

## **Best Practices of Financial Institutions (Not to be cited)**

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### **Abstract**

Institutions of financial intermediation are now amid recapitalisation, but they also need financial remediation programmes, both voluntary and mandatory. Consumer complaints are on the rise. They are stemming from alleged errors, processing mistakes, technical glitches, and other issues related to credit cards, ATMs, marketing programmes, debt collection practices or loan services. That is because, today's technology makes it easier than ever for consumers to identify, report, and join real complaints, placing banking and financial institutions in a reactive – and often costly – position. Financial executives need to take corporate social responsibility (CSR) seriously. They must execute remediation programs effectively to minimise cost, avoid heavy penalties and corrective actions, and enhance favourability among consumers and regulators.

Financial institutions are expected to embed sustainable business practices as part of their ethical approach in conducting their businesses. This study examines the role of internal and external pressures in CSR reporting among financial institutions in India, using the stakeholder theoretical frame. Undoubtedly CSR is the explicit reflection of the ethical system of a corporate firm, but consumers are less aware of them, especially with regards to banks in India. This paper analyses how banks are reorienting themselves towards a new system of corporate governance in a competitive world of business, especially because doing business out of others' finances is inherently fragile and the social cost of deviance is substantial, irrespective of the degree of the lapse. This is a study also in new global financial intermediation and value addition in banking services.

**Keywords:** Bank, CSR, disclosure, ethical finance

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## **Introduction**

Globalisation has generated interdependencies among as well as within economies and has thickened the global – local nexus in market relations. These changes are visible in the character and framework of the market. Participants on the supply side made up of business organisations are experiencing profound changes in expectations in the markets they participate, propelling them to pursue multiple objectives rather than limiting their goals to mere profit maximisation as envisioned by adherents of the neoclassical orthodoxy. What this implies is choices of market participants, herein the firms or corporate enterprises, affect multiple stakeholders, some directly and some others more indirectly. The objectives of corporate enterprises have transitioned from materialistic improvement to strategic choices that directly or indirectly contribute to improving the community's quality of life and to social betterment.

Putting it another way there are ethical issues and nuances concerning several stakeholders in the economic space that cannot go unnoticed and unattended. The question is whether sellers or corporate enterprises as participants in the market are being socially responsible and this is a foundational ethical question too. It concerns a particular type of corporate behavioural dimension and concept called Corporate Social Responsibility. CSR both as an abstract idea and as praxis has transitioned from being conceived merely as philanthropy to a perception of social responsibility and onwards to being comprehended as strategic corporate social performance. It is now not just a short run reaction to social and regulatory strictures but is evolving into a corporate endeavour of generating long term market value and standing. In fact this is an existential question i.e. to pursue a maximising life or a satisfying life (Rassendren & Prasad, 2013).

## **Rationale of the study**

Institutions whose fundamental business is financial intermediation are traversing a tumultuous period due to deliberate neglect of due processes, technical glitches and many other issues. They are enduring a phase of trust deficit from their consumers and from the society at large. Any intransigent and persistent neglect of ethics in financial operations i.e. any degree of callous approach towards Corporate Social Responsibility (CSR), will attract reactions and penalties from both those who have the authority to exercise oversight of the business activities of the financial sector and also from consumers. Hence the core objective of this paper is the conduct a descriptive survey of CSR engagements of select banks operating in India in order to delineate how these enterprises bring into their business loop the concerns of various stakeholders and through such engagements possess the potential of

improving favourability among consumers as well as regulators. The reasoning for choosing the Indian banking industry is its phenomenal growth. When taking the period between 1962 and 2018 aggregate deposits of Indian Banks has risen from Rs.14.17 billion to Rs. 1, 14,260 billion while total bank credit has also climbed up from Rs. 14.08 billion to Rs. 86,254. 25 billion (RBI, 2018). Comparatively the flow of funding from non-banking sources during 2017-18 has been only Rs. 8,869 billion. When both the set of flows are compared the significance of the banking sector to the economy as well as its market is evident.

It is against this backdrop that the banks have been chosen for the present study. Secondly given their important role in terms of their share in the market for finances, the impact of their intermediation between the financial and the real economy is very critical, is of a large scale and can make or break people's livelihoods. Hence it is relevant to explore how socially responsible are banks, here in the case of India, in their processes and practices and what framework of social responsibility – more specifically CSR - do they pursue and how do they report the same. In order to achieve this stated goal the paper is structured as follows:

- (a) The first part will be a review of literature that highlights evolution of CSR and the major debates concerning CSR that in vogue.
- (b) The second part will be a brief elucidation of the stakeholder theoretic frame.
- (c) The third part will be a review of literature concerning managers' attitude towards CSR.
- (d) The fourth part will be a description of the CSR and CSR disclosure of select Indian Scheduled Commercial Banks.
- (e) The last part will be a discussion followed by conclusion about the CSR engagements and the CSR disclosure practices of these select Indian Scheduled Commercial Banks using a stakeholder theoretic frame.

### **Evolution of CSR and major conceptual debates**

Although there were early debates in clearly conceptualizing the idea of social responsibility of business, the discourse began to acquire the quality of pragmatism when firms undertook socially responsible endeavours without compromising on their fundamental goal of earning profits. When examining the background to CSR there are many movements the idea has taken. According to Bert the threat of Communism from the Soviet Union in a way induced a response idea from free-market enterprise in the form of social obligations of business (Spector 1996). Therefore CSR took the shape of corporate philanthropy i.e.

‘corporate giving’ in the decade of the 1950s. The attention was on doing benevolent works to society and discourse about business’ social responsibility was very limited.

Following the 1950s, the civil rights movement, women rights activism, consumer rights movements and environmental rights activities of the decade of the 1960s began to shape the nature of business’ of social activities (Carroll, 1991 & 2008). Still these activities were not being linked to the firms’ financial performance. The absence of this social responsibility – profitability connection can be linked to a critical intellectual conflict that came to the foreground as to what constitutes duties of business enterprises – increasing profits of investors and shareholders or satisfying expectations of social obligations and public welfare (Levitt, 1958; Friedman, 1970; Davis, 1973). What initiated this debate and controversy? It is the sudden and great increase in social movements inducing corporates to respond by imputing welfare concerns in business plans as well as practices and this situation continued into the 1970s. Several writers such as Carroll (1979), Wartick and Cochran (1985) and Wood (1991) claimed that this set the tone for the notions of ‘responsibility, responsiveness and performance’, leading to a distinction between the idea of CSR and corporate social responsiveness wherein the former implied merely a responsible approach without attention to outcomes while the latter implied a responsive approach with attention to outcomes (Alachua & Idowu, 2017). On account of this, decades of the 1960s and 1970s come out as the period of ‘corporate social responsiveness’ (Frederick, 2008). Responsiveness means how well a person or organisations act in a particular way as a result of something else, like judicial activism against exploitative practices, environmental activism, consumer grievances, feminist activism etc. Here social movements caused the transition from responsibility to responsiveness wherein there is a twofold focus, firstly on results of business’ social responsibility activities and secondly on business’ using these activities to make any negative social response to business less harmful and unpleasant (Carroll & Shabana, 2010).

Besides CSR discourse had a second trajectory that of arguments for and against CSR. The argument against the idea of CSR normally starts with the traditional financial contention verbalized most commandingly by the late Milton Friedman in 1962. Corporate administration to Friedman possesses a singular duty which is to improve benefits and gains of proprietors or in the case of joint stock companies of shareholders. Issues concerning the general social sphere, in his frame of argument, are not meant to be the concern of specialists. They ought to be determined by the liberated workings of the free market framework. A second protest to CSR has been that business does not have the essential social aptitude to

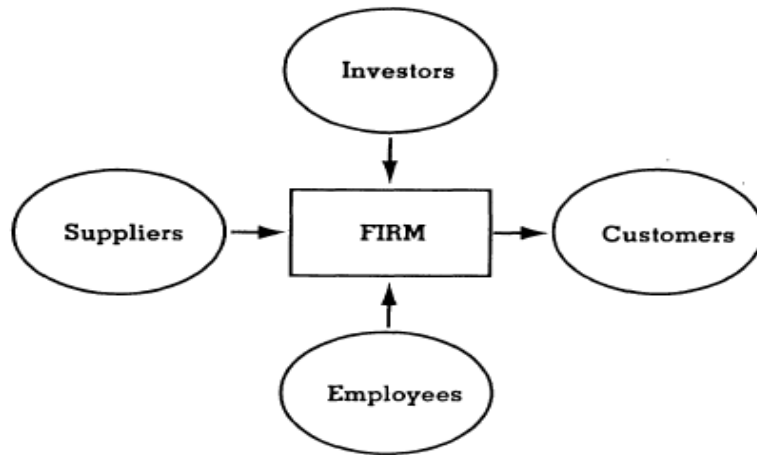
make socially arranged choices especially due to the reality that public goods suffer from the problems of non-excludability and free riding. Private business neither has the financial wherewithal nor the managerial capability to address these challenges (Davis 1973). A third complaint against CSR is that it weakens organizations' main role (Hayek 1969). A fourth contention against CSR is that because businesses have over time come to possess enough capabilities as well as force, CSR would augment its potential to wield greater power particularly in the social sphere (Davis 1973). A fifth contention is that one plausible outcome of attention to CSR is focus getting deviated away from competing in the global market. It ought to be noticed that the contentions presented here were resistances to the idea of CSR when the thought was treated narrowly.

In contrast contentions favouring CSR, as in the previous paragraphs, ordinarily start with the conviction of illuminated self-interest. A second contention for CSR is that it will avoid government regulation. Thirdly there is a repository of management talent, functional expertise as well as capital, and given several others have made serious attempts and failed to either mitigate or solve social problems, it automatically follows that business should be given the chance (Davis 1973). Another argument that legitimises CSR is that being proactive is superior to any act of responding because in the latter case social issues and to an extent even resentment is allowed to simmer and surface as a reaction that can undermine business objectives (Dennis et.al, 2009). This also means business ought to take part in socially responsible activities because people in general attribute significance to it. Such an idea led to CSR becoming a mature phenomenon by the end of the 1970s and in the 1980s. It meant a shift towards calculating the quality, importance and value of CSR policies as well as practices in connection with its performance on the financial cum market share domains.

### **Stakeholder Theoretic Frame**

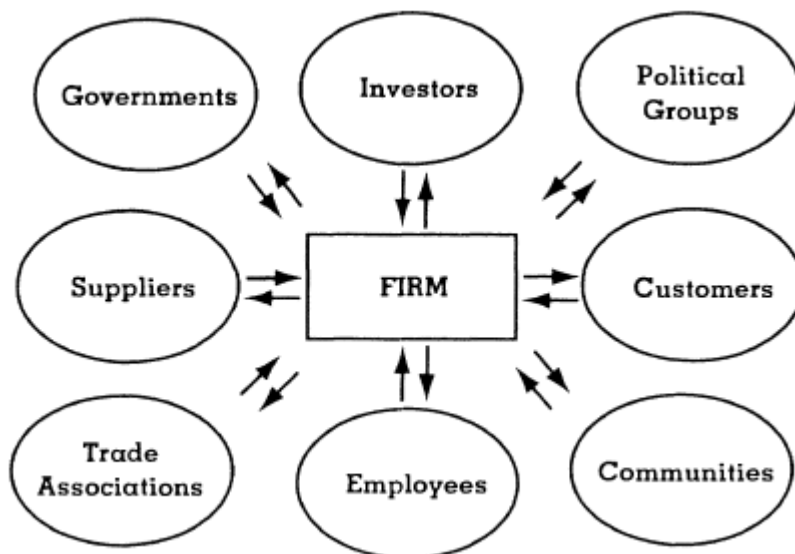
A main theoretical idea connecting various approaches to CSR is the stakeholder theory which will be explicated and cotextualised to the idea of CSR. According to the traditional model of the firm, there are three participants on the supply side namely, investors, employees and suppliers. They provide inputs that the firm transforms into customer favourable outputs. Suitable compensation is expected to be and is equal to the long run competitive equilibrium benefits (see Figure: 3 & 4 for the contrasting approaches). This traditional model is actually based on a separation thesis which states that business decisions are independent of moral nuances and vice versa (Friedman, 1970). But this is a weak proposition because all corporate decisions or choices are an amalgam of multiple dimensions and not just the economic. In contrast as per the stakeholder model there are persons and

groups that have stakes in a firm. There are two kinds of stakeholders namely internal – made up of shareholders, customers, employee and vendors – and the second group called as external stakeholders - made up of environment as well as local community. It is to be noted that while the first group has a more proactive connection with firm the latter group is more docile (Jamali, 2998). Nevertheless, all their interests and gains are of equal importance because they are not just interacting but also interconnecting entities (Sachs & Maurer, 2009).



*Adapted from: Donaldson & Preston, 1995*

**Figure 1: Input - Output Model of the Firm**



*Adapted from: Donaldson & Preston, 1995*

**Figure 2: Stakeholder Model of the Firm**

The stakeholder hypothesis sees the company as an entity through which various members fulfill numerous, and not generally totally harmonious, purposes. The hypothesis has three sorts of uses which are basic to comprehending it. First it is utilized to depict and clarify particular corporate attributes, for example, the nature of the firm, so that explanatory and predictive propositions can be brought out. Second in conjunction with field information it is utilized to explore the associations or absence of associations between stakeholder administration and the accomplishment of customary corporate goals, which is profit and growth of the firm. Third it is utilized to extract normative ethical rules for the operation and administration of companies.

In the stakeholder discourse attempts are made to combine all the above three theoretical approaches even though recognising distinctions among them are significant and critical. Recognising distinctions among the three dominant theoretical nuances of the stakeholder discourse begs the need to justify preference of the stakeholder theoretic over other propositions. This is accomplished when the three parts of the stakeholder proposition are conceptualised as settled inside each other. The outside shell of the proposition is its descriptive angle that makes connections seen in the outer world. At the second level is its instrumental quality. The focal center of the proposition is value driven as it considers how corporate administrators go about treating every partner's interests as having inherent worth (Donaldson & Preston, 1995).

The primary perspective advocating the descriptive view of the stakeholder theory is the belief of many managers that they are to fulfill more extensive expectations of members of society, not just shareholders. A second view is the part it plays as the verifiable premise for existing practices and ideas even in law (Orts, 1992). These two perspectives uphold the idea that stakeholders are characterized by their orientation to the company, instead of essentially by the organization's orientation to them. The second set of justifications concerns the connection between stakeholder strategies and organisation performance. This connection has never been tested directly, and its testing is ridden with data collection and methodological challenges (Clarkson, Deck, & Shiner, 1992). However, linking stakeholders to customary ideas of organisational behaviour can be accomplished through explanatory contentions. Here the bulk of ideas are based on the principal agent theory (Jensen and Mechling, 1976) and another theoretical frame of the firm as a nexus of agreements (Winter and Williamson, 1991). The reason is the dominance of the productivity as well as efficiency orientations.

Scholars of organisation studies contend that enterprises are organized to minimize

cost and capture scale economies. So the focus of stakeholder–agent relationship turns out to be organisational efficiency mediated by rules of governance that take cognisance of interests of all parties. So the stakeholder model is actualized as an arrangement of satisfactory agreements which incentivises organisational performance (Donaldson & Preston, 1995). This efficiency cum performance based stakeholder frame of business – society interconnection possess a wealth creation focus wherein the corporate firm is responsible to all its claimants – resource related, market related, society related and polity related, as they have the potential to create wealth besides simultaneously bearing related risk of firms’ wealth generating capacity. However, the issue here is about procedural justice and distributive justice. In the case of procedural justice, it is incorporating the principles of choice and action of all stakeholders into the firms’ strategy. As per the distributive justice idea attention is on deciding share of the outcomes to various stakeholders. It is dependent on how much they help to generating benefits for the firms and bear relevant risks (Sachs & Maurer, 2009). Such a descriptive perspective of stakeholder theoretic to CSR has resulted in two interesting explanatory arrangements – “The Grid of Values” (Longo et.al, 2005) and “CSR actions vis-à-vis key stakeholders” (Papasolomou et.al, 2005) which are given subsequently in Tables –1& 2.

