ISSN 1045-6333

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Discussion Paper No. 209

1/97

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Cambridge, MA 02138

The Center for Law, Economics, and Business is supported by a grant from the John M. Olin Foundation.

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Last revision: 12/96

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We are grateful to Professors Tamar Frankel, Howell Jackson, and Hal Scott for their suggestions; to David Gilo and Amir Licht for their research assistance; and to Gilad Gans of Israel's Antitrust Authority for providing us with data and for his comments.

JEL Class G20, L40, O53

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ABSTRACT

In Israel, as in a number of other economies, a few large banks have historically played a major role in the nonfinancial sector. At the end of 1995, the Israeli government appointed the Brodet Committee to examine bank investments in nonfinancial corporations. The Israeli Knesset subsequently adopted the committee's recommendations and imposed major limitations on the role of banks in the nonfinancial sector. These limitations required the two biggest Israeli banks to start selling much of their nonfinancial investments.

This paper is based on the research report that we prepared for the Brodet Committee at the request of the Israeli Finance Ministry and Antitrust Authority. We explain why we recommended to the Committee that substantial limitations be imposed on bank investment in nonfinancial companies. We provide a detailed analysis of the effects that bank-conglomerate combinations have in a small economy -- such as Israel's -- that is characterized by a great deal of concentration in both the financial and nonfinancial sectors. In particular, we analyze the effects that bank-conglomerate combinations have on the safety and soundness of banks, on the decisions of the investment funds managed by banks, and on the level of competition in the economy in both the short run and the long run.

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I. INTRODUCTION

At the end of 1995, the Israeli government decided to undertake a systematic examination of the desirable role of the big Israeli banks in the nonfinancial sector. This inquiry was motivated by the government's plan to sell the controlling blocks that it owns in the two biggest Israeli banks, Bank Hapoalim and Bank Leumi, which together dominate the financial sector in Israel. These two banks had for a long time held large stakes in major companies in Israel's nonfinancial sector, which is also characterized by substantial concentration. The government decided that, prior to the sale of its control blocks in the big banks, it would examine whether the large role of the two banks in the nonfinancial sector should be maintained or reduced. To this end, the government appointed a committee (the "Brodet Committee"[1]) to study the subject.

The Brodet Committee concluded that it would be desirable to reduce substantially the banks' investments in nonfinancial corporations. To this end, the Committee recommended placing substantial limits on the ability of banks to hold shares in nonfinancial companies. Legislation was then adopted to implement the Committee's recommendations. To comply with this legislation, the two big banks have started a process of selling a substantial part of their holdings in nonfinancial companies. The recommendations of the Brodet Committee encountered a great deal of opposition. While the legislation recommended by the Committee was passed, the Committee's approach continues to be in dispute, and there are still calls to weaken the legislative restrictions or, at least, to delay the deadline by which the

[1] The Committee was named after its chairman, David Brodet, the general manager of Israel's Finance Ministry.

banks must comply with these restrictions.

At the time that the Brodet Committee was appointed, we were asked, by the Israeli Finance Ministry and the Israeli Antitrust Authority, to prepare for the Committee an analysis of the effects of maintaining the big banks' large investments in the nonfinancial sector. The report we prepared for the Committee identified and analyzed the substantial distortions that maintaining the banks' investments would produce in the operation of both the financial sector and the nonfinancial sector of the Israeli economy. Our analysis also examined potential countervailing benefits of the banks' nonfinancial investments and concluded that they were unlikely to outweigh the substantial costs of the produced distortions. Accordingly, the approach that we recommended was that endorsed by the Committee -- placing substantial limits on banks' equity investments in the nonfinancial sector. In the course of our analysis, we examined the potential problems arising from banks' nonfinancial investments both in general and in the particular circumstances of Israel's economy. Since the issues that we analyzed are those that future students of the subject will be likely to encounter, we present below the analysis that we carried out.

Specifically, we present below the main part of our report to the Brodet Committee.[2] All the analysis below, it should be noted, is presented largely in the same language as in our report to the Committee. We have made only very minor cosmetic changes, primarily

[2] Omitted are the introduction and conclusion to our report, two brief sections -- one on the effect of our recommendations on the ease and profitability of selling the government's bank shares and one on issues remaining for consideration, and two appendices with data that we received from the Antitrust Authority. Anyone interested in the omitted sections can find them in the 1995 report of the Brodet Committee, in which our report appears as an appendix.

to reflect the fact that the last sections of our report do not appear here. Thus, all references to the existing combinations, existing rules, existing investments, etc. are to them as they were in November 1995.[3]

Our analysis is organized as follows. Part II highlights some important preliminary points concerning the substantial concentration that exists in both the financial sector and the nonfinancial sector of the Israeli economy, and concerning the scope of bank investments in nonfinancial companies.

Part III analyzes the effects of maintaining the banks' nonfinancial investments on the financial sector. First, significant bank equity investments pose a risk to the banks' safety and soundness and raise the implicit cost borne by the government as the de facto insurer of the public's deposits in those banks. Second, bank equity investments lead to distortions in the banks' management of investment funds, thereby undermining the important function of the financial markets in allocating capital. Third, the banks' nonfinancial investments would make the banking market less competitive both in the short run and in the long run. Fourth, considerations of bank profitability do not require maintaining the existing bank investments.

Part IV analyzes the effects of maintaining the bank investments in nonfinancial conglomerates on the performance of the nonfinancial sector. First, maintaining these investments would harm competition between the conglomerates and their existing competitors in the many markets in which the conglomerates operate. Second, maintaining

[3] To comply with the legislation adopted in light of the Brodet Committee's recommendations, the two big banks have started to sell some of their holdings in nonfinancial companies. To comply fully with the legislative requirements, however, the banks would still have to sell over time substantial holdings beyond those that they have already sold.

the existing combinations would discourage entry, both by domestic entities and by foreign investors, into the markets in which the conglomerates operate. Third, the banks' equity investments are unlikely to provide countervailing efficiency benefits that would outweigh the cost of the anticompetitive effects described above.

II. PRELIMINARY OBSERVATIONS

A. Concentration in the Financial Sector

The two big banks play a major role in the financial sector of the Israeli economy. The two banks dominate not only in banking services but also in securities-related activities.

According to data that has been provided at our request by the Antitrust Authority, in Israel the two big banks:[4]

* hold 64% of the bank deposits
* extend 62% of the bank credit
* service 66% of the bank accounts
* manage 63% of "kranot neemanut" assets
* manage 65% of "kupot gemel" assets

B. Corporate Control

Before we examine the nonfinancial companies controlled (fully or partially) by the banks, a preliminary concept that requires some explanation is that of corporate control.

1. What Percentage Gives Control?

One question arises as to what size of block provides the blockholder with some measure of control. Holding more than 50% of the shares of course guarantees control. But

[4] See Appendix A to our report to the Brodet Committee, which appears in the 1995 Brodet Committee Report.

when the other shareholders are dispersed, substantially less than 50% of the shares is generally sufficient to provide control. The critical point to recognize is that control is not an all-or-nothing variable: there is a continuum. While the extent of control that a blockholder has declines with the size of the holder's block, a block of 25% or more, if no other shareholder has a substantially larger block, would usually be sufficient to give the blockholder substantial influence that can be regarded as partial control.

We now move from the general to the specific: in the present case, Bank Hapoalim has full control of Hapoalim Investments, and Bank Leumi has full control of Africa-Israel. As to Koor, Clal, and Delek, for each of these companies, Bank Hapoalim has a large block with another block of a similar size present; in these three cases, Bank Hapoalim should be regarded as having partial control.

2. Control of Subsidiaries

Another question arises when there are pyramidal structures, as commonly exist in the case of the Israeli conglomerates. Suppose that A has a controlling block in company X and can thereby determine, should it so choose, who X's managers will be; and suppose also that company X has a controlling block in company Y. Should we analyze the situation as one in which A also controls company Y? The answer is yes. By virtue of its control over X, A can, should it so desire, determine who Y's managers will be. And this is what puts Y under A's control.

In the present case, some of the companies that are fully or partially controlled by the two banks have fully controlled subsidiaries. (There are many such subsidiaries in the case of Koor and Clal.) These subsidiaries should be accordingly regarded as being under the (partial or full) control of the bank that (partially or fully) controls their parents.

