, Bills 690, 697.

<sup>41</sup> Banking (Licensing) Law, *supra* note 19 at s. 50B(e).

Customer) Law, 5741-1981. The Supervisor of Banks may, with the approval of the Attorney General, obtain a written undertaking from the bank that it will refrain from certain acts or omissions that constituted the offense, compensate the customer, cancel any related transaction that is the subject of the offense, or even publish this matter to the public. Criminal proceedings will not be instituted against a bank that made such an undertaking, and subject to the decision of the Attorney General, such proceedings will not be instituted against an officer or employee of the bank.<sup>42</sup>

Lastly, the Banking (Licensing) Law, 5741-1981 empowers the Governor of the Bank of Israel, after consulting with the Licenses Committee, to cancel a bank license in certain cases, including when a bank violates a legislative provision in a manner that prejudiced its reliability; or when public welfare justifies such an act.

(ii) *The Capital Market, Insurance and Savings Authority*

In 2005, the Israeli banks received permission to engage in pension advice.<sup>43</sup> In this area of activity, the banks are subject to the supervision of the Capital Market, Insurance and Savings Authority (the “Authority”), which was originally part of the Ministry of Finance. In November 2016, it was transformed into a separate and independent statutory agency.<sup>44</sup> The Authority’s mandate and powers vis-à-vis the pension advice activity of the banks are promulgated in the Control of Financial Services (Pension Consulting, Marketing and Clearing) Law, 5775-2005.

Three important means of enforcement are at the disposal of the Commissioner to be used against a bank when a breach in pension advice occurs. The first is the imposition of civil financial sanctions of up to ILS 150,000 (or higher sums in cases of recurring or persistent breaches),<sup>45</sup> a much lower ceiling proportional to the authority of the Supervisor of Banks. This sanction could be imposed on a bank due to a breach of a Directive promulgated by the Commissioner, a breach of conditions included in its Pension Advisor License, a breach of regulations issued by the Minister of Finance, or a breach of certain provisions of the law. The process to impose a financial sanction is similar to that imposed by the Supervisor of Banks. Before the imposition of a fine takes place, the bank is afforded a hearing opportunity to voice its arguments. Eventually, the Commissioner is the one to decide on the matter. The Commissioner’s decision to impose a financial sanction is appealable to the Magistrates Court.

The second means of enforcement is a civil fine,<sup>46</sup> which may be deployed in cases of a breach that constitutes a criminal offense.

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<sup>42</sup> Banking (Service to Customer) Law, *supra* note 33 at s. 12.

<sup>43</sup> Banking (Licensing) Law, *supra* note 19 at s. 10.

<sup>44</sup> *Supervision over Financial Services (Legislative Amendments) Law*, 5776-2016.

<sup>45</sup> *Control of Financial Services (Pension Counselling, Marketing and Clearing) Law*, 5775-2005, s. 32.

The third means of enforcement is cancellation of the bank's Pension Advisor Licence, its suspension or its modification. This enforcement method can be used in a wide range of cases, including when a bank violates a legislative or administrative provision in a manner that reflects on its credibility or professionalism, or when the Commissioner is of the opinion that the licensee is unfit to hold a license, having taken into account the requirements of the profession, and if it is a body corporate, that there are aforesaid circumstances in respect of one of its officers or of a person that controls it.<sup>47</sup>

(iii) *Israel Securities Authority*

The Israeli Securities Authority (the "Securities Authority") is the regulator in charge of supervising the securities market. It is a statutory independent authority, whose goal is "to protect the interests of the investors in securities".<sup>48</sup>

As to the banking sector, the Securities Authority's mandate and powers are promulgated in the Securities Law, 5728-1968, and in the Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law, 5755-1995 (the "Regulation of Investment Advice Law"). The Securities Law applies to banks by virtue of their being public companies whose securities are traded on the Tel-Aviv Stock Exchange. Some of its provisions may also be relevant to the brokerage activity of the banks, such as the chapter on inside trading,<sup>49</sup> or the section on fraud in connection with securities,<sup>50</sup> although these issues usually involve the bank's employees rather than the bank itself. The Regulation of Investment Advice Law covers the banks' activities in the field of investment counselling, which is one of the main fields in the banking business.

The abovementioned laws include three courses of enforcement and sanctioning: criminal proceedings that take place in court; administrative proceedings before the Administrative Enforcement Committee; and, the imposition of a civil monetary sanction by the Securities Authority.

As a principle, violation of securities laws may constitute a criminal offence and involve criminal legal proceedings in court.<sup>51</sup> However, in cases where the violation was committed by negligence,<sup>52</sup> the Chairman of the Securities Authority has the authority to launch administrative enforcement proceedings in lieu of criminal proceedings.<sup>53</sup> If a negligent violation is indeed proven, the

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<sup>46</sup> *Ibid.*, s. 34.

<sup>47</sup> *Ibid.*, s. 10.

<sup>48</sup> *Securities Law*, 5728-1968, s. 2 [Securities Law].

<sup>49</sup> *Ibid.*, c. H1.

<sup>50</sup> *Ibid.*, s. 54.

<sup>51</sup> *Ibid.*, c. I; Regulation of Investment Advice Law, *supra* note 36 at c. H.

<sup>52</sup> See the explanatory notes in the *Efficiency of Enforcement Proceedings of the Securities Authority (Legislative Amendments) Bill*, Bills 439, 440. Regulation of Investment Advice Law, *supra* note 36 at, s. 38K.

Administrative Enforcement Committee is authorized to impose various administrative enforcement measures on the violator, such as financial sanctions, payment to any person who was injured by the violation, instructions to take actions to stop the violation and prevent its reoccurrence, cancellation of a license, permit or certification or their suspension, or a ban on serving as an office holder in a financial institution. If the violator is a senior office holder in a banking corporation, the Chairman of the Securities Authority should inform the Supervisor of Banks on his intent to start an administrative enforcement proceeding. The latter may raise its position concerning the matter.

The third course of enforcement is the imposition of a civil financial sanction by an internal committee of the Securities Authority.<sup>54</sup> This has usually been used in cases of technical violations.

In addition to the three courses of enforcement mentioned above, the Chairman of the Securities Authority has the power to agree with the violator (or a suspected violator) on avoiding any type of proceedings, if the latter agrees to the imposition of an administrative enforcement measure on him.<sup>55</sup>

(iv) *The Antitrust Authority*

The regulator entrusted with the promotion of competition in the Israeli economy is the Antitrust Authority. The Antitrust Authority is a statutory independent body, headed by a General Director. The Restrictive Trade Practices Law, 5748-1988, confers various powers upon the Antitrust Authority in order to deal with different forms of restrictive business practices (monopolies, concentration groups, mergers, and restrictive arrangements). Through these powers, the Antitrust Authority endeavors to increase the competition where it exists, to establish conditions for its creation where it does not exist, to enforce provisions of the law when they are breached, and to increase awareness to the existence of the laws of competition.<sup>56</sup> The Antitrust Authority's power applies to all the business entities in the country, including the banks.