**Table 1: Grid of Values**

TABLE II  
The grid of values (Longo et al., 2005)

Stakeholder	Expectations divided into value classes
Employees	Health and safety at work Development of workers’ skills Wellbeing and satisfaction of worker Quality of work Social equity
Suppliers	Partnership between ordering company and supplier Selection and analysis systems of suppliers
Customers	Product quality Safety of customer during use of product Consumer protection Transparency of consumer product information
Community	Creation of added value to the community Environmental safety and production



**Table 2: CSR vis-a-vis Stakeholders**

TABLE III  
CSR actions vis-a-vis key stakeholders (Papasolomou et al., 2005)

Stakeholder	Actions vis-a-vis key stakeholders
Employees	<ul style="list-style-type: none"> <li>Provides a family friendly work environment</li> <li>Engages in responsible human resource management</li> <li>Provides an equitable reward and wage system for employees</li> <li>Engages in open and flexible communication with employees</li> <li>Invests in employee development</li> <li>Encourages freedom of speech and promotes employee rights to speak up and report their concerns at work</li> <li>Provides child care support/paternity/maternity leave in addition to what is expected by law</li> <li>Engages in employment diversity in hiring and promoting women, ethnic minorities and the physically handicapped</li> <li>Promotes a dignified and fair treatment of all employees</li> </ul>
Consumers	<ul style="list-style-type: none"> <li>Respects the rights of consumers</li> <li>Offers quality products and services</li> <li>Provides information that is truthful, honest and useful</li> <li>Products and services provided are safe and fit with their intended use</li> <li>Avoids false and misleading advertising</li> <li>Discloses all substantial risks associated with product or service</li> <li>Avoids sales promotions that are deceptive/manipulative</li> <li>Avoids manipulating the availability of a product for purpose of exploitation</li> <li>Avoids engagement in price fixing</li> </ul>
Community	<ul style="list-style-type: none"> <li>Fosters reciprocal relationships between the corporation and community</li> <li>Invests in communities in which corporation operates</li> <li>Launches community development activities</li> <li>Encourages employee participation in community projects</li> </ul>
Investors	<ul style="list-style-type: none"> <li>Strives for a competitive return on investment</li> <li>Engages in fair and honest business practices in relationships with shareholders</li> </ul>
Suppliers	<ul style="list-style-type: none"> <li>Engages in fair trading transactions with suppliers</li> </ul>
Environment	<ul style="list-style-type: none"> <li>Demonstrates a commitment to sustainable development</li> <li>Demonstrates a commitment to the environment</li> </ul>

In a way this descriptive view of the stakeholder theory also appears instrumental in character and is prudence cum agency based as it focuses on the self-interest of the various stakeholders including the shareholders. In term of its foundation of ‘prudence’ it might seem to be on weak footing compared to its moral dimension. Here the reconciliation thesis states that discontinuity in a fundamental manner does not exist between self-interest as well as morality. There is no conflict between rational prudence and moral behaviour. However evidence established in a scientific way is sparse on whether action or not acting well will ultimately be in the best financial interest of the company. In terms of its agency perspective wherein the central idea is that corporate firms have duties based on trust towards stakeholders, the approach has two trajectories. According to the first one firm’s decisions and activities must be based on accepted moral foundations. However this does not necessarily assure that firms will fulfill their duties to stakeholders. The second combines and connects strategy with fiduciary approach, profit with duties to stakeholders. It is akin to Goodpaster’s idea of a ‘corporation with a conscience’ (Goodpaster, 1991). However making this a reality heavily depends on the firms’ managers and there is no real guarantee as to their ethical orientation (Gibson, 2000).

But as there are multiple stakeholders, connecting with all their interests is a challenge especially because shifting attention from shareholders to other stakeholders is a normative choice, that is to say it is a permanent choice of justice more than an efficiency choice. The argument is that corporate officials are not morally less obliged than anybody and this argument directly opposes a management control orientation to corporate behaviour. It is a deontological paradigm based on the belief that stakeholders have claims on firms and so firms both explicitly and implicitly have duties to them. It implies that the stakeholders are more than just means to maximum profit. At this juncture there is a serious debate as to whether stakeholders have needs or wants. The distinction between stakeholders' needs and wants is relative although both create duties to be performed for them. Putting it another way although all stakeholders have equal rights it does not make all rights equally legitimate at all times. So a firm may not have equal degree of duties towards all stakeholders. This argument becomes even more significant when stakeholders are groups and not just individuals. Stakeholder groups are aggregative entities and are distinct from mere individuals. Hence there are no equal stakeholders at all times but multiple stakeholder groups with differential degrees of claims on corporate firms in different time periods and contexts (Donaldson & Preston, 1995; Gibson, 2000).

This normative trajectory to stakeholder theory draws out of an evolving theory of property which justifies constrictions on the harmful uses of property because private is not an unfettered right and cannot be allowed to run contrary to goals of distributive justice. Implicitly this is related to sustainable property rights between the firm and its stakeholders because how much is distributed depends on how much is owned and used. Due to the above arguments a pluralistic theory of stakeholder management is essential. But this pluralistic theoretical orientation enlarges the breadth about who can be included as a stakeholder because corporate wealth creation process can change relationships between various stakeholders and their responsibilities, given changing contexts of the firm. However each of the principles of stakeholder responsibility has certain implications in the form of constraints. As to the first principle of specific stakeholder responsibilities the implication considered is, there are no generic responsibilities. The second principle of fair wealth distribution is a necessary incentive for stakeholders to be part of the firm's wealth creation process. With respect to changing from a static to a dynamic framework of stakeholders' responsibility, it is required to identify, design and implement those responsibilities. But recent trends show competitors and media as very powerful claimants. With respect to the former, firms as competitors may collaborate to accomplish common non-competitive goals. The latter is an

unusual position in that their activities are likely to have an influence on the firm but it is not necessarily a stakeholder. So it is important to differentiate between those who influence and those who have stakes in the firm, between those who will be opportunistic and acquisitive versus those who will be socially committed in their choices. In spite of these clarifications with regards to stakeholder responsibilities there are two missing links. The first is to move away from traditional strategic management frames to explain relation between stakeholders and firms. The second is the challenge of how to measure stakeholders' contribution. All these need empirical investigation. Nevertheless at its core stakeholder theory is a normative proposition that makes it obligatory for firms to perform their duties to stakeholders which in turn lubricates relations between the corporation and social constituencies so as to be able to “create, sustain and enhance value creating capacity” (Donaldson & Preston, 1995; Sachs & Maurer, 2009; Post et.al, 2012).

### **CSR of Select Indian Scheduled Banks**

Indian scheduled banks are broadly made up of two groups the public sector banks owned by the state and the private sector banks owned by private shareholdings. The latter is further subdivided in terms of their period of existence and private banks and new private banks. In this study both public sector banks and a private sector bank including the new ones have been considered as two groups of banks and does not include foreign banks operating in India. In each of the groups a description followed by a discourse analysis based on stakeholder approach is done for the top five banks sampled on the based on the size of their deposits as on March 31<sup>st</sup> of 2019. The detail of this sample is given in Table – 3 and 4 with regards to public sector banks and private sector banks respectively.

**Table 3: Top Five Public Sector Banks by Total Deposits (2019)**

<b>Rank</b>	<b>Name of Bank</b>	<b>Deposits-2019 (Rs. Crs)</b>
<b>1</b>	<b>State Bank of India</b>	<b>29, 11, 386</b>
<b>2</b>	<b>Bank of Baroda</b>	<b>6, 38, 690</b>
<b>3</b>	<b>Punjab National Bank</b>	<b>6, 76, 030</b>
<b>4</b>	<b>Canara Bank</b>	<b>5, 99, 033</b>
<b>5</b>	<b>Bank of India</b>	<b>5, 20, 862</b>

*Source: Indian Banking Association*

**Table 4: Top Five Private Sector Banks by Total Deposits (2019)**

<b>Rank</b>	<b>Name of Bank</b>	<b>Deposits 2019 (Rs. Crs)</b>
<b>1</b>	<b>HDFC Bank Limited</b>	<b>9, 23, 141</b>
<b>2</b>	<b>ICICI Bank Limited</b>	<b>6, 52, 920</b>
<b>3</b>	<b>The Federal Bank Limited</b>	<b>5, 48, 471</b>
<b>4</b>	<b>The Jammu and Kashmir Bank Limited</b>	<b>89, 638</b>
<b>5</b>	<b>The South Indian Bank Limited</b>	<b>80, 420</b>

*Source: Indian Banking Association*

When surveying the main web portals of the above mentioned banks two observations can be made regarding their best practices concerning corporate social responsibility. The first is all the banks in the sample demonstrated the tendency of communicating with their customers both present and potential. The second is all the banks in the sample communicated their CSR policies and activities by placing a head called CSR in their home webpage. However it is interesting to observe that Bank of India had a Citizen Charter which was not the case with the other banks chosen in the sample. The core stakeholder of this charter was the customer and about how the bank would deal with issues concerning this stakeholder. In fact it had made two categories of customers i.e. the normal customer and special customers wherein the latter consisted of pensioners, senior citizens, self-help groups, rural customers, semi-urban customers, tribal communities and communities in the north eastern states of India. An interesting observation that can be made here is while the other banks also focussed on their most critical stakeholder namely the customer through their 'know your customer' (KYC) approach, it the Bank of India that had a declaration in the form of a charter. Semantically a charter is defined as a formal statement of rights. When the Bank of India had formalised its commitment to the customer through a charter it was implicitly accepting the rights of customers. So here the most critical stakeholder actually has stakes in the form of rights that need to be met by a financial service provider.

In the case of the CSR activities of the banks in question all are engaged in activities and projects closely related to the socio economic development of the nation. To quote a few examples, the following list is indicative of the just hitherto made observation:

- (a) State Bank of India – preventive and primary health care, education for all, rural development, child empowerment, sports and games etc.

- (b) Bank of Baroda – Education and skill development, healthcare and general socio-economic development etc.
- (c) Punjab National Bank – rural self- employment training, farmers training, literacy etc.
- (d) ICICI bank – skill development, and self – employment etc.
- (e) The Federal bank – rehabilitation, environment, health care, financial inclusion, support to government agencies etc.
- (f) The South Indian Bank –student merit scholarships, sports, health care, environment.

### **Discussion, conclusion and scope for future research**

Out of the details gleaned out from the home page of the official website of the banks chosen in the study's sample, the indicative list of specific CSR activities of certain banks of the sample put forward in the preceding section and corroborating the same with the various versions of the stakeholder theoretic frame a few important observations and arguments can be put forward. These points are going to be foregrounded using the 2005 'Grid of Values' version of the stakeholder theory propounded by Longo et al and an attempt to interrelate the same to Carroll's CSR Pyramid (1996) is also undertaken. The framework called the 'grid of values', consist of four stakeholders namely customers, employees, suppliers and community. In the banking industry the role of the suppliers as a stakeholder is relatively indirect given the nature of the banking business. When it comes to the other three stakeholders, employees' conditions and interests are addressed by the banks based on mandated labour laws of the Indian government. The approach is akin to the legal responsibility component which is the second CSR element form the bottom of Carroll's CSR Pyramid (Carroll, 1996). Further all the banks have addressed their customer stakeholders through their 'know your customer' (KYC) approach which interestingly in the Indian context is also a legal obligation. There is an additional perspective that has been contributed by the 'Citizens Charter' approach demonstrated by the Bank of India. This bank has a separate declaration that their customers are an entity with rights and so it enjoins on the bank to ensure that their customers' entitlements are not compromised. Interestingly though this has connection to the legal component of the CSR Pyramid it simultaneously gets incorporated into the ethical element of the pyramid because ensuring anyone's rights are protected and not violated is in accordance with what is just, good and proper. Despite this exception in the banks of the study's sample, given that customers are the mainstay of the banking industry taking care of this stakeholder group has a clear business case to it and so while it is present in the grid of

values it simultaneously meets up with economic responsibility component which is right at the base of the CSR Pyramid.

Leaving aside these three stakeholder groups, what remains in the grid of values is the community stakeholder group. This now implies that all the various projects and engagements that are listed in the CSR policies and CSR disclosures of the banks herein chosen for observation are directly and closely related to the community stakeholder group within the grid of values. According to Longo et al's 'grid of values' the contributing to the community stakeholder group means valued enhancement for lives of people, the environment and overall productivity. Here almost all of the CSR activities of the sampled banks such as for example, green initiatives, health care, financial inclusion, health care, socio-economic development, skill enhancement, self-employment, farmers training, poverty eradication, mitigating malnutrition, child empowerment and so on, clearly fit into this variable of the grid. Simultaneously it illustrates a fit with the 'philanthropy' component which is right at the very top of the CSR Pyramid. Another observation that can be made is that these CSR components also are in synchronisation with the demand and expectations of nation building. The modern nation state as a welfare state and the Indian nation state is no exception is obligated to supply and/ or support out of its revenue the supply of these objects and services. They in fact the various dimensions of social provisioning which eventually improve citizens' welfare and well-being alongside augmenting national productivity. Therefore it can be inferred that in India the CSR of the banking sector is of the nature of being a corporate citizen, and this means being an active participant in increasing the wealth of the nation.

In this study an attempt has been made to typify the character, which is to say to represent the embodiments and salient characteristics of the corporate social responsibility engagements of select Indian banks. While putting forward this representation it has been possible to observe a pattern through the lense of the 'grid of values' and the CSR Pyramid. However the generalisability of the inferences can be further increased by analysing the pattern of spending among the various CSR activities and exploring the relative shares of the CSR fund given to the specific CSR projects. This would help highlight the manner of prioritisation attributed by different banks to different CSR aspects. Ultimately this would also help to know how the banks are positioning their CSR.

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# The Role of Political Economy in Designing Banking Regulation

The Israeli Bank Fees Reform as a Test Case

RUTH PLATO-SHINAR

## 7.1 Introduction

According to the Public Interest Theory, the aim of regulation is to maintain and promote the public interest. Regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices, and it is designed to improve the public's welfare by correcting market imperfections. The underlying assumption of the concept of regulation is that no other body (private, group, or the market as a whole) can satisfy the public's interest in a more effective manner, and therefore regulation was established as the mission of the regulatory agency. Regulation is assumed to benefit society as a whole, rather than any particular vested interests. The regulatory agency represents the interest of the society in general, within which it operates, rather than the private benefit of certain interest groups or those of the regulator himself. The regulators are perceived as professionals, specialists in their field, honest in their pursuit of public goals, and unbiased, thus capable of fulfilling their goals.<sup>1</sup>

<sup>1</sup> M. E. Levine and J. L. Forrence, "Regulatory Capture, Public Interest and the Public Agenda: Towards Synthesis," *Journal of Law, Economics and Organization*, 167 (1990); M. Hankte-Domas, "The Public Interest Theory of Regulation; Non-Existence or Misinterpretation?," *European Journal of Law and Economics*, 15 (2003), 165–194; R. Baldwin, M. Cave and M. Lodge, *Understanding Regulation: Theory, Strategy and Practice*, 2nd edn. (Oxford: Oxford University Press, 2012), 40–43; R. A. Posner, "Theories of Economic Regulation," *The Bell Journal of Economics and Management Science*, 5 (1974), 335, 335–341; J. den Hertog, "Review of Economic Theories of Regulation," Discussion Paper No. 10–18, Tjalling C. Koopmans Research Institute 5–21 (2010), [www.uu.nl/sites/default/files/rebo\\_use\\_dp\\_2010\\_10-18.pdf](http://www.uu.nl/sites/default/files/rebo_use_dp_2010_10-18.pdf).

However, this normative theory does not always match reality. The regulator does not always understand his task. He may use poor judgment in the prioritization of his goals. He may not act industriously enough in the fulfillment of his powers. He may prefer the interest of a specific interest group over that of the general public, and may act egocentrically by promoting his own self-interest.<sup>2</sup> As a result of these and other issues, regulators do not necessarily maintain and promote the public interest.