3. Control and Involvement

It should be emphasized that control over a company does not necessarily mean that the controller will be frequently involved in the company's managerial decisions. As explained below, the degree of one's control is measured by potential influence over the determination of who the company's managers will be. Thus, for example, if A has a controlling block in company X, and X has a controlling block in a subsidiary Y, then both X and Y should be viewed as controlled by A -- even if A rarely becomes involved in the managerial decisions of X and Y.

The reason for this is that, in the considered situation, the managers of X and Y will likely recognize that A has the ultimate say over whether they will continue as managers. This recognition will provide them with a clear incentive to produce results that will satisfy A. For the managers will understand that, if they were to act differently, A would be able to have them replaced.

In the present case, we understand that the suggestion has been made that the two banks do not commonly get involved in management decisions of the nonfinancial companies that are under their full or partial control. As explained, however, this lack of "intervention" does in no way imply that the banks' control does not influence how these companies are managed. An understanding of the different ways that control might have an influence suggests that the way in which these companies are run might well reflect their managers' recognition that the banks have blocks that provide them with a full or partial control over the companies.

C. The Large Role of the Bank-Controlled Conglomerates in the Nonfinancial Sector

The conglomerates that are (fully or partially) controlled by the two banks are a major presence in the nonfinancial sector of the Israeli economy. Israel's nonfinancial sector is also highly concentrated, with the considered conglomerates comprising a substantial fraction of that sector. The conglomerates partially or fully controlled by Bank Hapoalim are especially important in this regard.

A study that has been done at our request by the Antitrust Authority examines the companies included in the "mishtanim" category of the Tel-Aviv Stock Exchange (TASE).[5] The companies in the "mishtanim" are those whose shares are the most heavily traded on the TASE, and they tend to be the larger companies. Altogether, they constitute 71% of the total stock market capitalization of the TASE.

Since the focus of the study is on concentration in the nonfinancial sector, the study excludes companies in the mishtanim that are primarily engaged in banking. The study also excludes Bezek, the telephone monopoly whose shares are largely owned by the government. This leaves a set of 81 companies, operating in different industries throughout the nonfinancial sector.

The study highlights the significant role of the bank-controlled conglomerates in the

[5] This study can be found in Appendix B to our report to the Brodet Committee.

nonfinancial sector. This is especially the case for the conglomerates that are under the (partial or full) control of Bank Hapoalim. Altogether, there are 21 companies in the examined set which are under the (full or partial, direct or indirect) control of Bank Hapoalim. The companies in the Hapoalim group make up about 30% of the value of the examined set of 81 companies.

Another feature that the study highlights is the overall substantial concentration of the nonfinancial sector. In addition to the Hapoalim group, there are other significant conglomerate groups. To illustrate, the companies that belong to three conglomerate groups -- Hapoalim, IDB, and Hachevra LeIsrael -- make up about half of the value of the examined set of 81 "mishtanim" companies.

The study is a preliminary one. A more complete study would also include smaller publicly traded companies as well as companies that are not listed on the TASE. But the general picture that emerges from this study is clear: the degree of concentration in the nonfinancial sector of the Israeli economy is high, and the companies that now belong to the Hapoalim group make up a significant fraction of the value of this sector.

D. The Significance of Koor and Clal

The large share of the Hapoalim group is especially due to the two large conglomerates, Koor and Clal, which are under Hapoalim's partial control. Both of these conglomerates have a pyramidal structure, with various layers. As a result, both Koor and Clal control a significant number of publicly traded (as well as other) companies, and each controls assets of a substantially larger value than is indicated by the market value of the shares in Koor and Clal. Thus, if it is desirable to reduce bank control over nonfinancial companies, separating Koor and Clal from Bank Hapoalim is especially important.

E. Why Bank-Conglomerate Combinations are Especially Problematic in Israel

While it is common for countries to constrain equity investments by banks (see Section III.A.4 below), countries differ in the extent to which they restrict such investments. The circumstances of the Israeli economy, however, make constraints on equity investments especially important. The following features of the Israeli economy make the problems produced by the existing bank-conglomerate combinations especially worrisome:

(i) the two big banks manage most of the money invested by public investors in investment funds;

(ii) the banking sector is highly concentrated;

(iii) the bank-controlled conglomerates comprise a significant share of the value of the nonfinancial sector; and

(iv) the nonfinancial sector is in general substantially concentrated.

Features (i)-(iv), which characterize the situation in Israel but are not shared by most other advanced economies, are those that make substantial bank equity investments especially troublesome in the case of Israel. In the absence of such features, the main concern raised by bank equity investments is that of the banks' safety and soundness (see section III.A below). But due to the presence of features (i)- (iv) in Israel, the existing combinations raise other, serious concerns:

-- because of features (i) and (iii), the existing combinations would likely result in substantial distortions in the investment management sector and thus harm the functioning of the capital markets (see Section III.B)

-- because of features (ii) and (iii), the existing combinations would harm the competitiveness of the banking sector (see section III.C)

-- because of features (ii), (iii), and (iv), the existing combinations would have substantial anticompetitive effects on the performance of the nonfinancial sector (see Part IV).

F. Drawing Lessons from Past Behavior

Before proceeding, we should note that not all of the problems that we will discuss are ones that necessarily exist at present. One must remember that control of the banks is going to pass to private parties that will have strong incentives to maximize profits. While such incentives might lead to more efficient management, they may also lead managers to seek to extract more profits by "abusing" their market power, or their control over investment assets, and so forth. Thus, for example, if the existing managers of the bank-conglomerate combinations have not taken advantage of opportunities to act noncompetitively, this does not mean that a future controller of Bank Hapoalim or Bank Leumi would do the same.[6]

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[6]To take another example, it has been suggested that the banks have thus far refrained from frequently intervening in the management decisions of their conglomerates. As already explained, the lack of outright intervention by the bank does not mean that the conglomerates' decisions are not influenced by the existence of bank control. But let us suppose arguendo that the banks cannot exercise control without openly intervening in the conglomerates' affairs. In such a case, their not engaging in frequent intervention thus far would not imply that a future controller of the bank would act similarly.

Since control is being passed to private hands, it is important to ask whether the existing combinations would provide the private parties in control of them with opportunities and incentives to act in a way that would not best serve Israel's economy. This is the question on which much of the analysis below will focus.

III. EFFECTS ON THE FINANCIAL SECTOR

This Part analyzes of the effects of the bank-conglomerate combinations on the financial sector. Section A explains that the combinations may reduce the safety and soundness of the banking system, thereby increasing the likelihood that the government, as de facto insurer of the banks, will be required to bail out their depositors. Section B describes the distortions in the investment management sector caused by the combinations and explains why these distortions should be of special concern to Israel. Section C shows that the existing combinations are likely to reduce both short- and long-run competition in the banking sector. Finally, Section D explains that, despite assertions to the contrary, considerations of bank profitability do not provide an adequate justification for maintaining the existing combinations.

A. Effects of Bank Safety and Soundness

1. The Significance of Bank Safety

Maintaining a safe and sound banking system is a familiar and accepted reason for limiting banks' investments in commercial companies.[7] We therefore begin an examination of the bank-conglomerate structures by considering their effects on the health of the

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[7]See generally George J. Benston et. al., Perspectives on Safe & Sound Banking: Past, Present, and Future (1986); Symars, "The 'Business of Banking' in Historical Perspective," 51 Geo. Wash. L. Rev. 676 (1983).

controlling banks. However, as we explain below, in the case of the two big banks in Israel, there are other, more compelling reasons to be concerned about the banks' equity holdings.

The failure of a bank -- especially a major one -- will have repercussions throughout both the financial and nonfinancial sectors of an economy.[8] The failure of even one bank may erode public confidence in the safety of their deposits in other banks and cause a run on the banks.[9] Since most banks are not sufficiently liquid to pay their depositors all at once, a bank run may pose a severe problem for healthy banks. The withdrawal of deposits reduces the banks' ability to extend credit to businesses, leading to a contraction in economic activity and further bank failures.[10]

Because the consequences of bank failure to both the financial and the nonfinancial sectors of an economy are so severe, governments regulate the operation of banks to maintain an adequate level of safety and soundness.[11] To ensure the good health of the banking system, government regulations generally require that banks maintain an adequate amount of capital.[12] Capital adequacy rules are designed to give banks a sufficient cushion so that they can absorb larger than expected losses from bad loans without becoming

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[8]See Benston, supra, at 37-80.