A violation of the Restrictive Trade Practices Law constitutes a criminal offence.<sup>57</sup> However, in lieu of criminal proceedings, the Director General of the Antitrust Authority has the power to impose a civil financial sanction on the violator of up to NIS 1 million, and up to NIS 24 million if the violator is a corporation with a turnover of more than NIS 10 million.<sup>58</sup>

<sup>53</sup> Securities Law, *supra* note 48 at c. H4. See also: Regulation of Investment Advice Law, *supra* note 36 at c. G2.

<sup>54</sup> Securities Law, *supra* note 48 at c. H3; Regulation of Investment Advice Law, *supra* note 36 at c. G1.

<sup>55</sup> Securities Law, *supra* note 48 at c. I1; Regulation of Investment Advice Law, *supra* note 36 at c. H1.

<sup>56</sup> Based on the website of the Israel Antitrust Authority, in Hebrew, online: <<http://www.antitrust.gov.il/about/about1.aspx>> .

<sup>57</sup> *Restrictive Trade Practices Law*, 5748-1988, s. 47.

(v) *The Banking Corporations Sanctions Committee*

The Banking Corporations Sanctions Committee is a statutory committee that was established by virtue of the Prohibition on Money Laundering Law, 5760-2000. Its role is to impose civil financial sanctions on banking corporations for infringements of the law or related orders and regulations. The Committee is headed by the Supervisor of Banks, and its members include a jurist appointed by the Minister of Justice from among the staff of Minister's department (currently the Deputy Legal Counsel of the Israel Money Laundering and Terror Financing Prohibition Authority) and an employee from the Banking Supervision Department.<sup>59</sup>

(vi) *The Israeli Law, Information and Technology Authority (ILITA)*

The Israeli Law, Information and Technology Authority is a unit in the Ministry Of Justice, which is in charge of protecting the privacy of personal information, and of most of the regulatory activities related to data protection and credit data services. Its authority derives from three main laws: Protection of Privacy Law, 5741-1981; Electronic Signature Law, 5761-2001; and, Credit Data Service Law, 5762-2002. Its Enforcement Department performs all the enforcement activities with relation to the laws the ILITA is in charge of, including examination of public complaints and investigation of criminal offences. The ILITA is authorized to impose financial sanctions on entities — including banks — that infringe certain provisions of the Protection of Privacy Law in respect of databases.<sup>60</sup>

(vii) *The Company for Location and Restitution of Holocaust Victims' Assets*

Another entity, which is not a supervisory agency, but nevertheless has certain powers vis-à-vis the banks, is the Company for Location and Restitution of Holocaust Victims' Assets (the "Company"), a nonprofit organization of which the State of Israel is — and will always be — the only shareholder.<sup>61</sup> The Company's mandate is to locate assets of Holocaust victims and return them to their rightful owners. Assets whose owners cannot be traced are utilized to aid Holocaust survivors in need, and to help fund educational institutes and projects aimed at commemorating the Holocaust, clearly giving top priority to aid for Holocaust survivors. The Company has only been authorized to find assets located in Israel, including bank deposits.

<sup>58</sup> *Ibid.*, at ss. 50D & 50O.

<sup>59</sup> Prohibition on Money Laundering, *supra* note 33 at ss. 12 & 13. The decisions of the Banking Corporations Sanctions Committee are available online: Bank of Israel < <http://www.boi.org.il/en/BankingSupervision/AntiMoneyLaunderingAndTerrorFundingProhibition/Pages/SanctionsCommittee.aspx> > .

<sup>60</sup> *Administrative Offences Law, 5746-1985; Administrative Offences (Administrative Fine — Protection of Privacy) Regulations, 5764-2004.*

<sup>61</sup> *Holocaust Victims Assets (Restitution to Heirs and Endowment for Purposes of Assistance and Commemoration) Law, 5766-2006, c. B & F.*



The Holocaust Victims Assets (Restitution to Heirs and Endowment for Purposes of Assistance and Commemoration) Law, 5766-2006, obliges any person who holds a Holocaust Victim Asset, or an asset that is deemed to be a Holocaust Victim Asset, to report this to the Company, and to deliver the asset to the Company upon its demand.<sup>62</sup> Omission to report constitutes a criminal offence.<sup>63</sup>

With this understanding of the banking system and the various entities that regulate it in mind, we now turn to exploring the misconduct costs imposed on Israeli banks and their meaning.

#### 4. CASE STUDY: BANK MISCONDUCT COSTS IN ISRAEL

##### (a) Research Methods

As was previously explained, the major players in the Israeli banking system are the five largest banks that control almost 94% of the total assets of the system. Therefore, this research focuses on misconduct cases of these five banks and the subsidiaries of these banks, which are banks by themselves and operate in Israel or abroad. Accordingly, this research does not refer to other subsidiaries that do not constitute banks, such as trust companies, investment houses, credit card companies, underwriters, etc.

In order to analyze the misconduct costs of the five major banks in Israel, we constructed a database of misconduct costs that were incurred by the banks during a five-year period, from 1 January 2009 to 31 December 2013.

The data we collected in respect of each bank was classified according to the following categories:

- A short description of the misconduct case involved.
- The date of the misconduct case.
- The legal entity incurring the cost. As was explained above, our research focuses on the five largest banks and on their banking subsidiaries.
- The source of the data.
- The type/class of the misconduct involved. In this regard, we adhered to the types of misconduct that were determined by the International Conduct Costs Project,<sup>64</sup> and which reflect the circumstances giving rise to the imposition of the costs. These types include, for example: misconduct (usually mis-selling) related to Payment Protection Insurance

<sup>62</sup> *Ibid.*, ss. 9 & 10.

<sup>63</sup> *Ibid.*, s. 73.

<sup>64</sup> See: "Heads of Loss and Applicable Codes Used by Researchers", Conduct Costs Project, online: CCP Research Foundation <<http://foreigners.textovirtual.com/ccp-research-conduct-costs/274/151576/ccp2-list-of-codes.pdf>> .

(PPI); Money-laundering related issues (AML); adverse judgment and settlements in class actions against the bank (CLA); defective internal controls (such as rogue trader) (CON); breach of confidentiality (SEC); failure to disclose as required by law or regulation (DIS); payment related to tax irregularity (TAX); operational risk issues not covered by any of the above categories(OPE); other events indicating governance or management failure not falling within any of above categories (OTH).

- The jurisdiction where the event occurred.
- The regulator or authority who imposed the sanction; and in cases of court proceedings — the type of court.
- The amount involved.

The data was collected from primary sources, such as the official websites of the regulatory authorities and the financial annual reports of the banks. In addition, we used secondary sources such as articles published in financial journals and material published by the financial media. However, the secondary sources did not reveal any information that was not included in the primary sources, and therefore only served to support the primary sources.

After collecting the data from primary and secondary sources, we sent a questionnaire to each of the banks, detailing the information we gathered about it, and asking it to either correct or approve the information. Only two banks responded: one bank (First International Bank of Israel Ltd.) rejected our request and referred us to its financial statement. The second bank (Mizrahi Tefahot Bank Ltd.) noted an apparent error, which at the end turned out as a correct figure.