These regulatory failures may also apply in the banking sector and characterize the regulator of banks. Banking is a complex activity, obliging the regulator to use enhanced knowledge and a very high level of specialization. Banking is a dynamic field that requires the regulator to keep pace and adopt an active attitude in order to meet the market's needs. Often, the banking regulator is in charge of both prudential regulation (maintaining the stability of the banking system) and the conduct of business regulation, goals that may contradict each other and may require a sensitive balance between them, which is not an easy task. The banks, as a special interest group with a huge financial and political clout, may attempt to convince the regulator to adopt a policy that suits their needs, to the detriment of the general public. As a result of all these issues, the banking regulation, in many situations, fails to achieve its objective and does not work in favor of the general public.

However, the Israeli experience shows that under certain circumstances, public pressure can overcome such a regulatory failure and result in regulation fashioned to suit the interests of the public. A case that well illustrates this issue is the bank fees reform that took place in Israel in 2007, and which will serve as the test case in this chapter.

The structure of this chapter is as follows: section 7.2 describes the Israeli banking system with its special characteristics – a high level of concentration and a low level of competition. These idiosyncrasies created preliminary conditions for the creation of systemic failures in respect of the bank fees. Section 7.3 provides the background of the banking fees reform analyzed herein. It illustrates the problems that characterized the bank fees arrangements prior to the reform. The following three sections contain a chronological survey of the developments that took place in respect of bank fees throughout the years.

<sup>2</sup> This theory has been known as the “Public Choice Theory.” See, in general: J. M. Buchman and R. D. Tollison (eds.), *The Theory of Public Choice*, 4th edn. (Ann Arbor MI: University of Michigan Press, 1994).

Section 7.4 analyses the efforts for regulating the bank fees prior to the 2007 Reform, efforts that were unsuccessful in solving the failures of the system. Section 7.5 describes the Bank Fees Reform which, for the first time, established supervision over bank fees. The section also analyzes the Reform's immediate results. Section 7.6 deals with another turning point: The social protest that erupted in the summer of 2011 and which resulted in enhanced supervision over the bank fees. The measures that the Bank of Israel took at that point, together with a slow but consistent reduction of fees as an on-going implementation of the 2007 Reform by the banks, finally resulted in a true change in the bank fees arena.

The impression from the last three chapters is of a passive attitude of the Supervisors of Banks over the years, and of a clear agenda of non-intervention in respect of bank fees. Section 7.7 suggests two explanations for this approach. It argues that Supervisors of Banks tended to focus their attention on prudential regulation, rather than consumer protection, and therefore neglected consumerist issues, such as bank fees. Moreover, in their desire to strengthen the banks' stability, the Supervisors preferred not to take measures that could have cut the banks' profitability, and therefore avoided curtailing bank fees. The section also refers to regulatory capture, as an additional possible explanation for the passivity of the Supervisors. Section 7.8 concludes with a few thoughts regarding the relationship between the passivity of regulators, public pressure, and the role of the political echelon.

## 7.2 The Israeli Banking System

The banking system in Israel consists of five major banking groups that control about 94 percent of the bank assets in the country. In addition, there are three small independent banks and isolated branches of four foreign banks. The banking corporations provide a wide range of financial services, including corporate, commercial and retail banking, housing loans and credit card transactions. In addition, they provide investment counseling, brokerage services, and pension advice. The three credit card companies that operate in Israel are owned by the large banks.<sup>3</sup>

<sup>3</sup> For elaboration on the Israeli banking system, see: R. Plato-Shinar, *Banking Regulation in Israel: Prudential Regulation versus Consumer Protection* (Alphen aan den Rijn: Wolters Kluwer, 2016), 31–37. A recent law obliges the two largest banks to sell their credit card companies. See the Law to Enhance Competition and Reduce Concentration in Israel's Banking Sector (Legislative Amendments), 5777–2017.

In the field of insurance, the activities of the Israeli banks are limited due to statutory restrictions. They market, through special subsidiaries, property insurance and life insurance as incidental services to the provision of housing loans.<sup>4</sup> Other activities, which – due to the restrictions of the law – are performed by subsidiaries, are underwriting and portfolio management.<sup>5</sup> Although the banks are allowed to provide trust services pursuant to section 10 of the Banking (Licensing) Law, in practice these services are provided by subsidiaries of the banks as well. As a result of a 2005 reform in the Israeli capital market, the banks are prohibited from managing provident funds or mutual funds, and from holding companies that manage such funds.<sup>6</sup>

The banks are subject to the Banking Supervision Department at the Bank of Israel. The Department is headed by the Supervisor of Banks, who is appointed by the Governor of the Bank of Israel.<sup>7</sup>

As mentioned above, the Israeli banking system consists of five banking groups, whose joint assets amount to about 94 percent of the total assets of the system. Approximately 58 percent of these assets are held by the two largest groups (Bank Leumi and Bank Hapoalim). This centralized structure constitutes a duopoly, where two players control the vast majority of the activities of the sector.<sup>8</sup>

Concentration in the Israeli banking system is rather high. In 2015, the Herfindahl-Hirschman Index (HHI), 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 (CR2), 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>9</sup>

Another conspicuous characteristic of the Israeli banking system is the low level of competition between the banks. This observation is mainly based 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

<sup>4</sup> Banking (Licensing) Law, s. 11(b).

<sup>5</sup> Banking (Licensing) Law, ss. 11(a)(3a) and 11(a)(3b).

<sup>6</sup> For elaboration on the Capital Market Reform, see: Plato-Shinar, *Banking Regulation*, 23–24.

<sup>7</sup> For elaboration on these supervisory powers, see *ibid.*, 14–16, 66–73.

<sup>8</sup> Supervisor of Banks, *Israel Banking System – Annual Survey 2015* (August 2016), 8–9.

<sup>9</sup> *Ibid.*, 9. Supervisor of Banks, *Israel Banking System – Annual Survey 2014* (June 2015), 12.

of competition.<sup>10</sup> A low level of competition was also found using the Contestable Market Theory, according to which competition can exist, even in a concentrated market, on condition that a real threat of competition exists, pressurizing the existing players to behave competitively. Apparently, such a threat does not exist in the Israeli banking system.<sup>11</sup> The Paznar-Rosse H-Statistic value for the Israeli banking system in various years was found to be lower in comparison to other Western countries, thus indicating a lower level of competition.<sup>12</sup>

These characteristics of a high level of concentration and a low level of competition were used by the banks adversely against their customers, as will be explained in section 7.3.

### 7.3 Failures in the Bank Fees System

In Israel, until the bank fees reform of 2007, there was no supervision of bank fees.<sup>13</sup>

It transpired that, for many years, the banks in Israel had used the mechanism of bank fees in an inappropriate manner, in order to increase

<sup>10</sup> See, e.g., Report of the Team to Examine Increasing Competitiveness in the Banking System (March 2013), 51, [www.boi.org.il/he/NewsAndPublications/PressReleases/Pages/19032012e.aspx](http://www.boi.org.il/he/NewsAndPublications/PressReleases/Pages/19032012e.aspx) and summary in English at [www.boi.org.il/en/BankingSupervision/Survey/Pages/competition.aspx](http://www.boi.org.il/en/BankingSupervision/Survey/Pages/competition.aspx); 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), <http://mof.gov.il/Committees/competitivenessCommittee2015/MidReport2.pdf>; Bank of Israel, *Examination of the Prices of the Banking Services – Recommendations of the Work Teams* (January 2007), 4, [www.boi.org.il/he/Research/Pages/neumim\\_neum226h.aspx](http://www.boi.org.il/he/Research/Pages/neumim_neum226h.aspx).

<sup>11</sup> D. Rotenberg, "The Competitiveness in the Banking Sector: Theoretical Aspects and Empirical Evidence from Israel and Abroad," Banking Supervision Department Research Unit, Working Paper (2002), [www.boi.org.il/he/Research/Pages/papers\\_dp0502h.aspx](http://www.boi.org.il/he/Research/Pages/papers_dp0502h.aspx); Report of the Committee to Enhance Competitiveness in Common Banking and Financial Services, supra n. 10, at pp. 8–13 (in respect of retail credit); *Examination of the Prices of the Banking Services – Recommendations of the Work Teams*, supra n. 10, at pp. 6–12.

<sup>12</sup> Committee to Enhance Competitiveness in Common Banking and Financial Services, "Background Survey for the Interim Report," pp. 8–9. Bank of Israel, *Examination of the Prices of the Banking Services*, 8–9; Parliamentary Inquiry Committee on Bank Fees, Final Report (June 2007), 16–17, in Hebrew at [www.knesset.gov.il/committees/heb/docs/bank\\_inq.pdf](http://www.knesset.gov.il/committees/heb/docs/bank_inq.pdf).

<sup>13</sup> For an opinion that the bank is subject to a fiduciary duty when determining its fees, see L. Haim, "Bank Fees: Banking Liability in their Determination and Collection (following CA 4619/08 Mercantile Discount Bank v. Ezrat Israel Housing)," *Mishpatim Online*, 5 (2013), 51. For the opposite opinion, see R. Plato-Shinar, *The Bank's Fiduciary Duty: The Duty of Loyalty* (Israel: Bar Publishing, 2010), 103–105.

their profits at the expense of the retail sector (individuals, households and small businesses), that were perceived as weak customers.<sup>14</sup> A few problems could be noted in this regard.

Firstly, due to an absence of competition between the banks, the banks permitted themselves to charge very high fees. The level of fees increased sharply from year to year, even surpassing the rise of the consumer price index. For example, from June 1999 to January 2005, the level of fees increased by an average of 12.2 percent, in comparison to an increase of 7.9 percent in the consumer price index, meaning that the fees actually increased by 4 percent above the index.<sup>15</sup> In addition, in the years 2001–2003 there was a serious economic recession in the Israeli economy, which was accompanied by a sharp decline in real wages. Nevertheless, bank fees continued to rise.<sup>16</sup> In 2007, the average expenditure of an account holder for basic bank services was 73 percent higher than its counterpart in Western countries.<sup>17</sup>

Another problem was the multiplicity of fees charged by each bank for financial and operational services. In 2007, on the eve of the bank fees reform, there were banks that charged more than 300 different types of fees to retail customers. Between 1993 and 2007, the number of fees for actions in current accounts increased by 137 percent; the number of fees for computerized and technological services increased by 147 percent; and the number of fees in respect of credit cards increased by 189 percent.<sup>18</sup> While in other developed countries such as the United Kingdom and the United States, a current account with a positive balance bore no fees, and fees were charged only in cases of no cover or exceeding a credit facility, in Israel customers had to pay fees for each and every action which was executed in their account, no matter its balance, plus expensive fees in cases of a lack of cover or of a credit facility excess.<sup>19</sup> In 2005, the Israeli banks' income from fees charged to households constituted 49.5 percent of their total income from fees.<sup>20</sup>

In addition, the banks used to collect double fees for the same transaction. A good example for such a double fee was the "line-entry fee": For

<sup>14</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 32.

<sup>15</sup> *Ibid.*, 34. Knesset Research and Information Center, "The Prices of Banking Services," (May 2006), 3.

<sup>16</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 41.

<sup>17</sup> *Ibid.*, 36.

<sup>18</sup> *Ibid.*, 32.

<sup>19</sup> *Ibid.*, 35.

<sup>20</sup> *Ibid.*, 37.



every line that was recorded on the bank statement of the customer, the bank charged a fixed fee, even if the customer was charged with an additional, specific fee for the transaction itself. The banks explained that this fee was intended to cover their computer expenses in the handling of the customer's account. However, they used to charge an "account management fee" as well, another variety of a double fee. Other examples for double fees were: A "documents processing fee," a "collection fee" that was charged for every monthly installment of a loan repayment, "credit card membership fee," and more.<sup>21</sup>

A fourth problem was information barriers. The bank fees system was extremely complicated. It not only contained hundreds of types of fees, as explained above, but, in addition, some of the fees comprised a few levels (such as the fees in respect of securities trading). Rules promulgated over the years with the aim of making the fees simpler and clearer did not solve the problem.<sup>22</sup> As a result, customers were unable to understand the cost of banking services. In addition, each bank identified and calculated the fees differently, which made it impossible for customers to compare them from bank to bank.<sup>23</sup>

Last, but not least, one should mention the phenomenon of the great similarity in the level of fees that were charged by the different banks. For years, there was almost complete uniformity in the fees that the banks charged their retail customers. Moreover, when one bank raised a fee, the other banks were quick to update their parallel fee by a similar rate. Although this phenomenon lasted for years, the Supervisor of Banks did not intervene.

This phenomenon of great similarity among fee levels served as the basis for a lengthy investigation by the Director General of the Antitrust Authority. The investigation revealed that from the 1990s until 2004, the five major banks had exchanged among themselves information concerning the fees that they charged, which constituted a criminal offence.<sup>24</sup>

<sup>21</sup> *Ibid.*, 38, 42.

<sup>22</sup> See in section 7.4, below.

<sup>23</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 38.

<sup>24</sup> Israel Antitrust Authority, "A Ruling regarding Restrictive Arrangements between Israeli Banks regarding the Transfer of Information about the Bank Fees" (April 26, 2009), [www.antitrust.gov.il/subject/120/item/25879.aspx](http://www.antitrust.gov.il/subject/120/item/25879.aspx). However, in 2014, following an appeal that was filed by the banks with the Antitrust Tribunal against the Director General's ruling, the case was settled and the ruling against the banks was cancelled. In return, the banks undertook to pay the Antitrust Authority ILS 70 million. Not only was this sum much lower in comparison to the amounts involved, the banks were allowed to set off an

#### 7.4 Attempts to Regulate the Bank Fees Prior to the 2007 Reform

Until the bank fees reform of 2007, there was no systemic supervision of bank fees.

The competent authority to set prices on essential goods and services, by virtue of the Supervision of Goods and Services Law, 5756–1996, was the Ministry of Trade, Industry and Tourism. In isolated cases, where the Banking Supervision Department found it fitting to set a ceiling for the price of a specific banking service, it had to rely on the Ministry's authority, recommending it to act in this regard. The Bank of Israel did not see fit to change this situation, nor to assume the authority to set prices for banking services.

In 1993, the Bank of Israel appointed an internal committee to examine the bank fees. The committee reduced the number of fees charged to households and small businesses to 125 and prepared a standard list of fees to be adopted by all banks.<sup>25</sup> These steps were anchored by the Supervisor of Banks in Proper Conduct of Banking Business Directive No. 414. However, over the years, the banks gradually deviated from the Directive, while the Supervisor of Banks refrained to take any measures against them.

In 1998, the Knesset (the Israeli Parliament) amended the Banking (Service to Customer) Law, 5741–1981. It added section 5A, which obliged the banks to provide their customers with written information about the amount or rate of fees they charge. Information that did not refer to a specific customer, such as the bank's tariff of fees, had to be presented in a prominent location in all the bank's branches. In addition, every quarter the banks had to provide each customer with a notice detailing all fees charged that customer during the preceding three months. Section 5A did not deal with the amount of the fees or their structure. The obligations it imposed on the banks were only meant to increase transparency.

At the beginning of the millennium, public criticism of the banks for mistreatment of customers in general, and in regard to bank fees in particular, started gaining momentum. Serious allegations were made regarding the fees that were being charged to households and small

amount of ILS 35 million that they paid in settlement proceedings relating to class actions that were filed against them in this regard.

<sup>25</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 41; Knesset Research and Information Center, "The Prices of Banking Services," 8–9.

businesses. Expectation arose amongst the public of active intervention on the part of the Supervisor of Banks,<sup>26</sup> but the latter was slow to act.