[9]See generally Jonathan R. Macey and Geoffrey P. Miller, Banking Law and Regulation 47-49 (1992).

[10]It should be noted that even if a single bank failure does not lead to public panic and a run on the banks, the collapse of that one bank will at least temporarily reduce the availability of credit to the nonfinancial sector.

[11]See generally Michael P. Malloy, The Regulation of Banking 381-714 (1992).

[12]For a brief description of capital adequacy regulations in the U.S., see Macey and Miller, supra, at 284-288.

insolvent. Banking regulations also typically impose restrictions on the activities and investments of banks. As explained below, protecting bank safety also requires constraining bank investments in equity.

2. The Danger of Large Equity Investments in Commercial Companies

(a) Large investment in a single company

There is cause for concern if a bank has a significant fraction of its capital invested in the stock of a single company. The value of an equity investment in a given company will tend to be much more volatile than the value of a loan to that company. As a result, a large equity investment might increase the risk that the bank's capital will fall below the level that is considered adequate. For example, suppose a bank has 20% of its capital invested in the stock of a given company. In such a case, if the value of the company's stock declines by 50%, the bank will suffer a 10% reduction in its capital, possibly leaving the bank with inadequate capital.

It should be emphasized that even if the equity investment is in a company that is large and well diversified, there is still a significant risk that the stock will decline in value. Even large holding companies with subsidiaries in many different industries are not immune from suffering large erosions in share price. To take an example from recent Israeli experience, recall that, not too long ago, Koor's equity value declined dramatically, and the company had to go through restructuring. For this reason, considerations of financial safety and soundness warrant imposing substantial limits on a bank's equity investment in a single company -- no matter how stable that company's stock price may appear to be.

(b) Investment in several companies

In capital markets, the stock prices of many companies --including diversified conglomerates -- tend to move together since they are often influenced by the same macroeconomic factors, such as interest rates, the inflation rate, currency values, and conditions in the real economy.. Consequently, while diversification of a bank's equity investments among various companies might reduce the volatility of the value of these investments, it would by no means eliminate this volatility altogether. As a result, the presence of substantial equity investments -- even if those investments are diversified among a number of different companies -- increases the risk that adverse macroeconomic changes to the economy will significantly erode the capital of a bank. (This problem will of course be exacerbated if these macroeconomic changes also increase the incidence of loan default.) Thus, in addition to limiting the amount of bank capital invested in any single operating company, considerations of financial safety and soundness call for limiting the total amount of bank capital that may be invested in the equity of commercial companies.

3. Restrictions on Bank Equity Investments in Other Countries

The U.S. has completely eliminated the threat to the safety and soundness of banks from bank investments in equity. In the U.S., the Glass-Steagall Act and other law simply forbid banks from owning any stock in nonfinancial companies.[13] Over time there has been a liberalization of various other restrictions under the Glass-Steagall Act -- including restrictions on the ability of bank affiliates to underwrite, deal in stock, or market investment products to the public.[14] But the prohibition against bank ownership of stock in nonfinancial companies has remained a stable feature of U.S. banking law.

While European countries do allow equity investments by banks, even these countries impose restrictions on the ability of banks to own equity positions in commercial companies. The Second Banking Coordination Directive of the EEC imposes some mild restrictions on such equity investments. However, most European countries have chosen to impose stricter (and in some cases, fairly strict) limitations on their own banks.[15]

4. Government Insurance and the Divergence Between Private and Public Interest

An important reason for limiting a bank's equity investments is that the inherent volatility of these investments increases the likelihood that a bank will fail, which in turn

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[13]See National Bank Act of Feb. 25, 1863, §11, 12 U.S.C. §24 (seventh) (1988); Banking Act of 1933 (Glass-Steagall), §5(c), 12 U.S.C. §335 (1988).

[14]These are activities that Israeli banks are and have been engaged in for some time (see Section III.B. below).

[15]Countries with strict limitations on the ability of banks to own equity in commercial companies include Denmark (prohibition against holding controlling interest in any industrial company); France (regulatory approval required for any interest in excess of 10% of a company's shares); Ireland (same); Italy (shareholdings may not exceed 15% of bank's capital and must be approved by Bank of Italy); The Netherlands (regulatory approval required for holding in excess of 10% of a company's voting shares). See "Global Survey 1995," Institute of International Bankers 8-14 (Sept. 1995).

might lead to other bank failures and a contraction of real economic activity. Yet another reason why the Israeli government might find it desirable to limit the ability of banks to invest in equity is that, in the aftermath of a bank failure, the government is likely to be called on to compensate depositors for their losses.

In the U.S., state and federal government insurance programs insure most bank deposits.[16] Although in Israel there is no similar formal insurance program, there is de facto government insurance of bank deposits. In past occasions when banks have failed, the government ultimately compensated depositors. It is generally expected that the government would do the same in the future under similar circumstances.

It is worth noting that in the U.S., government deposit insurance programs are funded by premiums paid by banks.[17] In contrast, while in Israel the banks benefit from de facto government insurance, the banks are not required to pay a similar premium. Thus the government -- and the Israeli public -- bear a risk for which they are not compensated, and are thereby providing the banks a significant "subsidy".

The risk to the government from the possibility that it will be called on to reimburse depositors for their losses is of course exacerbated by the ability of the banks to engage in equity investments. The reason that equity investments offer higher returns is to compensate those who hold equity for bearing a higher risk of loss. Thus, to the extent banks invest in stock, the more likely it is that the government will ultimately be required to bail out

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[16]For a description of the FDIC insurance system, see Miles A. Cobb, Federal Regulation of Depository Institutions - Enforcement Powers and Procedures ¶ 6.02[3] (1984).

[17]See Macey and Miller, supra, at 253.

depositors. Since equity investments force the government to bear more uncompensated risk, they increase the insurance "subsidy" given to the banks.

It should be recognized that the owners of a bank will have very different interests from those of the government in determining the percentage of capital to be devoted to equity (rather than debt) investments. Compared to loans, equity offers a higher upside and a lower downside. Since the owners of a bank will capture all of the upside of their equity investments--but not bear all of the downside risk--they will have an incentive to expand the fraction of their capital that is devoted to equity. However, as the fraction of equity increases, the risk to the government also increases. Thus, the level of equity investment that would be chosen by a bank's owners, if they could freely choose, would likely impose a large expected cost on the government. As a result, it is generally desirable to impose constraints on the tendency of bank owners to increase their equity ownership. Indeed, because in Israel the government is not at all compensated for bearing the risk of bank failure, the case for constraining the ability of banks to own stock is even stronger than in the U.S, where funds for bailing out depositors ultimately come from the banks themselves.

5. Conclusions

Considerations of bank safety and soundness by themselves require that certain restrictions be imposed on bank investments -- both on the amount invested in any given company and on the total amount of such investments. The fact that the government is likely to bear directly the cost of compensating depositors in the event of bank failure is a further reason for such restrictions.

However, in the case of the Israeli economy, considerations of safety and stability are not the most important grounds for concern about equity investment by banks. As will be seen, there are other, more important reasons for such a concern.

B. Effects on Investment Management

In Israel, banks -- including Bank Hapoalim and Bank Leumi -- play a major role in providing investment management services to the public through bank-managed investment funds. As will be explained, substantial distortions are likely to result from the banks holding large blocks of shares while managing investment funds.

1. The Role of Banks in the Investment Services Industry

In many advanced economies, banks play only a minor role in the investment services industry. In the U.S., for example, although banks are permitted to manage investment funds through their subsidiaries, the investment services sector is dominated by non-bank financial firms.[18]

In Israel, banks are very much involved in the investment services industry through their management of various investment funds. (By "investment funds," we mean both "kranot neemanut" and "kupot gemel".) In fact, Bank Hapoalim and Bank Leumi dominate these aspects of the financial sector; together they manage more than 60% of the assets in the country's investment funds.

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[18]Melanie L. Fein et. al., Mutual Fund Activities of Banks §1.01 (1994) (only 6% of mutual fund assets are managed by bank-affiliated entities).

During the last decade, there has been an ongoing debate in Israel on the extent to which the continued participation of banks in the investment services sector is desirable. The Bejski Commission viewed such participation as undesirable. For present purposes, there is no need to reexamine the question of whether the banks' involvement in the investment services sector should be curtailed. We take the banks' existing role there as given. Our purpose is only to point out that, since banks dominate the investment management services industry, their holding large equity blocks is likely to lead to severe distortions.