Furthermore, we sent questionnaires to each of the relevant regulators who are empowered to impose sanctions on banks, asking them to provide us with data or information about misconduct costs they had imposed on the banks in the relevant period. Under the Israeli Freedom of Information Law, 5758-1998, governmental authorities are obliged to provide any information which is in their possession to any Israeli applicant requesting it.<sup>65</sup> The answers we received from the regulators did not provide new information that was not known to us. Most disappointing was the answer of the Supervisor of Banks — the main regulator of the banking system — admitting that they do not collect such data.

It should be emphasized that collecting the data was not an easy task. Some of the misconduct cases and their figures were easy to find, usually fines and sanctions that were imposed by the regulators and published on their websites. However, other cases and figures were much more difficult to reveal, tending to get tucked away in obscure parts of lengthy reports. Surprisingly, we could not

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<sup>65</sup> *Freedom of Information Law, 5758-1998*, ss. 1 & 7. Naturally, this law also includes exceptions that allow the authorities to refrain from providing the information. See ss. 8-10.

find the data in the banks' sustainability reports, while the financial annual reports usually referred to these matters in a general and rather vague manner.

A good source of information could have been the Public Enquiries Unit in the Banking Supervision Department. This unit, which handles public complaints against the banks, publishes annual reports describing its activity.<sup>66</sup> Our research revealed that there is no coherent methodology in respect of the structure and contents of these reports, which explains the significant modifications and alterations of the material included in the reports throughout the years. In 2009, the report was rather laconic and did not refer to each bank separately. In 2010 and 2011, the reports detailed complaints against specific banks, while mentioning the bank's name and the amounts refunded to customers. However, this was only done where the complaints revealed a systemic failure of the bank. Other complaints were mentioned in a general and anonymous manner. In 2012 and 2013, the reports included additional bank-specific information: the total amount of refunds that each bank paid to its customers as a result of complaints, including the amount of refunds paid by each bank *ex-grazia* despite the fact that the complaints were not found justifiable.<sup>67</sup> Under these circumstances, the reports of the Public Enquiries Unit, which could have been a major source of information regarding the specific cases of bank misconduct, provided limited information to be included in our database.

Another difficulty in collecting data related to class actions. Class actions, by their very nature, involve extremely high sums of money. Moreover, high sums of compensation are paid by the banks not only when the action is accepted and ruled against the bank, but also when the proceedings end in a settlement. Hence the importance of information about class actions to our research.<sup>68</sup>

However, it transpired that full data cannot be collected. The Class Actions Registry, where each and every class action should be registered by virtue of the Class Actions Law, 5766-2006, and which is supposed to include information about the developments of the action, usually did not include such information in respect of the actions against the banks. In particular, it did not include data such as the sum of compensation that was ruled by the court, nor the sum that was actually paid to the injured members of the group.

In addition, in many class actions the courts themselves did not specify the exact sum of compensation in their judgments. Very often, the judgment only imposed a general obligation on the bank to find all the injured customers and compensate each of them according to the damage suffered, without noting the

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<sup>66</sup> *Consumer Information Publications*, online: Bank of Israel < <http://www.boi.org.il/en/NewsAndPublications/RegularPublications/Pages/Default.aspx> > .

<sup>67</sup> In our database, we adopted a conservative approach and did not include the amounts paid in cases where the complaints were found unjustifiable.

<sup>68</sup> On class actions against banks under the Israeli law, see: Ruth Plato-Shinar, "Class Actions against Banks under the New Israeli Law on Class Actions", (2007) 26 *Annual Review of Banking and Financial Law* 255.

total amount of the compensation. In other cases, the ruling stated that every customer who approaches the bank on its own initiative will receive compensation.

In this regard, it was interesting to find out that the Supervisor of Banks does not follow up on settlements in class actions against the banks. He does not check whether they were indeed implemented, or what was the total sum of compensation that was actually paid to all the customers.

Another difficulty involved fiscal provisions that the banks made in respect of prospective regulatory fines, financial sanctions and large lawsuits resulting from their misconduct. Such provisions serve as indications of possible future misconduct costs and could have helped in detecting additional cases of misconduct. However, the amounts of such provisions in the banks' financial reports remained undetected.<sup>69</sup> According to the Supervisor of Banks' Reporting to the Public Directives, the banks are not obliged to include such data in their financial reports. In contrast, provisions that should be specified in the banks' financial reports are provisions for taxes and provisions for doubtful debts, which are irrelevant for this research.<sup>70</sup>

A related — yet different — issue that was mentioned in the banks' financial statements was “exposure to actions”. Under this category, the banks noted the amount of estimated additional exposure to actions filed against the bank, of which the probability of realization was estimated by the bank as “reasonable possible” or “not remote”, while specifying major claims and class actions that were submitted against the bank. However, since our definition of “misconduct costs” did not include estimations of costs, we could not use this information for the purposes of our research, and just made do with noting the amounts of such exposures as a remark in our database.

Another difficulty related to “expenses” incurred by the banks as a result of their misconduct. The Supervisor of Banks' Reporting to the Public Directives,<sup>71</sup> contain no binding rules as to the question of what should be included under the term “expenses”, or — more precisely — under the term “legal expenses”, and each bank decides for itself. Thus, the term “legal expenses” may include only fees paid to the lawyers of the banks for various legal matters, as opposed to fines, financial sanctions, compensation to customers, and similar misconduct costs. Furthermore, Israeli banks use to specify the amount of their “other expenses”, a general title for a wide range of expenses. Here, again, there are no

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<sup>69</sup> The only exception was a provision made by Bank Leumi Le-Israel in 2013, for expenses related to the investigation of the US Tax Authority against the bank, as is described in section 4.1.2. See: “Bank Leumi Le-Israel Ltd. and its Subsidiaries — Annual Report 2013” at 440, online: Bank Leumi < [http://www.leumi.co.il/static-files/10/LeumiHebrew/financial\\_statements/100011324.pdf?lang=he](http://www.leumi.co.il/static-files/10/LeumiHebrew/financial_statements/100011324.pdf?lang=he) > .

<sup>70</sup> Supervisor of Banks, *Reporting to the Public Directives*, Directive No. 630, etc., online: < <http://www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/Pages/divuah.aspx> > [Public Directives].

<sup>71</sup> *Ibid.*

binding rules as to the content of this category, which may have included the data we are looking for, but has been buried among many other irrelevant expenses.

All in all, there appears to be no systemic accounting methodology that enables the public to receive a comprehensive and exact picture of misconduct costs of banks. Therefore, we should bear in mind that the figures we found in our research are probably much lower than the actual figures of these misconduct costs.<sup>72</sup>

### (b) Our Findings

Despite the issues raised above, we managed to establish a comprehensive database of the misconduct costs incurred by the five major Israeli banks during the years 2009 and 2013.<sup>73</sup> In the following sections we present and analyze a variety of overviews of these costs.

#### (i) Overview of banks

Table 1 below summarizes the total misconduct costs of each of the five major banks in Israel during the years 2009-2013. Such information allows us to compare the different banks according to their level of behaviour.