In 2003, the Israeli Consumer Council launched a campaign concerning bank fees, which attracted intense media coverage and the attention of the Knesset Economic Affairs Committee, which decided to actively intervene in the matter. Between 2003 and 2008 this Committee held 21 hearings that focused or touched upon the banks' excessive fees. In addition, to signal their responsiveness to the public, various members of the Knesset initiated several bills that empowered the Banking Supervision Department in the Bank of Israel, to control bank fees.<sup>27</sup>

In 2003, the Supervisor of Banks appointed an internal team – the Team to Examine the Policy of the Banking Supervision Department in respect of the Prices of Banking Services (the “Fein Team”). In 2004, the Team submitted its report, which determined that the level of fees in Israel was high in comparison to other countries. The Team recommended, inter alia, abolishing many fees, reducing the level of others, and controlling the prices of banking services according to certain criteria.<sup>28</sup> However, it turned out that not everybody in the Bank of Israel agreed with these recommendations. While the Supervisor of Banks was willing to adopt the recommendations, the Governor of the Bank of Israel and other senior officials in the Banking Supervision Departments rejected them.<sup>29</sup> In addition, the Association of Banks in Israel rejected the Team's recommendations, and submitted a counter-report according to which the level of fees in Israel was shown to be similar to the level in other countries.<sup>30</sup>

In 2004, the Knesset Economic Affairs Committee appointed the Team to Examine Issues in the Banking System. It was headed by the Director of the Knesset Research and Information Center, and included representatives from the Economic Affairs Committee, the Israel Consumer Council, the Antitrust Authority, the Association of Banks, the

<sup>26</sup> Compare: P. Cartwright, *Banks, Consumers and Regulation* (London: Bloomsbury Press, 2004), 2, noting that “consumer expectations may not only apply to the relation between bank and consumer, but also to that between bank, consumer and the State, particularly the regulator.”

<sup>27</sup> S. Gilad, “Political Pressures, Organizational Identity, and Attention to Tasks: Illustrations from Pre-Crisis Financial Regulation,” *Public Administration*, 93 (2015) 593, 601.

<sup>28</sup> Knesset Research and Information Center, “The Prices of Banking Services,” 23–24.

<sup>29</sup> Gilad, “Political Pressures,” 602.

<sup>30</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 42; Knesset Research and Information Center, “The Prices of Banking Services,” 25–26.

Ministry of Finance, and the Deputy Supervisor of Banks. In July 2004, the Team published its recommendations in respect of competition in the household sector. As to bank fees, the Team adopted nearly all the recommendations of the Fein Team (which had called for intervention in the prices of the fees). In addition, it focused on increasing transparency regarding fees. For example, by sending a monthly fee statement to the customers, by creating a standard and simple tariff of fees that the banks would be obliged to adopt, by notifying the customer in advance of the fees involved in the requested transaction, and by receiving the customer's specific consent before charging expensive fees. The Team also recommended a duty of semiannual reporting by the Supervisor of Banks to the Knesset Economic Affairs Committee, about the measures taken by him in the preceding six months, in respect of the bank fees.<sup>31</sup>

Some of the above-mentioned recommendations regarding the transparency of the fees were adopted by the Governor of the Bank of Israel. In 2004 the Governor amended the Banking (Service to Customer) (Proper Disclosure and Delivery of Documents) Rules, 5772-1992, by adding new rules regarding due disclosure of bank fees. The rules obliged the banks to exhibit their tariff of fees in their branches, in a prominent manner. In addition, the banks were obliged to obtain informed, advance consent of fees changes from each customer before performing any banking transaction. This duty also applied to transactions performed on the phone or by electronic means.<sup>32</sup>

Immediately after these Rules entered into force, Bank Hapoalim (one of the two largest banks in the country) announced an increase of its line-entry fee by a few cents. This announcement created a new wave of public and media criticism. The Knesset Economic Affairs Committee threatened to promote a legislative bill to strictly limit the bank fees. At the end, the Committee, the Supervisor of Banks and the banks reached a "package deal," which came into force in December 2005. The "package deal" allowed the banks to collect a fixed fee (ILS 1.21) for every bank transaction performed in a current account, with a minimum monthly charge. In consideration, the banks agreed to abolish double fees such as the "account managing fee" and the "line entry fee"; to create baskets of fees that included a certain amount of

<sup>31</sup> Knesset Research and Information Center, "The Prices of Banking Services."

<sup>32</sup> Banking (Service to Customer) (Proper Disclosure and Delivery of Documents) Rules, 5752-1992, ss. 26 and 26A.

services for a fixed – and lower – price; and to facilitate the possibility for customers to switch between banks.<sup>33</sup>

The package deal was honored by the banks for almost one year. But then, in October 2006, the three largest banks decided one after the other to raise their fixed fees, without raising the prices of the baskets of fees. This move escalated public criticism to a new apex and led the Knesset Economic Affairs Committee to a new initiative – a Parliamentary Inquiry Committee in respect of the bank fees.<sup>34</sup>

Concurrent with preparations for establishing the Parliamentary Inquiry Committee, internal working teams at the Bank of Israel examined the issue of the bank fees. In January 2007, almost simultaneously with the formal establishment of the Inquiry Committee, the Bank of Israel published a report about bank fees. The report recommended a series of regulatory steps, as follows: Empowering the Supervisor of Banks to supervise the prices of banking services, especially in sectors where the level of competition is low; creating standard lists of fees while reducing the number of fees; determining a fixed price for the management of a current account; obliging the banks to provide reports about their fees to the Supervisor of Banks on a regular basis; and obliging the Supervisor of Banks to regularly publish comparative tables of the fees charged by the different banks.<sup>35</sup>

In June 2007, the Parliamentary Inquiry Committee published its report. The report pointed to a long list of failures that characterized the bank fees system in Israel, as was detailed in section 7.3. Moreover, the Committee determined that for years, the banks had taken advantage of their influence as pillars of the Israeli economy in order to increase their earnings, mainly at the expense of the retail sector, which was perceived as the weaker party in terms of its bargaining power in dealings with the bank. The Committee determined that “households in Israel pay a ‘lack of competition fee’ when purchasing bank services.”<sup>36</sup> The Committee further noted that, while Western countries had been implementing reforms since the 1980s, in order to encourage competition in the banking industry as well as the non-bank sector, not enough had been done in this field in Israel, because the policy of the Supervisor of Banks had not been sufficiently active in this regard. Throughout the

<sup>33</sup> Supervisor of Banks, *Israel Banking System – Annual Survey 2005* (May 2007), 116, [www.boi.org.il/en/NewsAndPublications/RegularPublications/Pages/skira05\\_skira05e.aspx](http://www.boi.org.il/en/NewsAndPublications/RegularPublications/Pages/skira05_skira05e.aspx).

<sup>34</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report.

<sup>35</sup> Bank of Israel, “Examination of the Prices of the Banking Services.”

<sup>36</sup> Parliamentary Inquiry Committee on Bank Fees, Final Report, 8.

past decades, the Israeli Supervisors of Banks had not implemented an active regulation policy in the field of retail banking.<sup>37</sup>

Based on these findings, the Committee's main recommendations that directly referred to bank fees, were as follows: (1) to transfer the authority of price control in respect of bank fees from the Industry and Trade Ministry to the Bank of Israel; (2) to cap the price of certain fees for a limited period of time (for this, it was recommended that banks and the Supervisor of Banks reach a voluntary agreement, in order to avoid conferring a new power on the Bank of Israel); (3) to determine a standard list of fees for the retail sector which would be identical for all banks, while reducing the number of fees and canceling double fees; (4) to create a few models of current accounts for which a fixed monthly fee could be charged; (5) to oblige the Supervisor of Banks to publish a comparative index of fees paid by household in each bank, which would thereby enable the public to compare fees between banks.<sup>38</sup>

The recommendations of the Inquiry Committee were immediately adopted by the Government and by the Knesset. In July 2007, based on a bill that was formulated by the Bank of Israel, the Banking (Service to Customer) Law was amended,<sup>39</sup> and the Bank of Israel was statutorily authorized to supervise bank fees.

### 7.5 The Bank Fees Reform of 2007

According to the above-mentioned amendment of the Banking (Service to Customer) Law, powers are conferred on the Governor of the Bank of Israel to oversee the fees.

The law grants the Governor two main powers: The first relates to retail customer accounts of individuals, households and small businesses, and empowers the Governor to determine and update – from time to time – a closed list of permissible fees.<sup>40</sup> The aim of the closed list was to reduce the number of fees, to prevent the charging of double fees for the same service, and to present the fees to the public in a way that is fair and understandable, giving the same names to the fees that are charged by the different banks, and ensuring that the customer can compare the prices of different banks. However, the aforementioned power does not include intervention in the prices or the level of the fees.

<sup>37</sup> *Ibid.*, 9.

<sup>38</sup> *Ibid.*, 9–13.

<sup>39</sup> Banking (Service to Customer) Law, Chapter B2.

<sup>40</sup> Banking (Service to Customer) Law, ss. 9I, 9J.

The second power conferred on the Governor is to declare certain bank services to be “a service subject to supervision.” Such a declaration allows the Governor to limit the amount of the fee charged for that service.<sup>41</sup> A service will be declared “a service subject to supervision” if one of the following circumstances exists: The fee charged for the service may reduce competition between the banks or between banks and other institutions that provide similar services; a customer can only receive the service from the bank where his account is managed; in the Governor’s opinion, the service is an essential service for which public welfare recommends supervision.<sup>42</sup>

By virtue of his power, the Governor published in 2008 a list of allowed fees while giving banks discretion to determine actual fees.<sup>43</sup> The result of this move was the abolition of many fees, and uniformity in the names and structure of the rest of the fees that remained in force.

In addition, very few services were declared “a service subject to supervision,” and for such services a limited price was specified.<sup>44</sup> However, regarding most of the fees, the Bank of Israel allowed the banks discretion to determine the level of the fees, while expecting competition to trigger a reduction in prices. Unfortunately, these expectations were not realized: It turned out that some banks took advantage of this reform to the detriment of the customers, and actually increased their fees.<sup>45</sup>

Opinions were divided as to the immediate consequences of the bank fees reform. The Bank of Israel determined that the reform led to a reduction in the “average basket of fees.”<sup>46</sup> However, the Israel Consumer Council found that the average fee charged to households actually increased.<sup>47</sup> In addition, the hope that the Fees Reform would immediately lead to price competition between the banks proved

<sup>41</sup> *Ibid.*, ss. 9K and 9N.

<sup>42</sup> *Ibid.*, s. 9K.

<sup>43</sup> Banking (Service to Customer) (Fees) Rules, 5768–2008.

<sup>44</sup> Services Subject to Supervision according to the Banking (Service to Customer) (Amendment 12) Law, 5767–2007, 5799 *The Official Gazette* (Yalkut Hapirsumim) 2927 (2008).

<sup>45</sup> Bank of Israel, “Data for the First Quarter after the Implementation of the Bank Fees Reform” (Dec. 30, 2008), [www.boi.org.il/he/NewsAndPublications/PressReleases/Pages/081230h.aspx](http://www.boi.org.il/he/NewsAndPublications/PressReleases/Pages/081230h.aspx).

<sup>46</sup> *Ibid.*

<sup>47</sup> Israel Consumer Council, “The Council’s Opinion in Respect of the Bank Fees after the Reform” (August 20, 2008), in Hebrew at [www.consumers.org.il/files/files/odaot/amlot/bemda2.doc](http://www.consumers.org.il/files/files/odaot/amlot/bemda2.doc).

unfounded. Few real differences have arisen between the prices charged by different banks for same fees. Since no meaningful improvement was seen, consumer organizations argued that the Governor was not active enough in his role, and was succumbing to the industry's power. However, the Governor did not change his policy. Save for a few specific updates, such as giving discounts to senior citizens, the disabled or the underprivileged on fees for basic clerk-assisted services,<sup>48</sup> the Governor did not broaden his supervision over bank fees.

### 7.6 Strengthening the Supervision over Bank Fees – The Social Protest of 2011

In summer 2011 something changed: A huge social protest erupted against the high cost of living in Israel. The protest did not focus on the high cost of banking services per se, but centered on the high cost of housing, food and transportation. Nevertheless, it also had an impact on bank fees, as will be explained below. The protest was supported by major portions of the public, in particular the middle class. It was encouraged by aggressive media coverage, prominent social leaders and social organizations, and it caused the political echelon to understand that actual change in the Israeli economy should take place.<sup>49</sup>

As a result of the protest, the government established the Committee for a Social-Economic Change (the “Trachtenberg Committee”). The Committee examined the different factors that influenced the cost of living in Israel. To this end, the Committee made an analysis of several key sectors of the Israeli economy where there were apparent failures and significant barriers to competition, including the banking sector. The Committee found that the high degree of concentration in the banking system created a concern as to a lack of competitiveness, as well as over-charging. In this light, the Committee recommended

<sup>48</sup> Banking (Service to Customer) (Fees) (Amendment No. 2) Rules, 5768–2008, 6705 Regulations File (Kovetz HaTakanot) 1290.

<sup>49</sup> For a wider description of the social protest and its impact on the regulatory agencies, see: Y. Chernin and Y. Lahav, “‘The People Demand Social Justice’: A Case Study on the Impact of Protests on Financial Markets,” *Accounting Economics and Law – A Convivium*, 4 (2014), 99, 103–105. See also: S. Alon-Barkat and S. Gilad, “Political Control or Legitimacy Deficit? Bureaucracies’ Symbolic Response to Bottom-Up Public Pressures,” *Policy and Politics*, 44 (2016), 41. S. Gilad, S. Alon-Barkat and A. Braverman, “Large-Scale Social Protest: A Business Risk and a Bureaucratic,” *Governance*, 29 (2016), 371.



establishing a team that would work toward increasing competitiveness in the Israeli banking industry.<sup>50</sup>

In 2012, the Minister of Finance and the Governor of the Bank of Israel appointed the Team to Examine Increasing Competitiveness in the Banking System, headed by the Supervisor of Banks. The mandate given to the Team was to focus on the retail banking sector – households and small businesses – and to recommend measures for developing competition in the sector.

The report published by the team in 2013 included recommendations aimed at enhancing competition in the banking sector to reduce the cost of banking services and improve the situation of bank customers.<sup>51</sup> In addition, the Committee expressly recommended more involvement by the Bank of Israel in respect of the bank fees charged to the retail sector. In particular it recommended to cancel a number of fees (in addition to those that were already abolished in the 2007 Reform); to declare additional services to be “a service subject to supervision” and to limit their fees; to alter the structure of fees charged in respect of securities trading and to reprice these fees; and to oblige the banks to provide the customer with comparative information about fees that were actually paid by other customers for similar trading activities, in order to increase the bargaining power of the customer in dealings with his bank.

<sup>50</sup> Report of the Committee for a Social-Economic Change (September 2011), 188, [http://hidavrut.gov.il/sites/default/files/%20%D7%A1%D7%95%D7%A4%D7%99.pdf?bcsi\\_scan\\_99FE300B8A2E1F36=1](http://hidavrut.gov.il/sites/default/files/%20%D7%A1%D7%95%D7%A4%D7%99.pdf?bcsi_scan_99FE300B8A2E1F36=1). Translation at [www.bjpa.org/Publications/details.cfm?PublicationID=13862](http://www.bjpa.org/Publications/details.cfm?PublicationID=13862).

<sup>51</sup> Report of the Team to Examine Increasing Competitiveness in the Banking System. It was believed that implementation of the Team’s recommendations would result in a loss of revenue for the bank of NIS 500-800 million. See: I. Avisar, “Stability is above everything,” *Globes* (July 16, 2012), [www.globes.co.il/news/article.aspx?did=1000766233](http://www.globes.co.il/news/article.aspx?did=1000766233); S. Aizescu, “The Competition Committee Is a Display to the Public as If the Banking System Is Handled,” *The Marker* (June 13, 2012), [www.themarket.com/markets/1.1730298](http://www.themarket.com/markets/1.1730298). On the other hand, various agencies, including the Israel Consumer Council, argued that the Team’s recommendations were insufficient to create real competition and significantly strengthen the position of bank customers, and that the real reason for this was the preference given to the prudential over consumer interest. See the speech of E. Peleg, CEO of the Israel Consumer Council, in the Knesset Economic Affairs Committee, following on publication of the Team’s Interim Report: Knesset Economic Affairs Committee, Protocol No. 921 (July 17, 2012), <http://main.knesset.gov.il/Activity/Committees/Economics/Pages/CommitteeAgenda.aspx?tab=3&AgendaDate=17%2f07%2f2012+12%3a00%3a00>. See also criticism of the General Director of the Israel Antitrust Authority, even though a representative of the Antitrust Authority was among the members of the Team: I. Avisar, “With All Due Respect to Gilo, the Ball Is in the Hands of Fisher,” *Globes* (July 18, 2012), [www.globes.co.il/news/article.aspx?did=1000766963](http://www.globes.co.il/news/article.aspx?did=1000766963).