2. Distortion of Investment

Consider a bank that has a significant investment in a company ("C"). The bank-managed investment funds will from time to time face the decision of whether to buy shares of C (or alternatively, whether to sell such shares). In such a case, the bank's incentives might be distorted. That is, the bank might have an incentive to have its investment funds purchase shares of C even if that would not be in the best interest of the investors in these funds.

For illustration, consider the case of a public offering of shares in a company in which the bank currently holds a large interest directly or indirectly. It is clear that existing shareholders -- including the bank -- will be better off the higher is the price of the offering. Thus, to the extent that the purchases of the bank's investment funds can affect the price at which the public offering can be conducted, the bank will have an incentive to use investors' money in those funds to support a higher offering price, even if other shares offer superior investment opportunities.

The investment decisions of the banks' funds in the secondary market are also likely to be influenced by the bank's holdings. Whenever the bank has a large but less-than-majority stake in a company (say, a 30% block), the bank's influence or control over the company may depend on whether the bank-managed funds own additional shares. Thus, the bank's direct private interests might be advanced by the decision of a bank-managed fund to purchase more shares, or not to sell shares that are already owned, even though such a decision may not be in the interest of the public investors in the fund.

The bank may also use its investment funds to support the price of shares owned by the bank. Whether or not the bank has (or seeks) control of an affiliated company, there are a number of reasons why the bank might care about the price of the company's shares. An increase in the price of a subsidiary's stock will increase the value of the bank (and its shares), thus making it easier for the bank to raise money in both the debt and equity markets. Bank-managed funds can thus be used to support the market price of a subsidiary's stock if there is temporary selling pressure or if it would be helpful to the bank to increase the trading price of the stock.

3. Note on Existing U.S. and Israeli Arrangements

The opportunities for investment funds to invest in the shares of affiliated companies are much more limited in the U.S. than in Israel. Unlike in Israel, companies engaged in the management of investment funds do not commonly hold large blocks in publicly traded companies.

Nevertheless, the Congress, government regulators, and the courts have long been aware of the distortions that can arise from money managers using managed -- that is, other people's -- money to buy shares in companies in which they have an interest. Consequently, investment companies (e.g., mutual funds) face very severe restrictions in purchasing shares in companies when their officers, directors, investment advisor, underwriter, or any entity affiliated with these persons (through 5% stock ownership or otherwise) hold shares in those same companies.[19]

The restrictions on the purchase of shares in an affiliate of the investment funds are embodied in various rules and regulations. In particular, Section 12(d)(3) of the Investment Company Act of 1940 prohibits a mutual fund from investing in the shares of its investment advisor (or any other); Section 17(a) prohibits investment companies from buying shares from or selling shares to an affiliate or even an affiliate of an affiliate; and Section 17(d) prohibits an investment company and any affiliated person from purchasing shares together in another company in a joint transaction. The Securities and Exchange Commission (SEC) has broadly interpreted these rules -- and others generally requiring investment advisors to avoid placing themselves in situations where there could be a conflict of interest -- to discipline investment companies that have purchased shares owned by their affiliates.[20] Thus, even though the companies that manage funds in the U.S. are extremely far from having the type of equity investments that the two banks have, U.S. lawmakers and

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[19] See generally Tamar Frankel, 2 The Regulation of Money Managers 371-585 (1986).

[20] See, e.g., Gabelli Group, Inc., et. al., In re, [1988-1989] Fed. Sec. L. Rep. (CCH). ¶ 84,316 (SEC Aug. 17, 1988) (investment advisor charged with violating Section 17(d) of the 1940 Act by joining with two investment funds under its control to acquire a 28% interest in a company).

regulators still believe that sufficient possibility for conflict of interest exists to justify severe restrictions on purchases by investment funds.

It should be noted that, under existing arrangements in Israel, the investment funds managed by a particular bank are prohibited from investing in the shares of that bank. These arrangements reflect the recognition of the inherent conflict of interest that arises when a bank-managed fund is permitted to invest in the bank's shares, an investment from which the bank directly benefits.

However, the potential for distortion in a bank-managed fund is clearly not limited to investment decisions involving the bank's own shares. When the bank also owns a substantial interest in another company, the potential for distortion may arise whenever the bank-managed fund considers investing in that company's shares as well.

It is easy to understand why the designers of the current Israeli arrangements did not apply them to investments by a bank-managed fund in the shares of companies affiliated with that bank. Given the size of the bank-managed investment funds, and the number and size of the companies that are bank-affiliated, a prohibition on investing in bank-affiliated companies would not have been feasible.

Given that this type of prohibition is infeasible, if the existing combinations are maintained, conflict of interest problems are likely to be present on a large scale. The only effective means of addressing these problems would therefore be to eliminate or substantially reduce the banks' large equity holdings.

4. Can the Problems be Eliminated by Fiduciary Duties and "Chinese Walls"?

It might be suggested that the considered conflict-of-interest problems can be addressed by imposing fiduciary duties on the bank-managed funds towards their investors and by separating the investment management services of the bank from its other activities. As explained below, such arrangements cannot eliminate the considered distortions.

(a) Fiduciary duties

Suppose that the subsidiaries operating the investment funds and the outside consultants making the investment decisions have a fiduciary duty toward the investors to choose the best investments for them. Although such a duty might reduce distortions in the fund's investment activities, its effect would be limited.

If the investment funds and their managers have incentives to choose particular investments, the fiduciary duty by itself will be unable to prevent these incentives from affecting the managers' investment decisions. The fiduciary duty can prevent an investment manager from being unduly influenced in his investment decisions only if he believes that a violation of this duty will be detected by investors or regulators and verifiable to a court or other authority. However, an investment decision is often the product of many different subtle and nonquantifiable considerations. It is thus difficult for investors or government regulators to determine that there has been a breach of fiduciary duty -- and even more difficult for them to prove the existence of such a violation to a third party.

Thus, as long as there is structural distortion, fiduciary duties can hardly be relied on to eliminate it.[21] It is for this reason that, in the U.S. and other advanced economies, investment funds have a fiduciary duty toward their investors and yet are still subject to substantial constraints designed to prevent conflict-of-interest situations from arising in the first instance.

(b) "Chinese Walls" and Independent Investment Committees

Now suppose that, in addition to having fiduciary duties towards the investors in the bank-managed funds, the investment management services of a bank are separated from its other activities. Suppose that all of the money management activities of the banks are conducted through subsidiaries; that the investment decisions of these subsidiaries are largely made by outside consultants; and that there is sufficient separation to limit the flow of information between the subsidiaries and the bank. For example, suppose that independent investment committees staffed with outside consultants will make investment decisions without consulting with bank personnel. Again, such an arrangement would reduce the distortion, but only by very little.

In some contexts, the use of "Chinese walls" can substantially eliminate the problem being addressed. For example, in U.S. investment banks, it is common for equity

[21]Fiduciary duties have their limits in other contexts as well. When a corporation has a controlling shareholder, for example, fiduciary duties require that all shareholders receive equal treatment. Still, it is generally recognized that controllers can capture some private benefits of control. Even in the U.S., where private benefits of control are small relative to those in other counties, they are significant. See, e.g., Michael J. Barclay and Clifford G. Holderness, "Private Benefits from Control of Public Corporations," 25 J. Fin. Econ. 371 (1989). Indeed, the very reason why control blocks carry a premium is that, in the presence of a controlling shareholder, fiduciary duties cannot ensure that a company's shareholders will all be equally treated.

investment departments to be separated from lending departments, so that private, inside information obtained by a lending unit in the course of extending credit to a particular company does not reach the investment department and give it an unfair advantage over other equity traders in the market.[22] This example illustrates the type of problems that can be at least partially solved with Chinese walls -- problems that would arise from the unrestricted flow of information within a large organization.[23]

But the problems discussed in this section do not arise from the flow of information between the investment management units of the bank and its other departments. The persons responsible for investment management do not need to receive information from other units of the bank to know that the bank has significant interests in certain companies. The knowledge that the bank has interests in these companies is sufficient to induce those running the investment subsidiaries to make investment decisions that will please the bank -- and thereby ensure their continued employment and compensation by the bank. Thus, there will be a natural distortion in their investment decisions, even if a Chinese wall is erected between their activities and the rest of the bank.