**Table 1: Total Costs by Bank (2009-2013)**

<b>Bank</b>	<b>Total Costs (GBP M)</b>
Bank Leumi Le-Israel Ltd.	126.94
Israel Discount Bank Ltd.	0.92
Bank Hapoalim B.M.	4.96
United Mizrahi Tefahot Bank Ltd.	2.24
First International Bank of Israel Ltd.	0.08
<b>Grand Total (GBP M)</b>	<b>135.14</b>

<sup>72</sup> Indeed, this was one of the preliminary presumptions of the International Conduct Costs Project. See: "Notes on Interpretation," Conduct Costs Project, online: CCP Research Foundation < <http://conductcosts.ccresearchfoundation.com/notes-on-interpretation> > .

<sup>73</sup> The values in Israeli Shekels (ILS) were converted to GBP, based on an exchange rate of 6.0814, which was the five year average of the "Representative Rate" published by the Bank of Israel. Since the definition of "misconduct costs" only includes costs that were actually incurred by the banks, we included in our research neither provisions made by the banks for prospective misconduct costs, nor self-estimations of the banks about such costs. In contrast, the website of the International Conduct Costs Project does contain such entries, which explains the differences between the figures referred to in this article, and those included in the website.

The data in this table show very clearly that Bank Leumi Le-Israel Ltd. bore the highest total costs, which were far higher than the other Israeli banks. The high amount mainly resulted from two issues:

- First, payment pursuant to a lawsuit that was filed against the bank by the Company for Location and Restitution of Holocaust Victims' Assets, in a sum of about GBP 20 million.
- Second, expenses that were incurred by the bank as a result of a criminal investigation that was executed by the American Tax Authorities, for allegedly assisting American customers to evade tax payments in the US in the years 2002-2010, and which amounted, at the time of research, to about GBP 105 million. This issue ended in 2015, with an arrangement between Bank Leumi, the United States Department of Justice and the New York Department of Financial Services. According to this arrangement, Bank Leumi paid a civil fine of USD \$400 million, and the proceedings against it were abolished, with neither criminal conviction nor restrictions on the Bank Leumi's activities in the US.<sup>74</sup> Since this case went beyond the timeframe of the research (2009-2013), we only included in our database the expenses that the bank incurred as a result of the investigations during the period of the research.

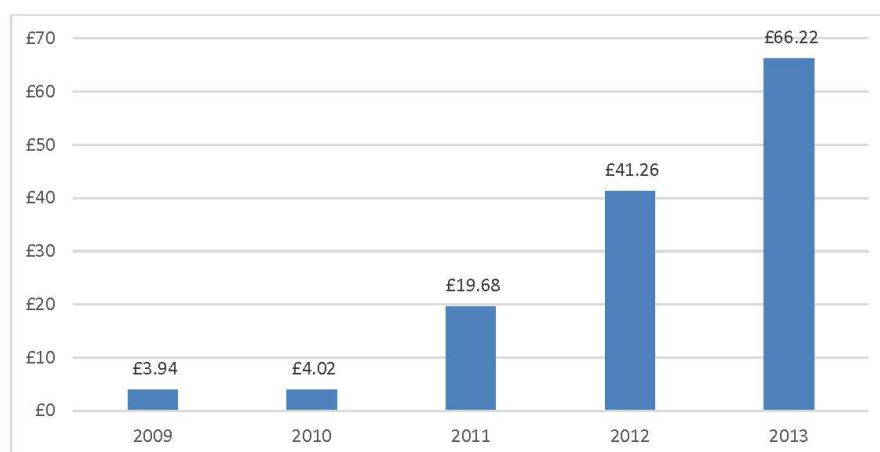
(ii) *Overview by year*

Figure 1 below presents an overview of the total misconduct costs of the five largest banks over the years. While the amount of misconduct costs increased moderately over the years 2009-2010, there was a significant increase between the years 2010-2013.<sup>75</sup>

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<sup>74</sup> "Bank Leumi Signs Arrangement with U.S. Authorities Related to the Group's Activities with U.S. Customers" (24 December 2014), online: Bank Leumi <<http://english.leumi.co.il/Articles/34676/>> .

<sup>75</sup> This finding raises the question, of whether such an increase resulted from a stricter enforcement of the regulators, or from increase in the number and level of misconduct cases; a question that exceeds our research and needs to be examined separately.

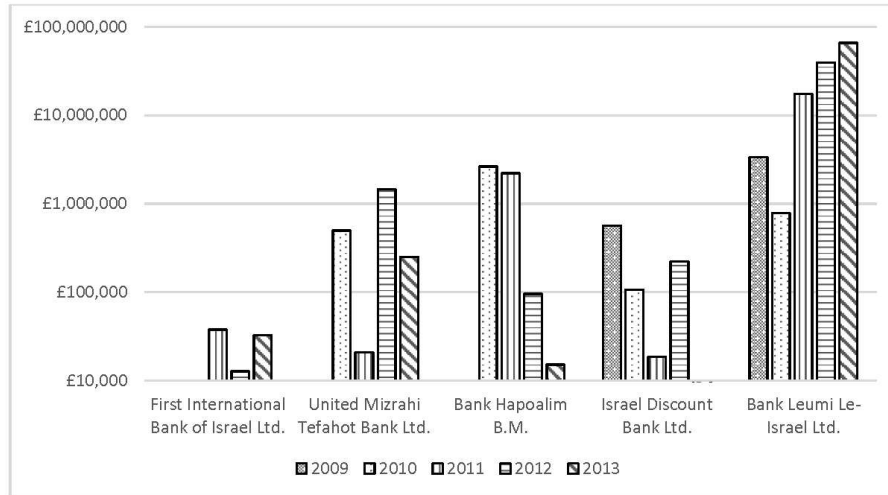
**Figure 1: Total Costs by Years 2009-2013 (in millions, GBP)**

However, if we compare the layout of misconduct costs over the years, for each bank separately, another impression is received. As can be seen in Table 2 and Figure 2 below, there is no one clear direction when examining the figures of the different banks throughout the years. One cannot point to a steady increase of the costs, nor to a steady decrease. The results of each bank seem to be sporadic, representing particular cases rather than a general trend.