In addition, attention was given to the small business sector. It was recommended to expand the small business group that enjoys discounted retail rates, and to require the banks to inform these businesses of their entitlement and how they could exercise it.<sup>52</sup>

The Bank of Israel promptly adopted these recommendations. It was even so quick to act that it implemented some of the recommendations immediately after publication of the Committee's interim report, without waiting for the final report.<sup>53</sup>

Moreover, the Bank of Israel did not stop at adopting the Committee's recommendations, but this time took even further measures. Over the years, it has gradually deepened and strengthened its involvement in respect of fees by initiating and implementing additional measures aimed at enhancing competition and reducing fee levels.

In this context, of particular interest was the initiative of the Bank of Israel in 2014, whereby it compelled banks to introduce uniform "baskets of fees" on current accounts.<sup>54</sup> A "basket of fees" includes a certain number of services at a fixed price, to be determined by each bank separately. Because of the Bank of Israel's concern that the banks might abuse the basket system in order to increase prices, as occurred when the Fees Reform came into effect in 2008, the Governor of the Bank of Israel declared the basic basket of fees a "service subject to supervision," which allowed him to determine the price of this basket.<sup>55</sup> However, as the transition to the basket system was not worthwhile for the banks, they did not bother to inform their customers about this. Another directive of the Bank of Israel required the banks to take proactive measures to bring the matter to the attention of their customers, and to report to the Supervisor of Banks the rate at which the customers subscribe to the basket of fees

<sup>52</sup> Report of the Team to Examine Increasing Competitiveness in the Banking System, 111–120, 125–127.

<sup>53</sup> See, for example: Banking (Service to Customer) (Cancelling Supervision of a Certain Banking Service and Its Amendment in Another Case), 5773-2012, 7196 Regulations File (Kovetz HaTakanot) 368; Banking (Service to Customer) (Fees) Rules, 5773-2012, 7196 Regulations File (Kovetz HaTakanot) 369; Banking (Service to Customer) (Fees) (Amendment No. 2) Rules, 5773-2013, 7261 Regulations File (Kovetz HaTakanot) 1385.

<sup>54</sup> Banking (Service to Customer) (Fees) (Amendment) Rules, 5774–2013.

<sup>55</sup> Banking (Service to Customer) (Supervision on Basic Track Service) Order, 5774-2014, 7360 Regulations File (Kovetz HaTakanot) 1001; Bank of Israel, "The Price of the Basic and Uniform Basket of Current Account Management Services will be under Supervision and will not Exceed NIS 10 a Month" (March 5, 2014), [www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/05-03-2014-BankSupervi.aspx](http://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/05-03-2014-BankSupervi.aspx).

system.<sup>56</sup> The Bank of Israel even launched a radio campaign to increase public awareness.<sup>57</sup>

In accordance with the obligation imposed on him by this law, the Supervisor of Banks reports to the Knesset Economic Affairs Committee every six months about actions taken regarding fees, and about the banks' implementation of the provisions of the law. These reports constitute a tool for supervising his actions.<sup>58</sup>

In addition, the Banking Supervision Department endeavors to promote banking services transparency by publishing detailed information about the fees that different banks charge, by issuing comparative tables, and by providing calculators on the Bank of Israel's website that are available for public use.<sup>59</sup>

To summarize, the social protest in the summer of 2011 resulted in enhanced supervision of bank fees. The measures taken by the Governor of the Bank of Israel and the Supervisor of Banks in response to the social protest, together with a slow but consistent reduction of fees through implementation of the 2007 Reform did, finally, result in a true change in bank fees.

## 7.7 The Passive Approach of the Supervisor of Banks

In section 7.3 we saw the failures that characterized the bank fees system, particularly in respect of the retail sector. Notwithstanding these problems, the Bank of Israel was not enthusiastic to actively intervene in this regard, and surely not to establish a systematic response.

<sup>56</sup> Supervisor of Banks, "Letter to the Banking Corporations: 'The Tracks Service'" (July 5, 2014), [www.boi.org.il/en/BankingSupervision/LettersAndCircularsSupervisorOfBanks/LettersOfTheBankingSupervisionDepartment/201405.pdf](http://www.boi.org.il/en/BankingSupervision/LettersAndCircularsSupervisorOfBanks/LettersOfTheBankingSupervisionDepartment/201405.pdf); Supervisor of Banks, "Letter to the Banking Corporations: 'The Tracks Service'" (June 21, 2015), [www.boi.org.il/he/BankingSupervision/LettersAndCircularsSupervisorOfBanks/LettersOfTheBankingSupervisionDepartment/201512.pdf](http://www.boi.org.il/he/BankingSupervision/LettersAndCircularsSupervisorOfBanks/LettersOfTheBankingSupervisionDepartment/201512.pdf); Supervisor of Banks, "Proper Conduct of Banking Business Directives: Directive no. 423 on 'The Tracks Service'," [www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/ProperConductOfBankingBusinessRegulations/423\\_et.pdf](http://www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/ProperConductOfBankingBusinessRegulations/423_et.pdf).

<sup>57</sup> Supervisor of Banks, Annual Survey 2014, 104.

<sup>58</sup> By virtue of s. 9R of the Banking (Service to Customer) Law. For an example of such a report, see: Bank of Israel, "The Semiannual Report on Common Banking Service Fees was presented today to the Knesset Economic Affairs Committee," (January 26, 2016), [www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/26-01-2016-BankingSupervisor.aspx](http://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/26-01-2016-BankingSupervisor.aspx).

<sup>59</sup> By virtue of the authority conferred on him in s. 16K of the Banking (Service to Customer) Law. The information is published on the Bank of Israel website: [www.boi.org.il/en/ConsumerInformation/ConsumerIssues/Pages/Amalot.aspx](http://www.boi.org.il/en/ConsumerInformation/ConsumerIssues/Pages/Amalot.aspx).

From the survey in section 7.4, it seems that until the Bank Fees Reform of 2007, the involvement of the Supervisor of Banks and the Bank of Israel in bank fees was rather limited. They focused mainly on efforts to increase the transparency of the fees, assuming market forces would cure customer mistreatment. Only in sporadic cases did they set a ceiling on the price of a banking service, relying on the general powers of the Ministry of Trade, Industry and Tourism to set the prices of essential services. Yet these interventions were too weak to provide a real solution.<sup>60</sup>

Even when professional teams, such as the Fein Team or the Team to Examine Issues in the Banking System, recommended regulating the prices of banking services, the Bank of Israel still did not take any active measure to implement these recommendations. And in those issues where the Bank of Israel did take an active part, such as the “package deal,” it only followed acts that were initiated and promoted by other political players, mainly the Knesset Economic Affairs Committee.

Most of the moves of the Bank of Israel were made only as a response to escalating public pressure, and simply as a gesture with no full commitment. Moreover, due to the general reluctance of the Bank of Israel to intervene in this field, its response was belated and attenuated.<sup>61</sup> The general impression of the Bank of Israel’s behavior is that of a firm agenda of non-intervention, an agenda which was even expressly admitted by the Deputy Supervisor of Banks during the Knesset debates.<sup>62</sup>

It was only toward the end of 2006 and the beginning of 2007 that the Bank of Israel could no longer adhere to this agenda. Two main political actors compelled it to intervene: The public, whose escalating pressure now reached a new peak, encouraged by aggressive media coverage; and the Parliament – headed by social activist members who were influenced by the public pressure, which led to the establishment of the Parliamentary Inquiry Committee. Presented with the possibility of serious social and parliamentary censure, the Banking Supervision Department could no longer ignore the issue of bank fees. Therefore, at that point, it changed its attitude and took an active part in the legislative

<sup>60</sup> Gilad, “Political Pressures,” 601.

<sup>61</sup> *Ibid.*, at p. 604.

<sup>62</sup> See the speech of Mr. Motti Fein, the Deputy Supervisor of Banks, at the Knesset State Control Committee, Protocol 7029 of 30 July 2003: “We do not think that there should be control over the banks’ fees, because control is a bad thing.”

process promoted by the Knesset, which resulted in the statutory Bank Fees Reform.

However, even after the law was amended, authorizing the Governor of the Bank of Israel to intervene in the prices of the banking services, the Governor used this power in a limited manner, leaving the level of most of the fees to the discretion of the banks themselves. The result was quick to come – there were banks that took advantage of the reform in order to increase their fees, with the Supervisor of Banks taking no measure against them.

Another milestone took place a few years later, once again as a response to a huge public protest. This time it was the social protest of 2011, that swept hundreds of thousands of people who went out on the streets and called upon the government to reduce the cost of living. The strength of this protest caused the Supervisor of Banks not only to head the Team to Examine Increasing Competitiveness in the Banking Sector, but also to immediately adopt the Team's recommendations, and to even take additional measures to reduce the fees.

The interesting question is what was the reason for the passive approach of the Supervisor of Banks and the Bank of Israel? Why, for so many years, did the Israeli regulators adopt such an attitude, despite the existence of public criticism? I believe that the main explanation for this situation is related to prioritization of regulatory goals, namely the preference of prudential regulation over consumer protection. In addition, I will refer to regulatory capture as another possible explanation for regulatory passivity.

### 7.7.1 *Prioritization of Regulatory Goals*

The Israeli Supervisor of Banks is in charge of both fields of banking regulation: prudential regulation (maintaining the stability of the banks), as well as consumer protection. However, the prudential role has always occupied the predominant place in the activities of the Supervisors of Banks, while consumer protection has received less attention.<sup>63</sup> This is not surprising. There are several reasons why bank regulators prefer to focus on prudential supervision rather than on consumer protection.

Firstly, banking instability will always attract a more vigorous response from regulators by virtue of its potential severity.<sup>64</sup> A bank that collapses

<sup>63</sup> Plato-Shinar, *Banking Regulation*, 84–86, 172–175.

<sup>64</sup> A. D. Schmulow, "Twin Peaks: A Theoretical Analysis," Center for International Finance and Regulation, Research Working Paper Series Project No. E018, at p. 9 (2015).

causes considerable damage, not only to customers and investors, but it may – through the contagion effect – harm the entire banking system and the economy as a whole.<sup>65</sup> Whereas improper conduct regarding a consumer, even if it involves a systemic failure rather than an isolated event, does not usually have such severe consequences.

In addition, the collapse of a bank could be perceived as a professional failure, both by the Banking Supervision Department as an organization, and by the Supervisor of Banks personally. No Supervisor would like a bank to collapse during his term in office. On the other hand, inadequate attention to consumer matters is not seen as a supervisory failure, and will at most attract public criticism. Considerations of protecting personal interests will therefore motivate the Supervisor to devote more attention to the supervision of stability.

A similar explanation is supported by the theory of Risk Based Regulation.<sup>66</sup> According to this theory, regulatory agencies are responsible for reducing risk to the public (“social risk”). However, in the event that a social risk materializes (such as the collapse of a bank), the relevant regulatory agency will be exposed to “institutional risk” as having failed to fulfill its duties, and it could lose its status and its power. Hence, in determining priorities between regulatory goals, the regulatory agency will also take this institutional risk into consideration, and will establish its priorities so as to prevent the institutional risk from materializing.<sup>67</sup>

In addition, it was found that regulatory agencies prefer to handle social risks with high salience (even if the probability of them materializing is low), rather than social risks with low salience (even if the probability of them materializing is high). This is due to the dramatic significance of social risk with high salience on the reputation of the

<sup>65</sup> J. R. Macey and G. P. Miller, “Bank Failures, Risk Monitoring, and the Market for Bank Control,” 88 *Columbia Law Rev.* 1153, 1156 (1988); L. Dragomir, *European Prudential Banking Regulation and Supervision* 30 (Abingdon: Routledge, 2010); X. Freixas, C. Giannini, G. Hoggarth and F. Soussa, “Lender of Last Resort: a Review of the Literature,” *Financial Stability Review* 151, 154 (1999); R. J. Herring and R. E. Litan, *Financial Regulation in the Global Economy* (Washington DC: Brookings Institution Press, 1995), 50.

<sup>66</sup> J. Black, “The Emergence of Risk-Based Regulation and the New Public Risk Management in the United Kingdom,” *Public Law*, 512 (2005); J. Black, “Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority,” 28 *Law and Policy* 1, 4 (2006); J. Black and R. Baldwin, “Really Responsive Risk-Based Regulation,” 32 *Law and Policy*, 181 (2010).

<sup>67</sup> H. Rothstein, M. Huber and G. Gaskell, “A Theory of Risk Colonization: The Spiralling Regulatory Logics of Societal and Institutional Risk,” 35 *Economy and Society*, 91 (2006).

organization and on its ability to survive the resulting institutional risk.<sup>68</sup> Because a bank collapse has much higher salience than mistreatment of a customer, we can understand why the Supervisor of Banks prefers to focus on prudential regulation.

Similarly, a recent political economic study examining why multiple-goal agencies succeed in achieving some goals and fail in others, claims that agencies will systematically over-perform on tasks that are easier to measure, and underperform on tasks that are harder to measure and that conflict with the achievement of the more measurable goals.<sup>69</sup> The prudential field is easy to measure because it quotes clear number parameters such as capital adequacy, liquidity and leverage ratios. Likewise, a prudential failure – the collapse of a bank or its inability to meet its obligations – is also visibly obvious. By contrast, the consumer field is difficult to measure because it has a social value orientation rather than a quantitative orientation and it is not based on measurable parameters.

To conclude this point, reputational considerations may well lead to the preference of prudential regulation over consumer protection.

It is worth noting that consumer protection supervision requires more inputs, manpower and resources than those required for prudential supervision.<sup>70</sup> Therefore, even if the Supervisor devotes identical resources to both these fields, the actual results will be more noticeable in the field of prudential regulation.

In addition to all these explanations, we must remember that past history and agency culture may also “lock-in” certain goals as primary over other goals.<sup>71</sup> A few studies that analyzed public agencies’ prioritization among multiple tasks and goals, suggested that agencies’ allocation of attention is guided by their idiosyncratic sense of mission. Tasks that were not defined as central to the agency’s mission, were underperformed.<sup>72</sup> For years, the Banking Supervision Department in Israel saw it as its mission to

<sup>68</sup> S. Gilad, “Attention and Reputation: Linking Regulator’s Internal and External Worlds,” in M. Lodge and K. Wegrich (eds.), *Executive Government in Crisis* (Palgrave Macmillan, 2012), 157, 158-159 (2012).

<sup>69</sup> E. Biber, “Too Many Things to Do: How to Deal with the Dysfunctions of Multiple-Goal Agencies,” *Harvard Environmental Law Review*, 33 (2009) 1.

<sup>70</sup> R. K. Abrams and M. W. Taylor, “Issues in the Unification of Financial Sector Supervision,” IMF Working Paper 00/213 (2000), 24.

<sup>71</sup> Biber, “Too Many Things to Do,” 61.

<sup>72</sup> J. R. DeShazo and J. Freeman, “Public Agencies as Lobbyists,” *Columbia Law Review*, 105 (2005), 2217; Gilad, “Political Pressures,” 593-594 (using the term “organizational identity”).



maintain the stability of the banking system, and it developed its organizational culture around this objective.<sup>73</sup> Hence, it is only natural that the Supervisor continues to promote this mission over the other objective for which he is responsible – regulating the banks’ conduct vis-à-vis customers. This is particularly true when the latter objective conflicts with the agency’s mission.