5. The Cost of the Distortion

There is reason to believe that the money management distortions discussed above are likely to be quite widespread. First, a significant fraction of the funds invested in the Israeli

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[22] See Harvey E. Bines, The Law of Investment Management Par. 10.06[2][a] (1986).

[23] Id.

capital markets come from bank-managed investment funds. Second, the companies whose shares are directly or indirectly owned by the banks comprise a substantial percentage of the companies that are listed on the TASE. Thus, there are many opportunities and incentives for tilting the funds' investment activity in favor of the banks.

The most obvious cost of these distortions is that investors will not get the best possible investment management services. Furthermore, and perhaps more importantly, the discussed distortions of investment decisions will impair the proper functioning of the capital markets. A major role of the capital markets is to allocate capital to where it can be most productively employed. It is generally recognized that this role is performed by having the capital markets channel funds to where the expected return is highest. However, the distortions considered in this section will often cause capital not to be allocated to its most productive use. That is, the distortion will cause investment to flow excessively to companies that are owned directly or indirectly by banks, whether or not they can employ the capital more productively than other firms, and away from other companies that do not have this type of connection to banks. Consequently, the capital markets will not perform effectively one of their most important functions.

6. Conclusions

For the reasons discussed above, we believe that maintaining the existing combinations would lead to distortions in the investment management sector -- which in turn would undermine the functioning of the Israeli capital markets. This problem would be quite severe in light of (i) the dominant role of the two big banks in money management, and (ii) the significant number of companies in which they (and especially Bank Hapoalim) have a direct or indirect interest.

If the existing combinations are maintained, the distortions would be unavoidable. Given the existing structures, seeking to eliminate conflict-of-interest problems by, say, prohibiting bank-managed funds to invest in companies in which the bank has (directly or indirectly) a large equity stake would not be feasible. Thus, assuming that the two big banks are permitted to maintain their dominant role in the investment management sector, the best way to deal with the distortions is to eliminate or at least greatly curtail the banks' equity interests in publicly traded companies.

C. Effects on Competition in the Banking Sector

We now turn to examine the effects that maintaining the existing combinations would have on competition in the banking sector in Israel. The effects that we identify arise because the two banks' large positions will give them substantial influence on how the conglomerates are managed. As will be seen, this influence will have a negative effect on competition in the banking sector.

1. Concentration in the Israeli Banking Sector

As already observed, and as Appendix A documents, the financial sector in Israel is highly concentrated. In particular, the two big banks dominate the various aspects of the financial sector -- both banking services (e.g., deposits, loans, account services) and investment management services.

Before proceeding, we should emphasize that we are not assuming that the large size of these two banks is, by itself, necessarily undesirable. This is an issue on which there are different views. There are some who argue that, given the size of the Israeli economy, there are economies of scale that make very large banks more efficient. If this view is correct, we should accept concentration in the financial sector as inevitable but we should still do whatever is possible to minimize the anticompetitive effects of such concentration. On the other hand, there are those who claim that economies of scale can be achieved with a substantially smaller level of concentration than we have at present.[24] If this is the case, it would be desirable to take steps to reduce the existing concentration.

For the purposes of our inquiry, we do not need to resolve the question of whether economies of scale make high concentration in the Israeli banking sector desirable. We take as given that, for now, the Israeli financial sector is substantially concentrated. Whatever the concentration, the banking market can still be made to behave better or worse, that is, more or less efficiently. Thus, given that we have large banks (whether or not that is inevitable), it is still desirable it minimize any adverse effects of their size on the financial markets.

2. The Limited Effect of International Competition

It might be argued that, even with the concentration we now have, the banks will behave in a fairly competitive fashion in order to ensure that they do not lose business to foreign banks. There are some sectors in which, even if there were only one Israeli

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[24]For a systematic account of this view, see David Rotenberg, The Optimal Structure of the Israeli Banking System -- Theory and Practice, Vol. 12, pp. 49-80.

company, that company would have limited market power on account of competition from imports. But in the financial sector, the discipline provided by foreign providers of financial services is limited for a number of reasons.

To start with, for certain services (e.g., checking accounts, cash, underwriting, advising), a bank must have branches in Israel to compete effectively. Furthermore, foreign banks are limited in their ability to offer investment services because of restrictions on the ability of Israeli citizens to invest in foreign companies (and so on). Foreign banks are also at a disadvantage in extending credit to Israeli companies. Israeli banks have deposits in shekels whereas foreign banks do not, since Israeli citizens cannot deposit their shekels in foreign banks. Thus, a foreign bank wishing to extend a shekel-denominated loan (either linked to the index or not) would have to bear a currency risk that an Israeli bank having shekel obligations (to its depositors) would not. To be sure, foreign banks are not at a currency-risk disadvantage in making dollar-denominated loans, but even in these cases Israeli banks still have an advantage in monitoring Israeli businesses to which they lend. For example, if the bank provides regular banking services to a borrower, the bank will have an advantage in monitoring the borrower's financial condition.[25]

For these reasons, we conclude that it is sensible to consider only banks operating in

[25]It is of course possible that in the future, foreign banks might establish subsidiaries or units in Israel, thereby reducing concentration. (The effect of the existing combinations on future entry will be discussed below.) However, the point of this section is that foreign competition will generally not be effective at keeping the banking market competitive unless the foreign banks begin operating in Israel.

Israel in determining the concentration of Israel's banking sector.[26]

3. Reducing the Vigor of Competition Among Existing Banks

Highly concentrated industries -- such as the banking sector in Israel -- typically give rise to noncompetitive behavior. When there are a small number of large firms, they will recognize their interdependence and tend to compete less aggressively. Each will recognize that competitive acts -- such as offering a better deal to attract customers from other firms -- is likely to be met by retaliation -- more competitive responses from the other firms. As a result, there will be a tendency for supercompetitive prices to result. (In the Israeli financial services sector, this would mean higher interest rates for borrowers and higher fees for various banking services).

The main countervailing force that can undermine noncompetitive behavior in the short run is that occasionally firms are tempted to deviate in order to enlarge market share.

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[26]This situation can be contrasted with that in some local markets in the United States. Although some of these markets are highly concentrated, this does not pose a serious competitive concern because non-local banks provide a threat. The difference is that clients of local banks in the U.S. can switch to a non-local bank much more easily than the clients of Israeli banks can switch to foreign banks. (For many Israeli clients, switching would in fact be impossible.)

Similarly, this situation can be contrasted with the one in some small European countries. We understand that it has been pointed out that in some small western European countries banking is also quite concentrated. However, in thinking about this analogy, one must keep in mind that in most of these countries the currency is freely convertible and there are no restrictions on capital flow to and from these countries. This of course makes switching to foreign banks much more possible than in the case of Israel.

In short, banks that have a large share of the banking market in a local U.S. market or in the market of a European country are disciplined to a much larger extent by the threat of "foreign" banks than are banks with a large share of the Israeli banking market.

Such deviation will often be induced by large buyers (in this case, large borrowers or customers of other banking services): the prospect of an immediate and significant increase in business may be too much to resist.

The problem that arises in the present instance is that the many of the largest users of banking services belong to the conglomerates that are controlled by the banks. For example, Bank Hapoalim is unlikely to feel that it must provide concessions to attract some of the business of firms that are affiliated with Koor and Clal. Moreover, these firms are unlikely to attempt to obtain secret concessions from Bank Leumi in exchange for moving all their business away from Bank Hapoalim. Thus, a significant portion of the major users of banking services in Israel will not engage in the type of aggressive seeking of better prices that tends to produce more competitive behavior.[27]

4. Reducing the Prospects for Entry in the Banking Industry

Even if the banking industry continues to remain concentrated due to economies of scale, it is important that entry be made as easy as possible, for two reasons. First, the prospect of entry will have a desirable influence on incumbent firms. If their behavior is too noncompetitive, or their provision of services too inefficient, incumbent firms will expect to be displaced by entrants. Thus, the threat of entry will lead existing firms to perform better. Second, ease of entry will be beneficial when performance indeed is poor. In an industry

[27]There are other reasons why the banks' control of these conglomerates may reduce the extent of competition in banking. In particular, bank control would exacerbate the "mutual forbearance" problem that will be explored when we consider the aggressiveness of competition in the nonfinancial sector.

such as banking, which is rapidly changing due to technological advances and the evolution of the Israeli economy, the optimal structure of the industry is not always obvious. If entry is easy, market forces will tend, over time, to produce desirable outcomes. If, on the other hand, entry is inordinately difficult, it is easier for less competitive and inefficient structures to persist.