**Table 2: Total Costs by Bank and by Year (GBP)**

Year	First International Bank of Israel Ltd.	United Mizrahi Tefahot Bank Ltd.	Bank Hapoalim B.M.	Israel Discount Bank Ltd.	Bank Leumi Le-Israel Ltd.
2009	0	0	0	567,304	3,372,579
2010	0	497,583	2,637,188	107,048	781,563
2011	37,748	20,883	2,210,068	18,573	17,397,309
2012	12,727	1,466,903	95,866	223,633	39,464,597
2013	32,379	249,877	15,164	7,674	65,919,867
<b>Total</b>	<b>82,854</b>	<b>2,235,246</b>	<b>4,958,286</b>	<b>924,232</b>	<b>126,935,916</b>

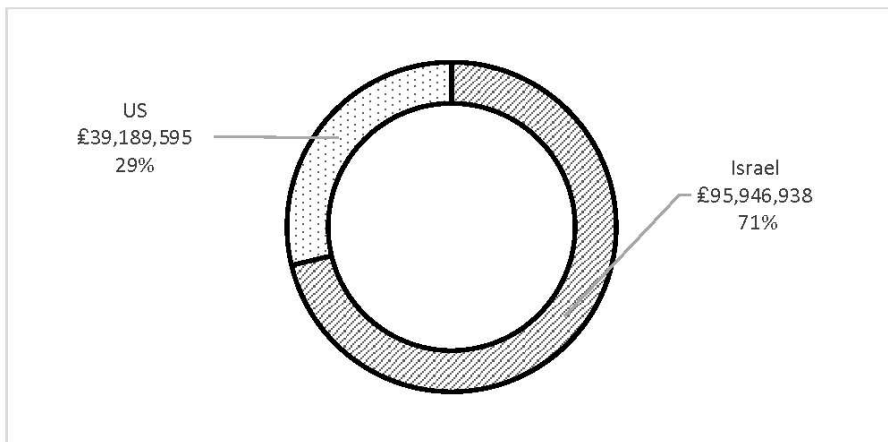
**Figure 2: Total Costs by Banks per Years 2009-2013 (GBP)**



*(iii) Overview by regulatory jurisdiction*

One of the classifications included in our research is the jurisdiction where the misconduct costs were imposed or originated. This was done in order to facilitate a comparative assessment of the practices of financial regulators in various financial market jurisdictions. In the case of the Israeli banks, only two jurisdictions were involved: Israel and the US.

**Figure 3: Overview by Jurisdiction**





As shown in Figure 3, there is a large gap between the amount of costs that derived from proceedings in the US (29%), and those that derived from proceedings in Israel (71%). However, while the costs imposed in Israel derived from a range of various cases, the costs from proceeding in the US derived only from one isolated case: the criminal investigation of the American Tax Authorities against Bank Leumi, as mentioned above.

It is important to mention that during the research period, there were additional investigations of foreign regulatory authorities into Israeli banks on matters of alleged criminal misconduct. These investigations did not involve a fine or financial sanction, and therefore they are not included in our data. Nevertheless, it is important to refer to them in order to have a more comprehensive view of behaviour of the Israeli banks.

Thus, for example, at the end of 2009, the supervisor of the Swiss financial market (FINMA) issued a reprimand against Bank Leumi Le-Israel Ltd. based on the actions of its Geneva subsidiary, which took place in 2007. Pursuant to a regulatory demand for information from the bank regarding a client who was suspected of insider trading, the bank provided incorrect information and recorded that information in its database. FINMA noted that the Bank Leumi had committed a serious infringement of the Swiss Federal Law on Banks and Savings.

Another example relates to the US Internal Revenue Service (IRS), which in 2013 launched an investigation into several Swiss banks that were suspected of helping US residents to evade taxes. The investigation included the Swiss branch of Mizrahi Tefahot Bank and Bank Hapoalim (Switzerland) Ltd., which is a subsidiary of Bank Hapoalim. In contrast to other Swiss banks, which received the approval of the US authorities to be included in a special arrangement and to settle the issue by paying a financial sanction, Mizrahi Tefahot Bank and Bank Hapoalim (Switzerland) were notified by the US authorities that they were not eligible to be included in that arrangement, because a criminal investigation had already been launched against each of them.<sup>76</sup> Analysts claim that this decision signifies that these banks could be facing an extensive fine if it turns out that they had indeed violated the US law.<sup>77</sup>

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<sup>76</sup> “Annual Report for 31.12.2013” (31 December 2013), online: Mizrahi Tefahot Bank < <https://www.mizrahi-tefahot.co.il/he/Bank/about-mizrahi-tefahot-he-category/investor-relations/previous-financial-reports/Pages/financial-reports-annual-2013-he.aspx> > at 401; “Annual Report for 31.12.2013” (31 December 2013), online: Bank Hapoalim < [https://www.bankhapoalim.co.il/wps/portal/PoalimPrivate/products?WCM\\_GLOBAL\\_CONTEXT=Poalim%20-%20Content/poalimsite/sitearea\\_aboutbank/finrep/2013/dochot13&contentIDR=6f2802804b79a4fcad-c9eff03520bbf4&useDefaultDesc=0&useDefaultText=0&proceed=1.](https://www.bankhapoalim.co.il/wps/portal/PoalimPrivate/products?WCM_GLOBAL_CONTEXT=Poalim%20-%20Content/poalimsite/sitearea_aboutbank/finrep/2013/dochot13&contentIDR=6f2802804b79a4fcad-c9eff03520bbf4&useDefaultDesc=0&useDefaultText=0&proceed=1.) > at 109-110.

<sup>77</sup> Irit Avissar, “Pisagot Analyst Terence Klingman: The Investigation’s Transfer to the US Implies the Bank Could Face a Bigger Fine in the Affair”, *Globes* (18 November 2013), online: Globes English < <http://www.globes.co.il/en/article-1000895042> > .

*(iv) Overview by type of misconduct*

As mentioned above, our research includes a classification of the misconduct costs according to the type of misbehaviour that generated them. Such a classification can help identify recurring rule-breaching behaviours and draw attention to malpractices of banks.

**Figure 4: Overview by Type of Misconduct**

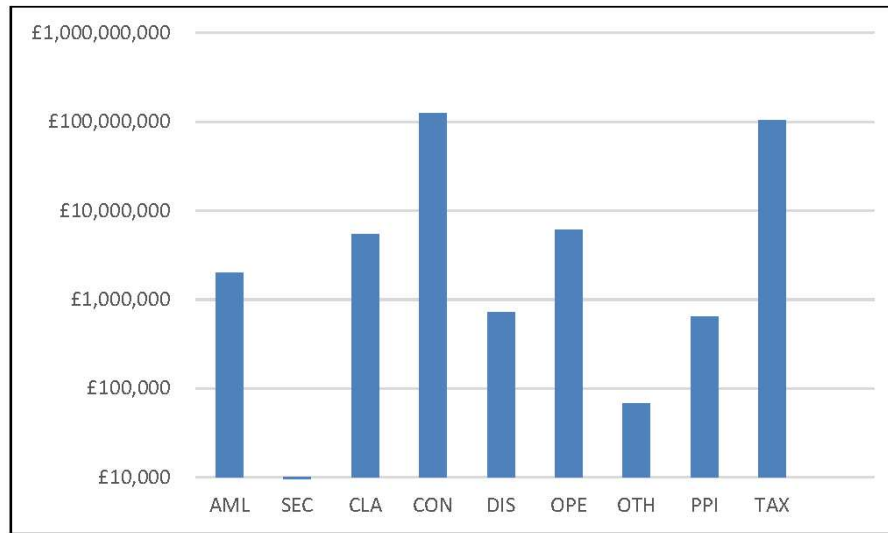


Figure 4 presents an overview of the costs according to the type of misconduct that generated the cost.<sup>78</sup> The five Israeli banks have incurred misconduct costs deriving from a broad range of breaches. The category with the highest amount of costs was the residual category of Defective Internal Controls (CON), which included cases such as the payment made by Bank Leumi to the Company for Location and Restitution of Holocaust Victims' Assets, for a failure to deliver assets of Holocaust victims held by the bank. The category with the second highest results was tax irregularities (TAX), which included the criminal investigation executed by the American Tax Authorities against Bank Leumi. Another residual category was Other Costs (OTH) that included issues such as money paid to customers as a result of handling public complaints and in respect of which specific details were not publicly provided. It should be noted that various misconduct costs could be classified as more than one type of misconduct. Such costs are included in Figure 4 in each of the relevant columns, simultaneously.