The focus of the Supervisors of Banks on prudential regulation, whatever the reasons for this may be, and their desire to strengthen the stability of the banks, led them to encourage high profitability for the banks, and they did so even when it resulted in sacrificing consumer protection.<sup>74</sup> As bank fees are a major source of profit for Israeli banks,<sup>75</sup> the Supervisors have, over the years, preferred not to limit the earnings that derive from fees and not to intervene in this area.

### 7.7.2 Regulatory Capture

As was explained in section 7.1, regulation is intended to benefit the general public. However, in certain cases, the regulated industry acquires a persistent and excessive influence over the regulator, which causes the latter to prefer the interests of the regulated firms over those of the public. In such cases, the question arises as to the existence of “regulatory capture”: i.e. “the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and towards the interest of the regulated industry, by the intent and action of the industry itself.”<sup>76</sup>

<sup>73</sup> Plato-Shinar, *Banking Regulation*.

<sup>74</sup> On the conflicts that may occur between prudential regulation and consumer protection, see: Plato-Shinar, *Banking Regulation*, 170–172; M. Taylor, “‘Twin Peaks’: A Regulatory Structure for the New Century,” Center for the Study of Financial Innovation (1995), 1, 15 (noting that the two goals “often conflict”); E. J. Pan, “Four Challenges to Financial Regulatory Reform,” *Villanova Law Review*, 55 (2010), 743, 745, 759 (“fundamental differences”); J. J. Norton, “Global Financial Sector Reform: The Single Financial Regulator Model based on the United Kingdom FSA Experience – A Critical Reevaluation,” *International Lawyer*, 39 (2005), 15, 42 (“inherent conflict”).

<sup>75</sup> In 2016, the total amount of fees collected by the five largest banks was NIS 14.5 billion, whereas the net earnings from interest were NIS 26.2 billion. See: E. Rosenberg, “The Banks’ Profit in 2016: More than 8 billion,” *YNET* (March 30, 2017), in Hebrew at [www.ynet.co.il/articles/0,7340,L-4942689,00.html](http://www.ynet.co.il/articles/0,7340,L-4942689,00.html).

<sup>76</sup> D. Carpenter and D. A. Moss, “Introduction,” in D. Carpenter and D. A. Moss (eds.), *Preventing Regulatory Capture* (Cambridge: Cambridge University Press, 2014), 1, 13. For criticism of this definition see: L. Tai, “Regulatory Capture and Quality,” New York University Law and Economics Working Papers, Paper No. 397 (2015), 6; D. F. Engstrom, “Corralling Capture,” *Harvard Journal of Law & Public Policy*, 36



The classical works on regulatory capture focus on the materialistic capture, which consists of materialistic benefits offered to the regulator by the regulated industry. These benefits may include bribes, gifts and various entrustments given to the regulator by the regulated firms.<sup>77</sup> They may also include career opportunities by way of express or implied promises for recruitment into a higher-paying job in the regulated firms (the “revolving doors” phenomenon).<sup>78</sup>

The more recent literature on regulatory capture deals with non-materialistic capture. One type of non-materialistic capture is “cognitive” or “cultural capture,” which is the creeping process of “colonization of ideas”<sup>79</sup> through which the regulator shares the views of the regulated industry. It mostly refers to the regulator’s education, background, experience, networks and social interaction with the industry, that may influence his worldview and mold it in a pro-industry manner. The result is that the regulator may identify – albeit even unconsciously – with the industry, its views and its needs.<sup>80</sup> A close interface or a permanent and continuing relationship between an institution and a regulator may increase the chance for a cultural capture. Such a close interface may, for example, be found in highly regulated fields such as the banking field, due to the need for the regulator to constantly design and enforce regulation on the regulated firms.<sup>81</sup>

Another type of non-materialistic capture is the “information capture.” For an agency to regulate an industry effectively, it needs to know

(2013), 31. See also the definition in: L. G. Baxter, “‘Capture’ in Financial Regulation: Can We Channel It Toward the Common Good?” *Cornell J. L. & Pub. Pol’y*, 21 (2011–2012) 175, 176. The subject of regulatory capture was recently discussed by the Israeli Committee to Reduce Concentration, in its Draft Methodology for the Examination of Economy-Wide Concentration 5–6 (Jan. 17, 2017), in Hebrew at [www.antitrust.gov.il/subject/203/item/34435.aspx](http://www.antitrust.gov.il/subject/203/item/34435.aspx).

<sup>77</sup> G. J. Stigler, “The Theory of Economic Regulation,” *Bell Journal of Economics and Management Science*, 2 (1971), 3; Posner, “Theories of Economic Regulation”; S. Peltzman, “Toward a more general Theory of Regulation,” *Journal of Law and Economics*, 19 (1976) 211. See also: J. Laffont and J. Tirole, “The Politics of Government Decision-Making: A Theory of Regulatory Capture,” *The Quarterly Journal of Economics*, 106 (1991) 1089.

<sup>78</sup> Stigler, “The Theory of Economic Regulation”; R. D. Eckert, “The Life Cycle of Regulatory Commissioners,” *Journal of Law and Economics*, 24 (1981) 113; E. Dal Bo, “Regulatory Capture: A Review,” *Oxford Review of Economic Policy*, 22 (2006) 203.

<sup>79</sup> Engstrom, “Corralling Capture,” 32.

<sup>80</sup> J. Kwak, “Cultural Capture and the Financial Crisis,” in Carpenter and Moss, *Preventing Regulatory Capture*, 71; *ibid.*, 18–20. Baxter, “‘Capture’ in Financial Regulation,” 183; N. Bagley, “Agency Hygiene,” *Texas Law Review*, 89 (2010) 1, 5.

<sup>81</sup> Committee to Reduce Concentration, “Draft Methodology for the Examination of Economy-Wide Concentration,” 12–13.

how the industry works and what it is capable of doing. But this information is often in the exclusive control of the regulated firms, resulting in a dependency of the regulator upon these firms. Such a dependency may also create a capture.<sup>82</sup> Information capture is more likely to occur when the regulation is highly complex, and when information asymmetry between the regulated industry and the regulator is greater.<sup>83</sup> These are features that characterize financial regulation and therefore suggest that information capture is more likely to happen in the financial sector.<sup>84</sup>

Banking regulators are not immune to regulatory capture. They, too, may be captured by the industry they are supposed to supervise – the banks. In fact, regulatory capture in the banking field should not surprise us. The banks, as special interest groups with huge financial clout, have a high-stake interest in the outcome of policy and regulatory decisions of the Supervisor. Therefore, the banks focus massive resources and energies on attempting to gain the policy outcome they prefer.<sup>85</sup> In contrast, members of the public, each with only a tiny individual stake in the outcome, ignore it. While the banks are better equipped and incentivized to concentrate their lobbying efforts,<sup>86</sup> the public suffers from “rational apathy,” whereby each individual prefers to avoid, rather than contribute, to public oversight of the matter at hand.<sup>87</sup> This situation is a fertile ground for the development of captive regulation.

<sup>82</sup> R. E. Barkow, “Insulating Agencies: Avoiding Capture through Institutional Design,” *Texas Law Review*, 89 (2010), 15, 23; Bagley, “Agency Hygiene,” 5; W. E. Wagner, “Administrative Law, Filter Failure, and Information Capture,” *Duke Law Journal*, 59 (2009–2010), 1321.

<sup>83</sup> C. Knill and A. Lenschow, “Modes of Regulation in the Governance of the European Union: Towards a Comprehensive Evaluation,” in J. Jordana and D. Lavi-Faur (eds.), *The Politics of Regulation: Institutions and Regulatory Reforms for an Age of Governance* (Cheltenham: Edward Elgar, 2004), 218, 231.

<sup>84</sup> M. Hellwig, “Capital Regulation after the Crisis: Business as Usual?” CESifo DICE Report 2/2010 (2010), 40; H. Hakenes and I. Schnabel, “Regulatory Capture by Sophistication,” Working Paper (2015), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2531688](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2531688). For the phenomenon of the “captured regulator” in the Israeli insurance market, see: HCJ 7721/96 *Association of Insurance Appraisers in Israel v. The Commissioner of Insurance*, 55(3) PD 625, 653.

<sup>85</sup> See, for example: D. Igan, T. Lambert, et al., “Winning Connections? Special Interests and the Sale of Failed Banks,” CEPR Discussion Paper No. DP12440 (2017).

<sup>86</sup> D. Igan and T. Lambert, Chapter 5; T. Lambert, “Lobbying on Regulatory Enforcement Actions: Evidence from U.S. Commercial and Savings Banks,” *Management Science* (2018).

<sup>87</sup> M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge MA: Harvard University Press, 1965); Laffont and Tirole, “The Politics of Government Decision-Making,” 1089–1090; Barkow, “Insulating Agencies,” 22.

Moreover, as was well described:

The particular processes involved in financial regulation suggest that the opportunity for capture might be greater than ever in financial services, particularly in relation to large-scale financial institutions, which have very deep engagements with the regulators. Banks are not only subject to rules that govern their structure, operations, and activities in advance but they are also subject to ongoing monitoring in a manner that involves broad regulatory discretion. One need not be totally cynical to recognize that the highly discretionary and continuous nature of bank regulation is dependent on and nurtures an environment in which the regulators and the regulated are engaged in such close, daily relationships as to nurture intense mutual empathy – perhaps even a kind of “transference” – between the two sides.<sup>88</sup>

Indeed, various studies determined – some of them based on empirical research – that bank regulators were actually captured by the banks.<sup>89</sup> Some even claimed that captive regulation was one of the causes for the Global Financial Crisis.<sup>90</sup>

Going back to the bank fees in Israel, we saw above the passivity of the Supervisor of Banks throughout the years and the policy of non-intervention in this field; a policy that served the interests of the banks and drifted away from that of the public. However, tempting as it may be, this fact by itself does not automatically lead to a conclusion of regulatory capture. Whereas classical scholars were quick to diagnose capture whenever any interest group appeared to benefit from regulation, or

<sup>88</sup> Baxter, “‘Capture’ in Financial Regulation,” 187.

<sup>89</sup> S. Johnson and J. Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon Books, 2010); W. H. Buiter, “Central Banks and Financial Crises,” Federal Reserve Bank of Kansas City’s symposium, Discussion Paper No. 619 (September 2008), 104–107 (noting that “there has been regulatory capture of the Fed by Wall Street during the Greenspan years, and that this is continuing into the present”); Baxter, “‘Capture’ in Financial Regulation,” 181–187. Hakenes and Schnabel, “Regulatory Capture by Sophistication”; D. Veltrop and J. de Haan, “I Just Cannot Get You Out of My Head: Regulatory Capture of Financial Sector Supervisors,” De Nederlandsche Bank, Working Paper No. 410 (January 2014), [www.dnb.nl/binaries/Working%20Paper%20410\\_tcm46-302769.pdf](http://www.dnb.nl/binaries/Working%20Paper%20410_tcm46-302769.pdf); Kwak, “Cultural Capture”; A. E. Wilmarth, “Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street?,” *University of Cincinnati Law Review*, 81 (2012, 2013), 1283.

<sup>90</sup> Johnson and Kwak, *13 Bankers*; S. Claessens, G. R. D. Underhill and X. Zhang, “The Political Economy of Basle II: The Costs for Poor Countries,” *The World Economy*, 31 (2008) 313; Kwak, “Cultural Capture,” 93; Hakenes and Schnabel, “Regulatory Capture by Sophistication.” See also the references in Carpenter and Moss, *Preventing Regulatory Capture*, 1; and in L. G. Baxter, “Capture Nuances in Financial Regulation,” *Wake Forest L. Review*, 47 (2012) 537.

when there was merely motive for capture, recent literature emphasizes the need to establish such a conclusion on the basis of empirical findings and their careful analysis.<sup>91</sup>

The Israeli banking system contains some features that may contribute to the creation of captive regulation or, at least, explain the tendency of the Supervisor of Banks to succumb to pressure exerted by the banks.

Firstly, as was explained in section 7.2, the Israeli banking sector is very concentrated. It is dominated by five strong banking groups, and in particular by the duopoly of the two largest groups. In addition, competition between the banks is low. A market of this type allows the banks to join forces and consort in their battle on the Supervisor's opinion, using their cumulative power for the benefit of their mutual interest.

In this regard it should also be emphasized that the interest group that is subject to the Supervisor of Banks is rather homogenous, being comprised of both banks and credit card companies which are subsidiaries of the banks. In contrast, when a regulator is in charge of various and different interest groups, the diversity of their interests reduces their ability to capture the regulator, especially in cases where the interests of these groups contradict each other.<sup>92</sup>

Another factor that may strengthen the power of negotiation of the banks in Israel (or at least of the two largest banks that constitute a duopoly) against the Supervisor, is based on the concept of being "too big to fail." The wide scope of activities of the large banks and their interconnectedness with other key players in the economy may lead the Supervisor to take into account considerations that stem from the systemic risk that such institutions create. The problem, in the current context, is not potential business failures and resulting bailouts, but the influence that such institutions exert when business is going well, thus creating a distortion in the decision-making process of the Supervisor.<sup>93</sup>

<sup>91</sup> Carpenter and Moss, *Preventing Regulatory Capture*; D. Carpenter, "Detecting and Measuring Capture," in *Preventing Regulatory Capture*, 57; D. A. Moss and D. Carpenter, "Conclusion: A Focus on Evidence and Prevention," in *Preventing Regulatory Capture* 451. See also: Baxter, "Capture Nuances."

<sup>92</sup> J. R. Macey, "Organizational Design and Political Control of Administrative Agencies," *Journal of Law, Economy and Organization*, 8 (1992), 93, 99; A. Eckstein, "Regulatory Inertia and Interest Groups: Empirical Evidence from the Field of Regulation of Capital Markets," *Bar-Ilan Law Studies*, 30 (2016), 635, 672.

<sup>93</sup> A. Ayal, "The Market for Bigness: Economic Power and Competition Agencies' Duty to Curtail It," *Journal of Antitrust Enforcement*, 1 (2013), 221, 233–238; Committee to Reduce Concentration, "Draft Methodology for the Examination of Economy-Wide Concentration," 6–7.

Secondly, the Israeli banks have very strong lobbying power. Their high profitability and large financial resources allow them to hire the country's most prominent and experienced lobbying firms to attend the Knesset debates on their behalf.<sup>94</sup> Similarly, the banks can afford to hire the best professionals in the market to provide policy makers with opinions and reports that are biased toward banking interests. In addition, the Association of Banks plays an important role as an informal lobbyist of the banks. Whereas, in other countries, banking associations engage in various tasks such as self-regulating their members,<sup>95</sup> the Association of Banks in Israel serves mainly as an intermediary between the banks and the policy-makers in various matters, focusing its efforts on convincing the regulators to shift their policy toward the interests of the banks.

Thirdly, the Advisory Board of the Supervisor of Banks, with which the Supervisor consults in the promulgation of new directives, contains nineteen members, of whom eight are representatives of the banks and only one is a public representative.<sup>96</sup> Needless to say, such a structure of the Board not only allows the banks to express their views, but also affords them the opportunity to convince the Supervisor to adopt a policy that suits their needs. In comparison, the Advisory Board of the Israeli Commissioner of Capital Markets, Insurance and Savings contains no industry representatives. Industry can express views on new directives by providing comments on drafts published by the Commissioner during the rule-setting process.<sup>97</sup>

<sup>94</sup> See, for example, the lobbying companies that represent the banks in the current debates about the separation of the credit cards companies from the banks: Z. Zrachya, "The Banks operate Lobbyists to Pressure Members of Knesset to change the Strum Committee's Recommendations," *The Marker* (September 6, 2016), in Hebrew at [www.themarker.com/news/1.3059725](http://www.themarker.com/news/1.3059725).