Allowing the banks to retain control of the conglomerates will impede entry -- especially large-scale entry or major expansion of existing competitors -- for the same reason described in the preceding section: A large fraction of potential customers belongs to conglomerates, and such potential customers are not likely to leave their parent bank to facilitate the entry or expansion of a competing bank. Thus, in addition to reducing competitive vigor among existing banks, bank control of the conglomerates will tend to stifle new sources of competition over the long run.

5. Conclusions

The Israeli economy now has a banking market that is dominated by its two biggest banks. Regardless of its concentration, however, this market can still be made to operate either more or less competitively. We have seen that maintaining the existing bank-conglomerate combinations would cause this market to operate less competitively. Efficiency would be harmed both in the short run (because the vigor of competition among existing banks would be weakened) and in the long run (because new entry would be deterred).

D. Are Large Equity Stakes Necessary for Bank Profitability?

We understand that it has been argued that the banks' equity investments in commercial companies are necessary for the profitability of the banks. According to this argument, profits from traditional banking activities have declined, and profits on equity investments are therefore needed to maintain bank profitability. This concern is difficult to address because we do not fully understand the argument and the facts on which it is based. Does the argument imply that the big banks cannot make a normal return on their traditional banking activities? If so, how do the smaller Israeli banks, which do not have large equity investments, survive? In any event, we see two major problems with the apparent logic behind this argument.

1. Are Equity Investments a Desirable Method for Increasing Profits?

It should first be emphasized that the big banks can make profits from equity investments without investing their own money. A substantial part of the profits of Israeli banks' now comes from their investment management activities. Banks are essentially financial intermediaries, borrowing money from the public and lending it to firms. Taking deposits, using those funds to invest in equity, and profiting from the spread in returns is one way of acting as an intermediary between public and the equity markets. Soliciting investments for equity mutual funds and profiting from management services is another. Thus the argument that banks must be allowed to profit from the equity markets must explain why it is essential that banks hold equity investments in addition to managing them.

To be sure, (i) borrowing money from the public and investing that money in equity might provide a bank with a higher return than (ii) soliciting funds from the public and investing it through the bank-managed investment funds. But the reason for the higher return is that (i) involves a greater risk for the bank than (ii). If the bank uses the public's deposits to invest in equity for its own account, the risk associated with the equity rests with the bank. In contrast, if the bank puts investors' money into equities through bank-managed investment funds, the risk remains with the investors. So the extra return achieved by the bank by using the public's deposits to invest in equities for itself would come only at the expense of added risk. Therefore, the higher return comes at the expense of reducing the safety and soundness of the banks and increasing the cost borne by the government as the banks' de facto insurer (see Section III.A. above). It is thus far from clear that having the banks follow strategy (i) rather than (ii) is a desirable way for them to pursue extra profits.

2. Do Equity Investments Require Large Blocks?

Suppose that society is willing to bear the increased risk to bank safety and soundness associated with having one of the banks, say Bank Hapoalim, invest up to 500 million dollars of its capital in equity investments.

In such a case, benefitting from the higher expected return offered by equities would not require that the bank invest the 500 million dollars in concentrated blocks of stock. The bank could instead invest the money in a diversified portfolio of stock. Thus, for example, the bank could hold 2% of the shares of every company in the "mishtanim". Or the bank could invest this amount in one or several of the investment funds it manages.

Holding a diversified portfolio would still provide the bank with the higher expected returns offered by equity. At the same time, it would not produce the substantial adverse effects that maintaining the existing combinations would produce -- adverse effects on the money management sector, and on competition in both the banking sector and the sectors in which the bank-controlled conglomerates operate. Thus, concerns about bank profitability do not provide a justification for the banks holding large blocks in the conglomerates.

IV. EFFECTS ON THE NONFINANCIAL SECTOR

Thus far we have looked at the adverse effects that maintaining the existing combinations is likely to have on the operation of the economy's financial sector. We now turn to look at the effects on the nonfinancial sector.

Section A begins by discussing the nature of our inquiry: the range of effects we consider and how the competitive analysis of conglomerates should proceed. This section highlights the fundamental difference between the conglomerate problem in Israel and in a large economy like the U.S. Section B analyzes the direct effects that bank control of the conglomerates has on the state of competition in the conglomerates' particular markets, as those markets are currently structured. Section C addresses the ways in which bank control of the conglomerates may reduce future competition in these markets due to adverse effects on entry. Finally, Section D considers the extent of any benefits that may arise in nonfinancial markets from bank control of the conglomerates. Our conclusion will be that maintaining the existing bank-conglomerate combinations would likely be, overall, substantially harmful to the performance of the nonfinancial sector.

A. Introduction: Nature of Inquiry

1. Two Possible Sources of Anticompetitive Effects

There are two aspects of the bank-conglomerate combinations that raise anticompetitive concerns. First, even if each of the banks were to control only one conglomerate, the very connection between the conglomerate and one of the big banks would produce anticompetitive effects. Second, when a bank has large blocks in more than one conglomerate (as in the case of Bank Hapoalim), the connection thereby established between the two conglomerates might also lead to reduced competition.

In the analysis to follow, it turns out that both aspects of the existing combinations would prove harmful to competition. We will often provide a single analysis that is applicable to both dimensions of control. We will, however, identify any important differences that emerge.

2. Inquiry Focused on Competitive Effects

Competition policy concerning conglomerates has often proved controversial because, in addition to carefully focused inquiries into competitive effects, concerns are also raised about possibly adverse social and political consequences of large concentrations of assets. In the United States, for example, the legislative history of the merger statute expresses such broad concerns,[28] but many commentators, including Phillip Areeda and Donald Turner,[29] have argued that analysis of conglomerate mergers should focus exclusively upon identified anticompetitive threats, and the most recent Department of Justice guidelines that address the subject[30] reflect a similar view.

Because our own expertise is in the economic area, our analysis will consider only

[28] See, e.g., Brown Shoe Co. v. United States, 370 U.S. 294, 312-23 (1962); Derek Bok, "Section 7 of the Clayton Act and the Merging of Law and Economics, 74 Harvard Law Review 226, 234-37 (1960).

[29] See Phillip Areeda and Donald Turner, Antitrust Law, vol. 5, 231-93 (1980).

[30] See 1984 Justice Department Merger Guidelines.

the economic effects of the existing combinations. We assume that the Israeli government will give whatever weight it deems appropriate to the social and political dimensions.[31]

3. The Importance of the Conglomerate's Size Relative to the Economy

In the context of the U.S. economy, many writers believe that the actual competitive threat posed by conglomerates is not of sufficient significance to warrant intervention. Because we largely share this view with respect to conglomeration in the U.S. economy, we wish to highlight upfront the fundamental difference in this respect between the Israeli and U.S. economies.

In countries such as the United States, even large conglomerates are small relative to the economy as a whole. For example, the largest U.S. nonfinancial corporation in 1987 (General Motors) had control over only 1.5% of the assets of nonfinancial corporations.[32] Other large corporations, conglomerate or otherwise, were much smaller. Thus, in 1982, there were more than 1300 nonfinancial corporations with assets of more than $250 million and almost 1900 financial corporations of similar size. In this context, linking a single financial corporation (such as a bank) with a single nonfinancial corporation -- even if both

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[31]Strictly speaking, one possible political effect of concentration is also an anti-competitive effect: large concentrations of economic power may be used to induce government regulators to act in ways that disadvantage rivals or otherwise suppress competition. Indeed, some antitrust commentators posit that the most significant source of anti-competitive market structures and performance is not private activity but government regulation. We emphasize that we are <u>not</u> addressing such concerns here.

[32]The figures reported here and others can be found in F.M. Scherer and David Ross, <u>Industrial Market Structure and Economic Performance</u>, ch. 3 (3d ed. 1990).

were among the largest in the economy -- would have a trivial effect on the economy as a whole. Similarly, joining control of two large nonfinancial corporations would be a rather insignificant event with regard to concentration.

The contrast with Israel is dramatic. As already emphasized, the two big banks as well as the major conglomerates they control have vastly larger market shares in the sectors of the economy in which they operate. Thus, the potential concerns about conglomerates in the United States (and in many other large economies) are insignificant relative to the concerns about conglomerates that arise in the Israeli context.