<sup>78</sup> See section 4(a) of this article.

It is interesting that a financial sanction in respect of consumer issues was imposed on a bank for the first time only in 2011. In that case, the Supervisor of Banks imposed a financial sanction of GBP 98,661 on Bank Hapoalim, for charging customers with fees that were not included in the bank's tariff of fees.<sup>79</sup> In addition to the financial sanction, the bank refunded the aggrieved customers a total amount of GBP 822,179. The bank was also instructed to take steps to prevent the recurrence of the deficiencies found by the Banking Supervision Department in this area.<sup>80</sup>

## 5. ANALYSIS

According to public interest theories, the main goal of a regulatory agency is to protect and promote the interest of the public. The objective of regulation is to benefit society as a whole, rather than to promote the interests of specific interest groups or the interests of the regulator.<sup>81</sup>

In order to fulfill their role in respect of the public interest, regulators — including banking regulators — are usually equipped with three main powers:<sup>82</sup> (a) rule-making or standard-setting: the establishment of norms that are binding on the supervisees; (b) monitoring: operating an administrative monitoring and control system to ensure compliance with the binding norms and to detect breaches that require attention, and (c) enforcement: Enforcement generally deals with punishment, namely imposing sanctions in the event of a breach of binding norm.<sup>83</sup> Needless to say, that without the power of enforcement, the first

<sup>79</sup> For elaboration on the bank fees system in Israel which is subject to supervision, see: Ruth Plato-Shinar, "The Bank Fees Regime in Israel — A Political Economy Perspective", in Emiliios Avgouleas and David Donald, eds., *Financial Regulation: Political, Economic and Theoretical Foundations* (Cambridge: Cambridge University Press, forthcoming) [Plato-Shinar, "Bank Fees"]; Keren Borenstein-Nativ, "Structural Power and Corporate Political Activity: The Politics of Banking Fees in Israel" (work in progress).

<sup>80</sup> *Imposing of Financial Sanctions on Bank Corporations*, (13 March, 2012), online: Bank of Israel <<http://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/120313f.aspx>> .

<sup>81</sup> Baldwin, Cave & Lodge, *supra* note 4 at 40-43.

<sup>82</sup> David Levi-Faur, "Regulation and Regulatory Governance" in David Levi-Faur, ed., *Handbook of the Politics of Regulation* (London: Edward Elgar Publishing, 2011) 3 at 6; Bronwen Morgan & Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (New York: Cambridge University Press, 2007) at 3; see also: Rolf. H. Weber, "Mapping and Structuring International Financial Regulation — A Theoretical Approach," (2009) 20:5 *European Business Law Review* 651 at 652. For an approach that calls for acknowledging the licensing power as a fourth and separate power, see Plato-Shinar, "Regulation in Israel", *supra* note 11 at 18-19.

<sup>83</sup> In this regard, see the enforcement pyramid of Ayres & Braithwaite, *supra* note 10 at 35. Their enforcement pyramid includes these sanctions, rated from the lightest to the most severe: Persuasion, warning letter, civil penalty, criminal penalty, license suspension, and finally license revocation. According to the authors, most of the regulatory enforcement should be executed at the basic level of persuasion, while the rest of the sanctions should

two regulatory powers will have no practical significance, and will not be able to satisfy the public interest.

The efficiency of the enforcement depends on various factors, including, first and foremost, on the willingness of the regulator to intervene and impose a suitable sanction in cases of breach of the binding norms. However, we argue that the transparency of the sanction imposed on the banks, and in our case — the transparency of the misconduct costs incurred by the banks — is just as important. As explained in section 1, information about misconduct costs incurred by the banks provides us with a picture of how well behaved banks are. It also enables us to assess the legal and ethical behaviour of banks, which is a matter of key public importance. However, if this information is kept secret, or is provided to the public in such a manner that cannot be easily accessed, it loses much of its efficiency power.

As explained in section 2, misconduct costs stem from two origins: regulatory enforcement and public enforcement. These two sources are inter-connected, complement each other and nourish each other, with transparency playing a major role in this regard. When regulatory enforcement is visible to the public, it increases public awareness of the behaviour of banks and plays an educative role — it teaches the public about what is right and what is wrong in banking conduct, and about their right to act through public enforcement channels; it encourages customers and investors to question the business practices of their banks and their level of business ethics; and, it may lead to lawsuits and class actions against banks that breach the rules, thus increasing public enforcement. At the same time, enhanced public awareness may lead to public pressure against the regulator, demanding a stricter level of supervision and a more intensive involvement on its part, thus increasing regulatory enforcement.

Information about misconduct costs is particularly important in the field of banking. One of the characteristics of the banking system is the existence of information asymmetries between the banks and their various stakeholders, including customers who use the services of the banking system and investors who invest their money in the banks' securities.<sup>84</sup> However, the general public is unable to assess the conduct of the bank, due to the difficulties to obtain information. Assessing the behaviour of the bank requires obtaining a great deal of information about the business policy of the bank, the type and extent of the risks that it has taken upon itself, and transactions in which it is involved. The evaluation of a bank's level of compliance and obedience of the law involves a

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become more and more rarely used as one climbs the pyramid, until license revocation takes place. However, the authors note that the pyramid is not applicable to "banking or affirmative action regulation."

<sup>84</sup> Edward P. M. Gardener, *United Kingdom Banking Supervision: Evolution, Practice and Issues* (London: Allen & Unwin, 1986) 36, described it as "the primary and historical rationale for bank supervision". See also: Peter Cartwright, *Banks, Consumers and Regulation* (Oxford and Portland: Hart Publishing, 2004) at 16. Plato-Shinar, "Regulation in Israel", *supra* note 11 at 8.

sophisticated process of interpreting not only the financial and sustainable statements of the bank, but also of assessing and analysing every single arrangement made by the bank.

The difficulty to obtain relevant and up-to-date information about the bank's behaviour is only one barrier. Another barrier is the cost of information. Obtaining the information is an expensive process for customers, investors or other interested individuals. Moreover, even if they obtained the information, it is doubtful that they would be able to properly analyze and understand it. These activities would probably involve further high costs.