<sup>95</sup> See, e.g., the activity of the Swiss Bankers Association that published guidelines, recommendations and agreements: [www.swissbanking.org/en/home/standp\\_unkte-link/regulierung-richtlinien.htm](http://www.swissbanking.org/en/home/standp_unkte-link/regulierung-richtlinien.htm). In Australia, the Australian Bankers' Association Inc. has developed industry codes and standards: [www.bankers.asn.au/Consumers/Industry-Standards](http://www.bankers.asn.au/Consumers/Industry-Standards).

<sup>96</sup> The Hebrew website of the Bank of Israel: <https://www.boi.org.il/he/Banking-Supervision/Pages/about.aspx>.

<sup>97</sup> On the ability of interest groups to informally influence the regulatory agency, already in the very preliminary stage of the rule-making process, see: N. A. Mendelson, "Regulatory Beneficiaries and Informal Agency Policymaking," *Cornell Law Review*, 92 (2007) 397, 429–431. S. W. Yackee, "The Politics of Ex Parte Lobbying: Pre-Proposal Agenda Building and Blocking during Agency Rulemaking," *Journal of Public Administration Research and Theory*, 22 (2012), 373.

Fourthly, the revolving door phenomenon has become common practice in Israel. Many Supervisors of Banks have found themselves, at the close of their term in office, as chairpersons or holders of other senior positions in banks.<sup>98</sup> Incumbent Supervisors may prefer to keep good relations with the regulated firms to secure future appointment and, in so doing, inadvertently collaborate with the needs and interests of these firms.

These idiosyncrasies may serve as fertile ground for the creation of regulatory capture. For the purposes of this chapter, these indicators may explain the sensitivity of the Supervisors of Banks, throughout the years, to the pressures exerted against them by the banks, and the Supervisors' responsiveness to the banks' desires and needs. This situation, in its turn, may also explain the regulatory tendency to support the banks on the question of fees and serves as an additional explanation for the passivity of the Supervisors in this regard.

## 7.8 Conclusion

Today, more than ten years after the Bank Fees Reform took place, it seems that Israeli supervision over bank fees resulted in an improved situation in the retail sector. Reports by the Bank of Israel in recent years show a consistent trend of reduced fees and the existence of a "wide variance" in prices between the different banks,<sup>99</sup> which is an improvement in the protection afforded to consumers.

The Supervisor of Banks and the Bank of Israel understood that they could not stay passive and indifferent any longer. Continuous public scrutiny compelled them to stay alert and keep pace, by constantly examining the bank fees system and by imposing additional limitations in response to the changing circumstances. The duty of reporting to the

<sup>98</sup> For example: Dr. Meit Heth (1969–1975) became the Chairperson of Bank Leumi; Galia Maor (1982–1987) became the CEO of Bank Leumi; Dr. Amnon Goldschmidt (1987–1992) became a deputy CEO at Discount Bank, and later a director at First International Bank; Zeev Avels (1992–1998) became the Chairperson of Union Bank; Dr. Yitzhak Tal (1998–2003) became a director at Tefachot Mortgage Bank; Ronny Hizkiyahu (2006–2010) became the chairperson of the First International Bank. Before being nominated as the Supervisor, he served as a senior banker in various banks. In 2016 he was appointed as the State Accountant General. Hedva Ber, the current Supervisor, served as the Chief Risk Operator at Bank Leumi, before being appointed as a Supervisor.

<sup>99</sup> See, e.g., "The Semiannual Report on Common Banking Service Fees." I. Avisar, "A Decrease of 17% in Four Years in Household Bank Fees," *Globes* (July 16, 2015), in Hebrew at [www.globes.co.il/news/article.aspx?did=1001053777](http://www.globes.co.il/news/article.aspx?did=1001053777).

Knesset, which enhances the accountability of the supervisory process, constitutes an important mechanism for controlling the regulatory echelon.

Before the reform took place, the banks had threatened that supervision of fees would have a negative influence on the market, compelling them to raise interest rates, and that it would ultimately harm customers instead of protecting them. However, although the Reform did decrease banks' earnings, they still exist and thrive. They passed the global financial crisis relatively unscathed, and continue to make enormous profit.<sup>100</sup>

Having said this, two reservations should be made. Firstly, the fact that improvement has been achieved up to now does not mean that the Supervisor can rest on his laurels and let market power continue from here. As was mentioned above, the Supervisor must constantly examine the bank fees system and impose additional limitations in response to changing circumstances. For example, the current trend that the Israeli banking system is undergoing, namely the closing of branches and the move to digital banking, reduces banks' costs and should – respectively – also reduce the fees charged for banking services.<sup>101</sup>

Secondly, the positive results of the Israeli Bank Fees Reform do not necessarily lead to the conclusion that bank fees should be subject to supervision in all countries. However, where banks abuse their market power to the detriment of weaker customers, such as households and small businesses, in a systematic manner and as prevailing practice, as was the case in the Israeli banking market, then supervision should take place, in order to protect the underdog.<sup>102</sup>

<sup>100</sup> In comparison, in the United States at the time of intensive banking legislation at the end of the 1960s and the beginning of the 1970s, the banks claimed that the legislation that protected the customers would destroy the credit market and would harm the American economy as a whole. It is interesting that among the opponents were not only the banks but also the Federal Reserve Bank. The claims were rejected, laws and regulations were enacted, and nothing untoward happened in the credit market, which continued to prosper and succeed. See J. A. Spanogle, "Regulation of the Bank-Customer Relationship in the United States," *Journal of Banking and Finance Law and Practice*, 4 (1993), 18, 22–23.

<sup>101</sup> See, e.g., draft amendment, Banking (Service to Customer) (Fees) Rules, 5768-2008, of Jan. 25, 2017, [www.boi.org.il/he/BankingSupervision/DraftsFromTheSupervisorOfBanks/Pages/Default.aspx](http://www.boi.org.il/he/BankingSupervision/DraftsFromTheSupervisorOfBanks/Pages/Default.aspx).

<sup>102</sup> It is interesting to note that even Adam Smith, who supported market freedom and who invented the metaphor of the "invisible hand," justified supervision of the banks for fear that the collapse of a bank would cause damage to the public at large. See: A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Book II chap. II, 308. See also E. G. West, "Adam Smith's Support for Money and Banking Regulation:



The lesson that can be learned from the Israeli bank fees reform is that there is sometimes a need for other political actors to intervene when the regulator has adopted a passive approach and neglected the public interest. It was the Knesset that adopted the uncompromising socio-economic approach on banking fees, establishing the Inquiry Committee on Bank Fees, and finally enacting the Bank Fees Reform. The Government also played a role, by establishing the Trachtenberg Committee which, in its turn, led to the establishment of the Team to Examine Increasing Competitiveness in the Banking Sector. Without these initiatives, it is doubtful whether the bank fees reform would have taken place and would have been further developed as it actually was.

Nevertheless, the legislator and the government should be cautious about excessive intervention into the expert discretion of the regulator. They should interfere only in those cases where the public interest is unjustifiably harmed, and to the minimum extent that is required. Indeed, in the Israeli bank fees affair, the legislator did not directly intervene in the level of fees. It sufficed in granting authority to the Bank of Israel as the professional body to determine the list of permissible fees, and to set prices only in exceptional cases. Similarly, the Trachtenberg Committee avoided dealing by itself with the lack of competition in the banking system. Instead, it recommended the establishment of a professional committee to examine this subject. Experience shows that these initiatives constituted an adequate framework for leading the regulator to change its attitude and take active measures to protect the public interest.

Last, but not least, the Israeli experience demonstrates the value of public pressure. It shows that in certain situations, a strong public protest can overcome the passivity of the regulator, and result in improved supervision.

A case of Inconsistency," *Journal of Money, Credit and Banking*, 29 (1997) 127; M. Carlson, "Adam Smith's Support for Money and Banking Regulation: A case of Inconsistency?," *History of Economics Review*, 29 (1999), 1, [www.hetsa.org.au/pdf-back/29-A-1.pdf](http://www.hetsa.org.au/pdf-back/29-A-1.pdf).



# **A Study on Determinants of Household Debt Repayment Using Hazard Model**

**- focusing on Middle/old-aged people over 45years old -**

2019.08.20

- **Background and Purpose**
- **Approach Method**
- **Empirical analysis**
- **Summary**

# 1. Background and Purpose

## Aging index

- In 2000, the proportion of people over 65 years old was 7%, but in 2018, the portion of the population increased to 14.3%, exceeding the aged society standard of 14%;  
In 2060, the proportion is expected to exceed 41%  
(National Statistical Office, 2018).

: Aging society(over 7%), Aged society(over 14%), Super aged society(over 20%)

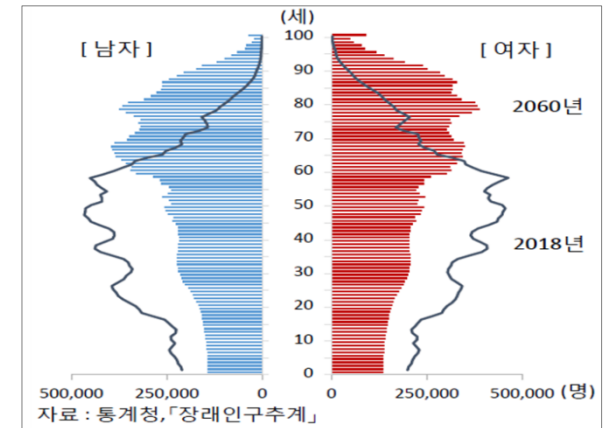
- The burden of household debt has dramatically increased in the 40-50s, and the center of household debt is expected to move to the Middle/old-aged according to population movements

: As of the first quarter of 2018, the household debt ratio is 30% for the 40s, 28% for 50s, 21% for 30s and 17% for 60s.

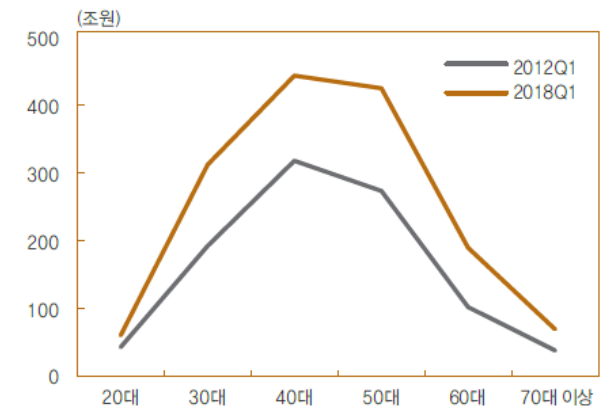
: Compared to the first quarter of 2012, most of the loans increased in the 30-50s, where the economy is active.

(Bank of Korea 2018.9)

<Figure 1> Population Pyramid



<Figure 2> Distribution of Debt Scale by Age Group



주: 1) 20대는 18~19세 포함      자료: 가계부채DB

# 1. Background and Purpose

- Korea 's household debt is increasing at a rapid pace around Middle/old-aged people, which could seriously aggravate the problem of household debt in the future.

(Kim Ji Sub, 2015)

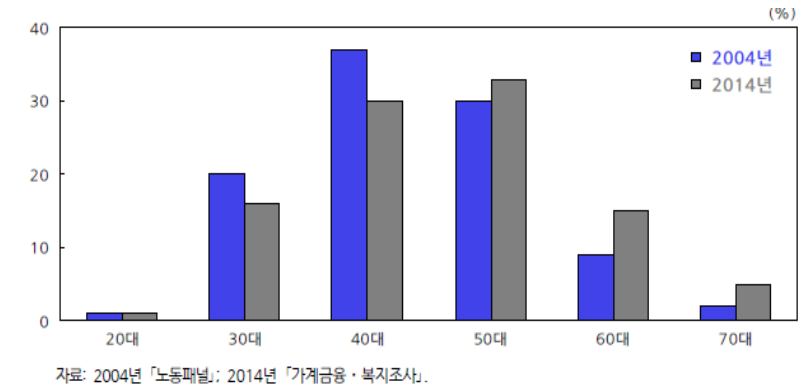
## ① Household debt ratio to income

- The ratio of the household debt to the income of the elderly over the age of 60 is the most serious among OECD countries.
  - : The ratio of household debt to income over 60 years old is 161%, which is well above the average of all age groups(128%)
  - : This ratio is the highest among the comparable OECD countries, and the household debt ratio of households over the age of 60 is higher than that of all age groups.

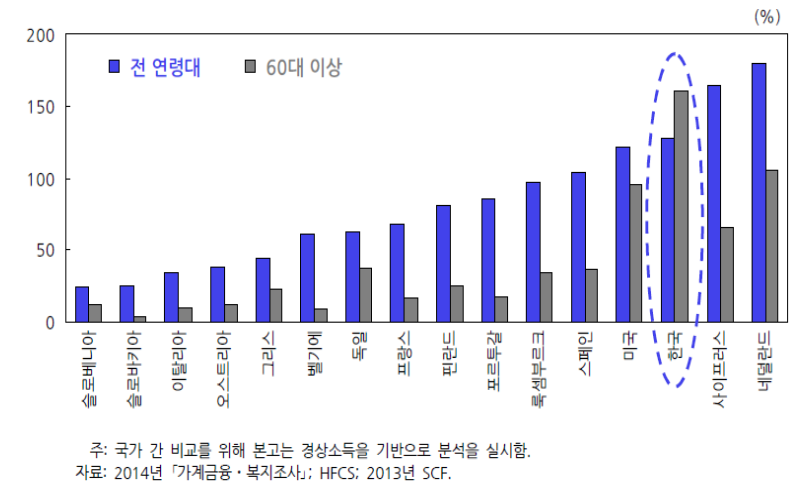
## ② Structural characteristics of income and assets

- In total income, pension income and transfer income account for 29% and the proportion of earned income and business income exceeds 50%. That indicates that the Middle/old-aged households in Korea have an income structure sensitive to economic fluctuations and the availability of debt repayment is weak.
- The ratio of household debt to financial assets is 74%, which is higher than that of all age groups (67%)

<Figure 3> Change in composition ratio of household debt by age group



<Figure 4> Ratio of household debt to income



## Importance of household debt research

- In Korea, Middle/old-aged households are relatively weak in debt repayment ability, so if macroeconomic conditions are to be changed suddenly, the debt repayment capability will likely deteriorate. (Kim, J, S., 2015)
- Along with low fertility and aging, Middle/old-aged households have a high debt burden, which is likely to increase the social problem.

## A summary of previous research

- There have been various studies on household debt since the 1990s, but, research focusing on Middle/old-aged households limited, especially reviews on debt repayment are in short supply.
- As a result of a study of Middle/old-aged households, Yilmazer and Devaney (2005) found that elderly households with low asset levels may have difficulty in repaying their debts, and the need to analyze the household debt repayment problem based on longitudinal data analysis.
- Choi Pil-sun and Min In-sik(2008) pointed out that the elderly in Korea has a relatively large debt, and The 60s or older have a high debt burden and a lower debt repayment ratio.
- Kim Woo-young and Kim Hyun-jung (2010) pointed out that Korea's debt holding probability and average debt size was the largest in the age group of 45 to 54 years.

# 1. Background and Purpose

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- Kim Min-jung and Cho Hye-jin (2013) estimate that 13.6% of elderly households with debt holdings can repay their debts entirely as financial assets after retirement. When using real estate other than residential housing, the debt repayment rate was 36%, using all assets, including residential housing, the debt repayment rate was 78.7%. And many retirement households without earned income predicted that debt repayment would be difficult.
- Kim Ji-seop and Oh Yun-hae (2016) interpreted that the change in population structure led to an increase in the household debt repayment burden of Middle/old-aged people. They accumulate assets in line with the rise in life expectancy but did not reduce household debt in advance.

# 1. Background and Purpose

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## Purpose

- This paper focuses on research that explores the determinants of debt repayment among Middle/old-aged people over the age of 45. Specifically, we investigate the key factors affecting the repayment rate of Middle/old-aged households and analyze dynamically how the debt repayment ratio varies with time. In particular, examine how the inheritance, which means retirement and the transfer of wealth between generations.
- In particular, This paper considered the possession characteristic of real estate debt to verify the difference of the determinants of the debt repayment ratio. Possession characteristic includes whether possesses real estate debt or not, whether possesses personal home purchase loan or not, whether possesses a rental deposit or not.
- In the end, suggest practical implications.