B. Direct Effects on Competition

This section examines the effects that maintaining the existing combinations would have on the competition among existing firms in the markets in which the conglomerates operate; the effect on new entry will be considered later. The existing combinations would reduce competition in two ways. First, as subsection 1 will explain, because bank control of the conglomerates brings some competitors under the control or influence of a single entity, these competitors will compete less aggressively against each other. Second, as subsection 2 will explain, the broader the scope of large entities in the economy, the less aggressive will be the competition between these large entities and outsiders.

Before beginning our analysis, we pause to comment on the significance of such anticompetitive effects in the Israeli economy. In highly unconcentrated industries, as often exist in large economies, reasonably competitive outcomes are typical, and are unlikely to be upset by modest increases in concentration or by less than aggressive behavior by one or two competitors. By contrast, in the Israeli economy, in which we understand concentration in many industries to be quite high, the problems we identify are very serious. A given increase in concentration is particularly damaging when concentration is already high. Also, in highly concentrated industries, the performance of the industry greatly depends on whether competitors behave aggressively toward their rivals or exercise restraint. In such circumstances, market structures that reduce competitive vigor may be very costly.

1. Reduced Competition among Firms Controlled or Influenced by a Single Entity

When two large conglomerates are under the substantial influence of a single entity, the anticompetitive effects are similar to those that would arise from a merger. Thus, any time that the two conglomerates controlled by Bank Hapoalim (Koor and Clal) operate in the same industry, the effect may be similar to that from a horizontal merger of the relevant entities. Therefore, in any industry in which two or more of the many companies in the Hapoalim group are active there are probable anticompetitive effects. These effects may also arise whenever one of the conglomerates is an actual or potential competitor with a controlling bank in a particular line of business, such as underwriting or the management of investment funds.

This problem (and most of the others that we identify below) are exacerbated to the extent that there is a further connection, through Clal, with IDB. For example, if the two leading competitors in an industry are parts of the Koor and IDB conglomerates, one might expect some competition between them. But such competition may be moderated under the existing combinations because Koor is linked with Clal through Hapoalim, and Clal is linked with IDB. Thus, in industries in which more than one of these three conglomerates are present, performance might reflect the aggregate market power of the firms controlled by all three conglomerates. As a result, the inquiry into direct horizontal competitive effects needs to be broader than an examination of competitive overlap between Koor and Clal.

Unfortunately, the prospect of direct injury to competition is not limited to the instances just described in which a bank may induce the conglomerates it controls to behave less competitively. In addition, the fact that major banks will control conglomerates -- even a single conglomerate, as with Bank Leumi's control of Africa-Israel -- may dampen competition in the markets in which any (even one) of these conglomerates operate. To illustrate the problem, suppose that the most important competitor of one of Africa-Israel's businesses is an independent firm (not part of the same conglomerate) but one that gets its financing from Bank Leumi. In this instance, Bank Leumi has an incentive to exercise its financial influence in a manner that will induce the independent firm to compete less aggressively.[33] Because such restraint will increase profits in the industry, Bank Leumi

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[33]A bank often has significant influence over the behavior of firms that rely on it for financing. The firms may depend on the bank for extensions of credit in times of sudden need. In addition, debt often carries an array of covenants, many of which will be violated by the debtor at any point in time. The covenants are to protect the bank, and the bank will ordinarily not cause trouble for the debtor as long as the identified problem is not serious. But the bank may, at its option, exercise its rights in a manner that could disrupt the firm.

One might be skeptical about the likelihood that a major competitor of one of Africa-Israel's businesses would choose Bank Leumi as its bank and arrange its finances such that Bank Leumi has significant influence. But such skepticism is unwarranted. First, these banks have such a large share of the total business that it is unlikely that all of the conglomerates' independent competitors could avoid dealing with these banks. Second, it is not the case that the independent firm would be disadvantaged by such dependency; instead, it may gain. By having a financing relationship with the parent bank of a major competitor, an independent firm may in essence be voluntarily subjecting would benefit because of the gain to Africa-Israel.[34]

The problem just described can arise in another way. Even if the controlling bank does not provide financing to the potentially aggressive competitor, the bank may, by virtue of the investment funds that it manages, hold shares in these competitors. This adds yet another channel of potential influence.

In summary, direct costs to competition might arise in all markets in which companies in the Hapoalim group overlap with each other or with companies in the IDB group. In addition, direct costs to competition might arise in all the markets in which companies in the Hapoalim group or the Leumi group overlap with competitors that are financed by their parent bank or have a significant amount of equity held by funds managed by the parent bank. Given the large size and scope of both the banks and their conglomerate groups, one would expect such problems to arise in many industries.

2. Reduced Competition between the Conglomerates and Completely Independent Firms

We have just described how maintaining the existing combinations may reduce competition between companies in a bank's group and other companies that are also controlled or substantially influenced by the bank. There is an additional concern that there

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itself to competitive restraint in exchange for the bank's implicit promise that its conglomerate will show similar restraint in return. The result of mutual restraint in the industry will be higher prices and thus more profit for all involved.

[34]We observe that the problem arises primarily because of Bank Leumi's significant equity stake in Africa-Israel. When a bank merely holds debt of competing enterprises, its incentive to induce the competing firms to exercise restraint is limited: as long as the firms are solvent, increased profits to the firms will not increase the profits of the bank.

would be less aggressive competition even with regard to completely independent firms, aside from any effects resulting from the problems identified in the preceding subsection. This further problem involves what is sometimes referred to as mutual forbearance.[35]

To explain, consider the case in which firm A competes aggressively with firm B in market 1. Perhaps firm B is a large firm attempting to maintain a supercompetitive price and firm A is a smaller firm that is undercutting the price to expand its market share. One possibility is that firm B can also lower its prices, but this response is not always fully effective: it may not be possible to drive A from the market and firm B might lose even more profits by attempting to "punish" firm A. Thus, firm B might seem helpless to prevent firm A's competition. In some instances, however, firm B might have another option. Suppose that firms A and B also operate in market 2. Furthermore, it might be the case that firm A has much to lose from more aggressive competition in this second market. In that case, firm B -- unable to punish firm A for its aggression in market 1 -- might be able to punish A in market 2, where firm A is more vulnerable.[36]

We now explain how the present case raises these concerns about mutual forbearance.

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[35]The leading, recent treatment of this subject is B. Douglas Bernheim and Michael Whinston, "Multimarket Contact and Collusive Behavior," 21 RAND Journal of Economics 1-26 (1990). For empirical evidence in support of the theory, see William Evans and Ioannis Kessides, "Living by the 'Golden Rule': Multimarket Contact in the U.S. Airline Industry," 108 Quarterly Journal of Economics 341-66 (1994), and Kirsty Hughes and Christine Oughton, "Diversification, Multi-market Contact and Profitability," 60 Economica 203-24 (1993).

[36]The idea that the optimal punishment for aggression might involve striking back at the aggressor's weakest point -- which might be located at a different point than that of the aggressor's initial attack -- is quite familiar in the contexts of warfare and diplomacy, as well as in the present context of competition.

The basic theory suggests that the problem will arise and be more significant the greater the range of contacts across markets. With so many companies belonging to the Hapoalim group and thus at least partially under the bank's control, the extent of their reach across markets is much greater. As a result, it will more often be the case that a firm that is aggressive against this group of companies in one market will have reason to fear punishment in another market. The converse also is true: the companies in this group will be less aggressive because there are more markets in which they might face effective retaliation from others.

It should be clear that the problem we identify in this subsection may operate in synergy with that examined in the previous section. The number of sources of aggressive competitive behavior will be reduced to the extent competitors are commonly controlled, are subject to influence through the bank that is allied with a competitor, and are subject to effective retaliation, possibly in other markets. If the banks and conglomerates involved in this case each constituted a tiny fraction of the relevant sectors of the economy, the banks' control of the conglomerates would pose only modest and occasional anticompetitive risks. But when each firm is of such massive scope, the aggregate of these anticompetitive effects could be substantial in many markets.

C. Raising Barriers to Entry

Because concentration is so high in many industries in Israel, the potential for entry is extremely important. The very prospect that new firms might enter a market can sometimes cause incumbent firms with market power to exercise restraint. Moreover, actual entry is the most likely source of renewed competition in many existing industries. As Israel privatizes more businesses and relaxes the extent of regulation, the potential for greater competition in the future fostered by new entry is of great importance.