In order to enable the public to easily access information about the banks' behaviour, the preliminary requirement should be a full disclosure of the misconduct costs incurred by the banks. However, as explained in section 4, we encountered serious difficulties in collecting this information, due to the lack of transparency. Surprisingly, such information was not included in the banks' sustainability reports, while their financial reports only provided partial information in a general and rather obscure manner. In sum, there appears to be a serious lack of transparency that prevents the public from receiving a comprehensive picture of the misconduct costs of banks.

The apparent "shyness" of banks when it comes to providing full details of misconduct costs to the public is at odds with their various recent statements about changes in culture and about adopting measures of accountability and transparency.<sup>85</sup> However, banks are not the only ones to blame. The banks allow themselves to adopt a minimum level of disclosure when it comes to misconduct costs, based on the directives of the Supervisor of Banks. By virtue of its authority, the Supervisor of Banks publishes the Reporting to the Public Directives, which stipulate what information should be disclosed to the public in the banks' financial reports and in what manner.<sup>86</sup> However, they do not oblige the banks to specifically disclose financial sanctions or other misconduct costs.

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<sup>85</sup> "Sustainability Report 2015: Economic, Social & Environmental Responsibility" (2015), online: Bank Hapoalim <[https://www.bankhapoalim.biz/wps/portal/Poalim-Private/products?WCM\\_GLOBAL\\_CONTEXT=/wps/wcm/connect/Poalim%20-%20Content/poalimsite/sitearea\\_aboutbank/achraiuhevratit/reports&proceed=1](https://www.bankhapoalim.biz/wps/portal/Poalim-Private/products?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/Poalim%20-%20Content/poalimsite/sitearea_aboutbank/achraiuhevratit/reports&proceed=1)> [Sustainability Report 2015]. Bank Hapoalim, Code of Ethical Conduct, at 18, online: Bank Hapoalim <<http://www.bankhapoalim.com/wps/wcm/connect/55cc83804e58c3739c8a9f8715f0fbe3/BankHapoalimCodeofEthicalConduct.pdf?MOD=AJPERES&mod=125539622&CACHEID=55cc83804e58c3739c8a9f8715f0fbe3>>. Mizrahi Tefahot Bank, Corporate Social Responsibility Report 2015, at 27, online: Mizrahi Tefahot Bank <[https://www.mizrahi-tefahot.co.il/Lists/BankMizrahiSiteAssets/PDF-English/TfahotBank\\_corporate\\_report\\_2015\\_Full\\_Digital\\_EN\\_150916.pdf](https://www.mizrahi-tefahot.co.il/Lists/BankMizrahiSiteAssets/PDF-English/TfahotBank_corporate_report_2015_Full_Digital_EN_150916.pdf)> [Corporate Social Responsibility Report 2015]. The banks state in their reports that they provide information regarding the financial possibilities available to their customers in detailed manner and transparency. In addition, they state that they provide a wide range of tools, products, services, information and guidance in order to ensure that customers are familiar with all of the possibilities available to them, in order to reach prudent and independent decisions. See, for example Sustainability Report 2015, at 28, 45, and 85.

Since the major banks are publicly traded companies, they are subject to the Securities Law, which obliges banks to immediately report the details of any event or matter that deviates from the corporation's ordinary course of business, due to its nature, scope or potential result, and which has or could have a significant effect on the corporation or on the price of the corporation's securities.<sup>87</sup> However, this duty of reporting covers only significant misconduct costs, and does not oblige the banks to disclose other sanctions and costs.

One directive that may be relevant to misconduct costs is Directive No. 625 on the matter of Corporate Responsibility Report, which obliges the banks to publish a Corporate Responsibility Report.<sup>88</sup> This Directive states very laconically that:

A banking corporation will provide disclosure for those matters that are relevant to its activity in the area of corporate responsibility for the period of up to two years ending on the date of the report (the reporting period). The Corporate Responsibility Report is likely to relate to matters, such as commitment to involvement in the community, the environment, to employee welfare and the work environment, fairness to customers and business ethics. It is recommended to provide disclosure of relevant quantitative indices and relevant standards in accordance with which the banking corporation operates in this field.<sup>89</sup>

It can be noticed that this Directive does not require banks to disclose their misconduct costs. It makes do with imposing a general duty of disclosure vis-à-vis "matters such as fairness to customers and business ethics". In addition, the provision of "quantitative indices" is only drafted as a recommendation; thus enabling banks to escape a detailed disclosure of their misconduct costs, and resulting in low levels of transparency in this regard.

For comparison, it should be mentioned that the Sustainability Reporting Guidelines published by the Global Reporting Initiative (GRI),<sup>90</sup> recommend reporting significant fines and non-monetary sanctions for non-compliance with law and regulations. The report should be built in terms of total monetary value of significant fines, in terms of total number of non-monetary sanctions, and in terms of cases brought through dispute resolution mechanisms. In addition, the current version of the guidelines recommends reporting the context against which significant fines and non-monetary sanctions were incurred.<sup>91</sup>

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<sup>86</sup> Public Directives, *supra* note 70.

<sup>87</sup> Securities Law, *supra* note 48 at s. 36. Securities Regulations (Periodic and Immediate Reports), 1970, s. 36(a).

<sup>88</sup> Public Directives, *supra* note 70, Directive No. 625.

<sup>89</sup> *Ibid.*, s. 2.

<sup>90</sup> See: *G4 Sustainability Reporting Guidelines*, online: Global Reporting Initiative < <https://www.globalreporting.org/information/g4/Pages/default.aspx> >. The previous version of the guidelines, which was in effect at the period of the research (2009-2013), was G 3.1 Sustainability Reporting Guidelines.

All the five major Israeli banks publish Corporate Social Responsibility (CSR) Reports, a trend that started already in 2008.<sup>92</sup> The banks' CSR Reports purport to adopt the GRI Recommendations. However, they do not fully match the GRI Recommendations. Our impression is that although the banks adopted the general spirit of the GRI Recommendations and declared the principle of transparency to be part of their culture, they actually implemented them in a minimal manner. Even when the banks do mention a misconduct cost, they usually fail to provide its amount and its full details, and make do with referring the reader to their financial statements, making it very difficult to view the whole picture.<sup>93</sup> The isolated exceptions to this practice were mainly cases that involved huge financial sanctions and that had already been covered by the media; namely, where the information was already public.<sup>94</sup>

In summary, backed up by the Supervisor's Directives, the banks make do with a minimum level of reporting of their misconduct costs. Despite their attempts to present themselves as sustainable, ethical or social, the banks do not volunteer to increase the level of transparency above the level required by the regulator.

The low level of transparency raises the question of why is the Supervisor of Banks so reluctant to demand a higher level of disclosure from the banks in respect of their misconduct costs. We believe that the main explanation for this situation is related to prioritization of regulatory goals, namely the preference of prudential regulation over consumer protection. Another possible explanation may be regulatory capture.

#### (a) Prioritization of Regulatory Goals

The Israeli Supervisor of Banks, who is the main regulator of the banking system, is in charge of two regulatory objectives: maintaining the stability of the banking system ("prudential regulation"), and consumer protection. However, the role of maintaining the stability of the banks has always monopolized a predominant place in the activities of the Supervisor of Banks.<sup>95</sup> A bank that

<sup>91</sup> *Ibid.* G4 — SO8. See also: G4 — EN 28 (relating to environmental issues), and G4 — PR 9 (relating to products and services).