# 2. Approach Method

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- Scope of study : Middle/old-aged household(Head of household: 45 or older)
- Source: Korean Longitudinal Study of Ageing (short: KLoSA)
- Approach
  - To apply the Survival analysis model, I set up the debt repayment of the middle/old-aged households as a hazard event. .
  - Analysis model: Kaplan-Meier, Cox proportional hazard model.
- Statistical package: R program, SPSS, EXCELL



# 3. Empirical analysis

## Research hypothesis

### [Hypothesis 1]

depend on whether middle/old-aged households possess a real estate debt or not, the difference in the debt repayment trend considering the time flow exists.

### [Hypothesis 2]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences between factor groups.

### [Hypothesis 3]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences depend on whether they possess a real estate debt or not.

### [Hypothesis 4]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences depend on Type of Real Estate Debt.

<Table 1> Definition of variables to be applied to the extended hazard model

Type			Variable Description
Socio-Demographic Factors	sex	time fixing factor	male, female
	age		45~54, 55~64, 65 years or older
	education level		elementary, secondary, university
	marital status		marriage, separation or divorce etc.
	residence type	time variation factor	general house, apartment
	residence area		large cities, small cities, town and villages
Financial Factors	asset		log of total assets per household
	income		log of total income per household
	expenditure		log of total expenditure per household
Economic activity Factors	labor status	time variation factor	Participation, no participating
	retirement phase		economic activity: under 55 years old; partial retirement age: 55-64 years; full retirement age: 65 years and over
Subjective Psychological Factors	health status (current status)		good, normal, bad
	health status (compare last survey)		better, unchanged, worse
	saving status		yes, no
	heritage availability		high, normal, low

# 3. Empirical analysis

## Descriptive statistics

- to successfully derive the analysis results, the study extracted 500 households and 1,986 observations as sample households used for the empirical analysis.
- Before the actual analysis, the paper conducted a T-test to describe the frequency of the variables and verify the differences among the variable groups.
- Among them, 345 observations corresponding to debt repayment accounted for 17.4% of the total. Of the total analysis households, 1,172 observations of real estate debt hold 59.1% of the total. Debt repayment was relatively high in the households that didn't possess real estate debt.
- Break down the real estate debt into the home purchase loans, and rental deposits, 1,356 observations possess home purchase loan in which Occupied 68.2% of the total. And 700 observations possess a rental deposit in which occupied 35.2% of the total.
- Of the total analysis households, the household with rental deposits showed lower debt repayment rates than other households.

<Table 2> Frequency of debt repayment by households with real estate-related debt

Type		Total (1,986)	No repayment (1,641/82.6%)	Repayment (345/17.4%)	P
Real estate debt	Hold	1,172 (59.1%)	1,009 (86.1%)	163 (13.9%)	0.104
	not hold	814 (40.9%)	632 (77.6%)	182 (22.4%)	
Home purchase loan	Hold	1,356 (68.2%)	1,136 (83.8%)	220 (16.2%)	0.003
	Not hold	630 (31.8%)	505 (80.2%)	125 (19.8%)	
Rental deposit	hold	700 (35.2%)	651 (93.0%)	49 ( 7.0%)	0.005
	not	1,286 (64.8%)	990 (77.0%)	296 (23.0%)	

\* Based on the first (2006) time of starting observation

# 3. Empirical analysis

[Hypothesis 1]

depend on whether middle/old-aged households possess a real estate debt or not, the difference in the debt repayment trend considering the time flow exists.

## Kaplan-Meier survival analysis results

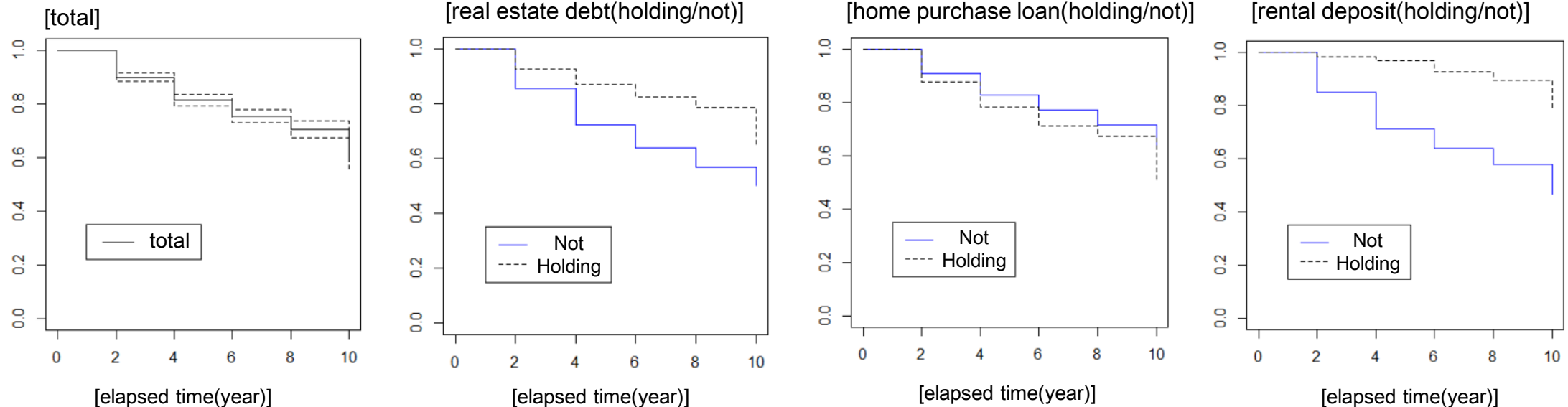
The survival rate of middle/old-aged Korean households shows a significant difference depending on whether they have real estate debt or not.

- In other words, the households that didn't possess real estate debt have a low survival rate, which means that the debt repayment rate is high.

On the contrary, the survival rate of the households that possess real estate debt is relatively high, which means that the debt repayment rate is low.

The trend of survival curves showed a significant difference by type of real estate debt.

- Of the household that possesses home purchase loan, The survival curve did not show a significant difference compared to not possesses.
- But, did show a significant difference depending on whether they possess rental deposit or not.



# 3. Empirical analysis

## Correlation analysis

This is the result of the correlation analysis for the variables except the nominal scale. As a result of the analysis, the coefficient of correlation between total assets of households and the likelihood of miscarriage was 0.573, between income and expenditure was 0.694, and between health status (①) and health status(②) was as high as 0.540. Therefore, households' assets, income, and health status(②) are excluded from the study model.

<Table 3> Correlation analysis by variables

type	asset	income	Expenditure	health stat(①) (current status)	health stat(②) (compare last survey)	heritage availability
asset	1					
income	0.347 ***	1				
expenditure	0.432 ***	0.694 ***	1			
health status(①) (current status)	-0.194 ***	-0.274 ***	-0.287 ***	1		
health status(②) (compare last survey)	-0.148 ***	-0.220 ***	-0.236 ***	0.540***	1	
Heritage availability	0.573 ***	0.251 ***	0.291***	-0.191***	-0.123***	1

\* Signif. codes: 0 '\*\*\*' 0.001 '\*\*' 0.01 '\*' 0.05 '.' 0.1 ' ' 1

## Variable Extraction

The study used the AIC method (backward) to extract the optimal explanatory variables. As a result of AIC model, age, education level, residence type, retirement stage, labor status, health status, miscarriage, and total saving were adopted as significant variables and gender, saving insurance coverage, residence area, marital status, Was removed from the model.

<Table 4> Result of variable extraction by AIC method (backward)

	variable	Step 1	Step 2	Step 3	Step 4	Step 5	Step 6
	<none>	1898.0	1895.0	1893.3	1891.6	1890.0	1888.9
select	age	1900.5	1898.1	1896.2	1894.5	1894.2	1892.9
	residence type	1904.3	1901.2	1899.2	1895.7	1893.9	1892.8
	labor status	1899.0	1896.6	1894.9	1894.2	1892.5	1893.2
	retirement phase	1898.2	1895.3	1893.4	1891.3	1889.7	1888.9
	health status	1899.3	1896.2	1894.6	1893.3	1891.7	1891.0
	heritage availability	1901.8	1898.9	1897.0	1895.5	1894.2	1893.6
	expenditure	1900.7	1897.5	1896.8	1894.8	1893.7	1891.9
Remove	sex	1897.2	1894.2	1892.2	1890.5	1888.9	-
	saving status	1896.4	1893.4	1891.7	1890.0	-	-
	residence area	1896.8	1893.5	1891.6	-	-	-
	marital status	1896.3	1893.3	-	-	-	-
	education level	1902.8	1899.8	-	-	-	-

# 3. Empirical analysis

[Hypothesis 2]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences between factor groups.

## Hazard Model Analysis Results

- The P-value for the LRT test and the P-value for the Wald test were less than 0.001.
- The key variables affecting the rate of debt repayment are age, education level, residence type, retirement phase, health status, the possibility of providing heritage, and total expenditure of households.

<Table 5> Results of determinants of debt repayment ratio①

variable		HR	Std.Err	Z	P
age		1.050	0.019	2.496	0.012*
education level (By: university)	secondary	2.078	0.259	2.816	0.004**
	elementary	1.908	0.285	2.263	0.023*
residence type (By: apartment)	General house	0.665	0.163	-2.484	0.013*
retirement phase (By: Economic Activity)	partial retirement	0.592	0.273	-1.917	0.055.
	full retirement	0.441	0.436	-1.876	0.060.
health status(current status) (By: bad)	normal	1.165	0.165	0.930	0.352
	good	1.977	0.258	2.632	0.008**
heritage availability (By: low)	high	0.571	0.191	-2.912	0.003**
	normal	0.814	0.186	-1.099	0.271
Log of total expenditure		0.481	0.323	-2.258	0.023*

n= 654, number of events= 189 ; Likelihood ratio test = 52.48 on 12 df, p=5e-07;

Wald test = 51.32 on 12 df, p=8e-07; Score (log-rank) test = 52.38 on 12 df, p=5e-07

Signif. codes: 0 '\*\*\*\*' 0.001 '\*\*' 0.01 '\*' 0.05 '.' 0.1 ' ' 1

# 3. Empirical analysis

## [Hypothesis 3]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences depend on whether they possess a real estate debt or not.

- <Table 6> is the result of analyzing the determinants of debt repayment ratio into three cases. First is the total households, second is the households with real estate debts, and third is the households without real estate debts.
- In households without real estate debt, variables such as residence type, retirement phase, labor status, health status, and heritage availability were not adopted.
- In households that own real estate debt, the labor status variable has been newly adopted instead of excluding health status.
- Age is a commonly adopted variable and the debt repayment rate increased with age. These findings support the life-cycle hypothesis, regardless of property ownership.
- In the case of owning real estate debt, the level of retirement variables was the highest, and the coefficients of partial retirement and full retirement were lower than the total households. It means that the burden of repaying the debt due to retirement is even more severe in households with real estate debt.

<Table 6> Analysis of determinants of debt repayment ratio②

variable		HR(hazard ratio)		
		total	real estate debt (○)	real estate debt (X)
age		1.050*	1.087*	1.029*
education level (By: university)	secondary	2.078**	1.942.	2.426*
	elementary	1.908*	1.263	2.382*
residence type (By: apartment)	general house	0.665*	0.565*	
retirement phase (By: Economic Activity)	partial retire	0.592.	0.276**	
	full retire	0.441.	0.119**	
labor status (By: no)	participation		1.609.	
health status (current status)(By: bad)	normal	1.165		
	good	1.977**		
heritage availability (By: low)	high	0.571***	0.386***	
	normal	0.814	0.626.	
Log of total expenditure		0.481*	0.462	0.439*
N(number of events)		654(189)	382(93)	289(99)
Likelihood ratio test		52.89***	46.24***	27.26***
Wald test		51.32***	44.87***	22.95***
Score (logrank) test		52.38***	47.62***	24.48***

Signif. codes: 0 '\*\*\*' 0.001 '\*\*' 0.01 '\*' 0.05 '.' 0.1 ' ' 1

# 3. Empirical analysis

## [Hypothesis 4]

The key factors that affect the debt repayment rate of middle/old-aged households exist mutual differences depend on Type of Real Estate Debt.

- <Table 7> shows the results of exploring the factors affecting the debt repayment ratio for home loans and lease deposits.
- In households with home loans, age, educational attainment, type of residence, retirement stage, labor participation, health status and total expenditure have been adopted as key factors.
- In households with lease deposits, health status, the likelihood of miscarriage and total expenditure have been adopted as key factors.
- In the model of the home purchase loan, The variable coefficients did not show any significant difference compared to the analysis results.
- In the model of rental deposit, The absence of an age variable means that age and debt repayment are irrelevant. It's inconsistent with the life cycle hypothesis. When the state of health is good, the probability of debt repayment is high, and when the possibility of miscarriage is high, the likelihood of debt repayment is low.

<Table 7> Determinants of Debt Repayment Ratio③

variable		HR		
		total	home purchase loan	rental deposit
age		1.050*	1.107*	
education level (By: university)	secondary	2.078**	1.543	
	elementary	1.908*	0.828	
residence type (By: apartment)	general house	0.665*	0.466*	
retirement phase (By: Economic Activity)	partial retirement	0.592.	0.260*	
	full retirement	0.441.	0.110*	
labor status(By: no)	participation		1.953*	
health status (current status)(By: bad)	normal	1.165	0.927	2.985*
	good	1.977**	2.057.	2.670
heritage availability (By: low)	high	0.571***		0.228**
	normal	0.814		0.440.
Log of total expenditure		0.481*	0.227*	0.208.
N(number of events)		654(189)	212(71)	219(28)
Likelihood ratio test		52.89***	30.71***	17.56**
Wald test		51.32***	29.7***	16.59**
Score (logrank) test		52.38***	31.6***	18.17**

Signif. codes: 0 '\*\*\*' 0.001 '\*\*' 0.01 '\*' 0.05 '.' 0.1 ' ' 1

# 4. Summary

The problem of the household debt of middle and elderly citizens is likely to become more severe as the population ages. In the 1990s, research on a household debt has diversified into the home economics and consumer studies fields. However, research focusing on middle and elderly households limited, and studies on debt repayment are in short supply.

This paper focuses on research that explores the determinants of debt reimbursement as a research subject for the elderly over the age of 45. The data were analyzed using the first to sixth data from the KLoSA, and the analysis method was applied to the hazard model considering the variation of time(t). The results showed that age, education level, residence type, retirement stage, health status, the possibility of providing a legacy, the total expenditure of households were the main variables influencing the debt repayment of middle-aged households.

This result is consistent with the life cycle hypothesis that reflects the retirement consumption puzzle and the intergenerational transfer theory. Age showed a positive correlation with the repayment rate and was adopted as a critical factor affecting the repayment rate regardless of the real estate-related debt holdings. The shift in the retirement stage showed a negative correlation with the debt repayment rate and supported the claim of the retirement consumption puzzle. The total expenditure showed a negative association with the debt repayment rate, and the probability of providing miscarriage was 61.4% slower than the 'low' households with 'high' debt repayment rate.

There was a difference in the variable on the debt repayment rate of the middle and elderly household depending on the type of real estate debt. As a result, age, education level, residence type, retirement stage, labor participation, health status, and total expenditure were adopted as critical factors in households with home purchase loans. In the case of households with rent deposits, health status, the likelihood of providing miscarriage, and total expenditure were the key factors.

In households with home purchase loans, the burden of debt repayment was more significant in retirement, and labor participation was a newly adopted variable, indicating that income is an essential factor in helping pay off debt. In the case of households with loans for housing, the likelihood of legacy provision was not taken as a variable, and the age was not adopted as a variable in households with rental deposits, so it was found that there were differences in the factors affecting debt repayment depending on the type of real estate debt.