Although the prospect of entry is grounds for hope, maintaining the existing combinations would do a great deal to discourage entry. First, as Section 1 will explain, some of the most important potential entrants -- the controlled conglomerates themselves -- may be removed from play due to the ownership structure. Second, as discussed in Section 2, the joint control of Koor and Clal as well as the large banks' linkages with the conglomerates may make entry in many industries much more difficult. Thus, maintaining the existing combinations would serve not only to reduce competitive vigor in the short run but also to undermine the prospects for enhanced competition through entry in the long run.

1. Reduced Entry by Conglomerates

In some industries, technology may be simple, capital requirements limited, inputs readily available, and potential demand great; in those markets, entry will be easy. But in other industries, few individuals or firms may have the relevant combination of factors needed to enter successfully. In industries in which entry is most difficult -- which presumably includes many of the most concentrated industries in Israel -- the most plausible entrants often will be the existing large conglomerates.[37] They alone may possess the capital, range of skills, networks to supply inputs and distribute outputs, and the credibility necessary to enter an industry.

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[37]See, e.g., Arjen van Witteloosturijn and Marc van Wegberg, "Multimarket Competition: Theory and Evidence," 18 Journal of Economic Behavior and Organization 273-282 (1992).

In Israel, however, the number of firms in a given industry is often quite small; there are also only very few conglomerates. Suppose, for example, that in a highly concentrated industry that is not behaving very competitively, Clal is an industry incumbent earning significant profits as a result of the present low level of competition. Suppose also that the most plausible entrant would be Koor and that Koor's entry would enhance competition significantly. If Koor were independent, one might expect it to enter. But if Koor is controlled by the same bank that controls Clal, then it is not likely that Koor would enter to restore competition.[38]

Again, we emphasize that these problems, which are recognized to occur occasionally in large economies such as the United States, are quite serious in Israel. In the United States, for example, there would often be many large conglomerates with the relevant capabilities to enter a market (and each would be independent of the other firms). By contrast, in Israel the options will usually be far more limited. Losing a large potential entrant when there is only one (or a few) available would have a much more adverse effect than losing one entrant among many.

2. Reduced Entry by Independent Firms

In some industries, important entrants will not be confined to the few conglomerates under discussion. Other, smaller conglomerates, independent firms, or even some individuals might be able to enter concentrated industries and have a significant

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[38]In addition, the arguments in Section B suggest that, even if Koor did enter, it is unlikely to behave as an aggressive competitor if it and Clal are both partially controlled by Hapoalim.

procompetitive effect. Such entrants will find entry more difficult if the two banks remain in control of their conglomerates.

The general nature of this problem is that entry usually requires doing many things simultaneously: raising capital, acquiring access to technology, securing a range of inputs, and finding markets for one's output. In a world in which each of these many items are supplied or demanded in competitive markets, entry often will be possible: the entrant simply can enter into a variety of contracts and proceed with its business. Problems can arise, however, if one's competitors have control over some of the necessary factors.[39]

Suppose, for example, that one wishes to enter an industry in which Clal is the leading firm. To succeed, one needs a steady and substantial flow of inputs from a firm in another industry that is part of the Koor conglomerate. If Clal and Koor are both partially controlled by the same bank, Koor may be uncooperative, rendering entry difficult, to the (anticompetitive) benefit of Clal.

Again, such effects would be rare if the relevant firms controlled an insignificant fraction of the economy. But this is not the case in Israel. Because of the large number of companies in the Hapoalim group, there is a significant possibility that entry might often be impeded because some number of the many relevant input markets and output markets needed might be controlled by other branches of the conglomerate empire.

Note that a similar problem might arise if the potential entrant depended on Bank

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[39]See generally Oliver Hart and Jean Tirole, "Vertical Integration and Market Foreclosure," Brookings Papers: Microeconomics 205-286 (1990); Janusz A. Ordover, et. al., "Equilibrium Vertical Foreclosure," 80 American Economic Review 127-143 (1990).

Hapoalim or Bank Leumi for financing and its bank controlled a conglomerate that was a leading player -- with much to lose from renewed competition -- in the market in which entry was contemplated. Due to the huge size of these banks, this is not a remote possibility.

Finally, we observe that difficulties can arise even when the relevant factors can be obtained from independent sources.[40] Suppose, for example, that an entrant can find a single source that is not controlled or influenced by the bank or its conglomerate(s). The entrant could not expect to be treated well by this independent source, for the independent firm would realize the predicament that the entrant is in and take advantage of the situation. Thus, entry can be made more difficult even when the banks and conglomerates have less than complete control over the factors necessary for successful entry.

D. Possible Efficiencies Arising from the Banks' Control of the Conglomerates

We have explained that maintaining the bank-conglomerate combinations would be likely to have detrimental effects on competition -- both directly, by reducing the vigor of competition in the markets in which the conglomerates operate, and in the long run, by reducing the prospects for entry. The question remains whether there are any countervailing benefits that might justify suffering these anticompetitive effects. We now explore the sorts of efficiencies that might arise and suggest why they are not likely to be significant relative to the costs to competition that we have identified.

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[40]For further exploration of this argument, see Thomas Krattenmaker and Steven Salop, "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price," 96 Yale Law Journal 209-293 (1986), and other writing by Salop and various co-authors in economics journals.

1. Economies of Scale and Scope

Sometimes, greater aggregations of assets are justified by economies of scale and scope. For example, the merger of two small firms might be justified because they can combine operations and thereby reduce their average costs. Similarly, combining firms that produce different products might produce some economies with regard to overhead functions.

Although it might be argued that economies of scale or scope may arise due to the banks' control of the conglomerates, this seems unlikely. First, the banks' control of the conglomerates -- and Bank Hapoalim's control of several conglomerates -- do not actually involve combined operations. Thus, the normal mechanism by which economies are achieved is inoperative. Second, given the huge size and scope of the firms involved, it does not seem very likely that much greater aggregation would be necessary.

2. Enhanced Global Standing

It has been suggested that having a strong relationship with a major bank would help a conglomerate operate internationally. It is true that having a relationship with a bank might be useful, but the ordinary way in which this is accomplished is by a conglomerate and a bank having a strong and stable lending relationship. If the existing combinations are broken up, a conglomerate would still be able to maintain a stable relationship with the bank that is its main provider of credit and financial services. A large equity stake does not seem essential in this regard.[41]

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[41]We also note that if special arrangements were needed for a particular global activity -- perhaps cooperation between Koor and Clal on some project -- a joint venture

3. Improved Corporate Governance

It might be suggested that a bank's equity stake in a conglomerate is desirable because the bank will monitor the managers of the conglomerate. A debate has been going on as to whether influence by financial institutions is desirable.[42] But that debate considers the choice between having a bank with a large equity position and having shareholders that are totally dispersed, with no major shareholder.

Our understanding is that, if the banks' blocks in the conglomerates are sold separately, the result would not be that the managers of the conglomerates would face dispersed ownership with no monitoring. As explained in Part V, the government could ensure that the blocks in the conglomerate are sold to separate buyers. (Indeed, Clal and Koor, the two largest conglomerates, already have large shareholders -- IDB and Shamrock.) Thus, even if the government were to have the blocks sold into the market, the managers of the two largest conglomerates would not be left unmonitored.

Thus, the conglomerates are in any event going to have one (or more) large shareholders that would monitor their managers. The only question is whether it is important to have a large shareholder that is a bank. There is no a priori reason to think that a bank would be generally better at monitoring.[43] Thus, considerations of corporate governance

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formed for that limited purpose would suffice. There is no need to eliminate competition generally, within the Israeli economy, to accomplish this purpose.

[42]See, e.g., Mark Roe, "A Political Theory of American Corporate Finance," 91 Colum. L. Rev. 10 (1991).

[43]In fact, we have suggested that the banks' monitoring would generally be less desirable because of the ways in which bank monitoring would be used to induce less competitive behavior.

do not provide a basis for maintaining the existing combinations.

4. Conclusions

We have discussed three possible sources of efficiencies that allegedly might arise from permitting the banks to retain their equity stakes in the conglomerates.[44] None of them seems very significant; indeed, each of them may be nonexistent.

Against these extremely limited possible benefits, we have explained that the costs in terms of reduced competition in a range of markets, as well as reduced entry in the long run, are substantial. Thus, our conclusion is that, overall, maintaining the existing combinations would be harmful to the nonfinancial sector.

[44]We have also examined whether there are other potential sources of efficiencies; we have not identified any other efficiencies that appear to be significant.