<sup>92</sup> The adoption of the GRI Guidelines spread gradually amongst the five major banks, starting with the G3.1 version, and transitioning to the new G4 version in 2014.

<sup>93</sup> "Corporate Social Responsibility Report 2013", online: Leumi Group <<http://plus.leumi.co.il/wp-content/uploads/LeumiReportEngCSR011014.pdf>> at 39 (where the bank referred to the investigation of the American Tax Authorities without providing any figures). Another example is Mizrahi Tefahot Bank that mentioned in its CSR Report, in a very laconic manner, an investigation "with regards to the bank's businesses in the USA". See Corporate Social Responsibility Report 2015, *supra* note 85 at 99.

<sup>94</sup> "Corporate Social Responsibility Report 2014", online: Leumi Group <[http://english.leumi.co.il/static-files/10/LeumiEnglish/CSR\\_Full\\_Report\\_2014.pdf?lang=enat43](http://english.leumi.co.il/static-files/10/LeumiEnglish/CSR_Full_Report_2014.pdf?lang=enat43)> (where the bank noted the amount of the expenses related to arrangement with the US Tax authorities).

<sup>95</sup> Plato-Shinar, "Regulation in Israel", *supra* note 11 at c. 3.1 and 5.1.

collapses or encounters difficulties, affects not only its customers and investors, but it also has implications on the financial strength of the economy as a whole. Hence, throughout the years, Israeli Supervisors of Banks have shown great reluctance to do anything that may endanger not only the stability of the banks, but even their profitability or the public trust in them.<sup>96</sup> This trend may also explain the tendency not to take strong measures in respect of misconduct costs, and not to demand their full disclosure.

### **(b) Regulatory Capture**

Another possible explanation for the attitude of the Supervisor of Banks may be the phenomenon of “regulatory capture”. As was explained above, according to the public interest approach, regulation is designed for the benefit of the public. However, in certain cases, the regulated industry acquires a persistent and excessive influence over the regulator, and causes the regulator to prefer the interests of the regulated firms over those of the general public. The regulator is thus “captured” by the industry it regulates.<sup>97</sup>

Indeed, the Israeli banking system contains several features that may contribute to the creation of captive regulation or, at least, explain the tendency of the Supervisors of Banks to succumb to pressure exerted by the banks. These features include the strong economic clout and negotiation power of the banks, which has intensified due to the concentration of the banking sector and the lack of competition between the banks; the intensive lobbying activities of the banks; the role of the Association of Banks in negotiations with the regulatory echelon; the banks’ dominance in the composition of the Advisory Board of the Supervisor of Banks (9 out of 19 members); and the phenomenon of “revolving doors” which has become common practice.<sup>98</sup> These features may also explain the tendency of the Supervisors of Banks not to demand a higher level of transparency vis-à-vis the banks’ misconduct costs.

## **6. CONCLUSIONS AND RECOMMENDATIONS**

Banks’ misconduct costs have gained increased interest in recent years worldwide, especially as their level has dramatically increased from year to year. Misconduct costs are one of the best means to measure the ethical and legal

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<sup>96</sup> One example is the reluctance to intervene, prior to the Bank Fees Reform of 2007, in respect of the bank fees charged to the retail sector, which were extremely high and unfair. See: Plato-Shinar, “Bank Fees”, *supra* note 79.

<sup>97</sup> The classic literature on regulatory capture includes: George J. Stigler, “The Theory of Economic Regulation”(1971) 2 Bell Journal of Economics and Management Science 3; Richard A. Posner, “Theories of Economic Regulation”(1974) 5 The Bell Journal of Economics and Management Science 335 at 335-341; Sam Peltzman, “Toward a more general Theory of Regulation” (1976)19 Journal of Law and Economics 211. See also: Jean-Jacques Laffont, Jean Tirole, “The Politics of Government Decision-Making: A Theory of Regulatory Capture”(1991) 106 The Quarterly Journal of Economics 1089.

<sup>98</sup> Plato-Shinar, “Bank Fees”, *supra* note 79 at s. 7(2).



behaviour of a bank. Moreover, they impact the profitability of the bank and may also influence its prudential status. Therefore, they play an important role in the conduct of risk management.

The findings of our research provide an overview of the banks' misconduct costs and a preliminary interpretation of the meaning behind these figures, focusing on the Israeli banking system. However, they also raise a few important questions that exceed the scope of our work and deserve separate research, including: What is driving these costs? Are these costs a fair reflection of the bank's wrongdoing? Are they effective? Are these costs an industry problem or a bank-specific problem? To what extent should we be concerned about conduct risk and its potential to incite systemic risk?

Other issues that our research brings to the fore and which deserve a further study are: the effectiveness of legal risk management; the role and effectiveness of the banks' codes of ethics and their cultural transformation programs; the responsibility of the Board of Directors and the management of the banks for improving the bank's behaviour; the role that shareholders should play in ensuring misconduct problems are confronted and addressed quickly; and the roll of public enforcement as an additional tool to regulatory enforcement.

A major topic, which projects on all the above mentioned issues, is the crucial need for enhancing the transparency of the banks' misconduct costs. If there is no comprehensive reporting duty of banks' misconduct costs, it becomes challenging to estimate them, and virtually impossible to figure their true level. The data collected from available public sources can only be considered as the best minimum estimation. Taking into consideration, as was mentioned above, that misconduct costs are not only a matter of ethics, but entail a conduct risk, this is a seriously worrying situation from both the banks' and the public' perspectives.

Due to the enormous implications linked to the banks' misconduct costs, one would expect the banking regulator to oblige banks to disclose their misconduct costs in a clear, comprehensive and detailed manner. Unfortunately, in Israel this is not the case. It appears that the importance of misconduct costs reporting has not been given due attention by the regulators. In this article, we offered two explanations for this situation: first, with prudential regulation as the Supervisor of Bank's main goal, the Supervisor is reluctant to make any move that may endanger not just the stability of the banks, but their profitability and the public's trust; second, a possible regulatory capture. However, these explanations deserve further examination, which is beyond the scope of this research.

Based on our research, our main recommendation for the banking regulators is to oblige the banks to publicly report their misconduct costs, both in their financial statements and in their CSR Reports. Under the suggested obligation, banks will have to report the total amount of their misconduct costs, to provide data about these costs, and to specify significant costs while providing detailed information about them.

The regulator's directive should determine a clear and detailed definition of the term "misconduct costs", similarly to the definition used in this research. This definition includes not only sanctions imposed on banks, but each and every expense that derives from or is related to the misbehaviour of banks. In addition, the directive should specify the data required and the level of detail that banks should provide. Finally, the directive should determine what is considered as "significant", based on either the sum of the cost or its nature.

In any event, we have to bear in mind that reporting misconduct costs is only the first stage. Without the banks' true efforts to improve their conduct and their ethical culture, no real change will occur, and the amounts of misconduct costs will continue to increase and endanger the system.