

Chapter 5

Institutional Investors

Institutional investors' share of the public's asset portfolio amounted to 36 percent at the end of 2002, much the same as that at the end of 2001. A decrease in the proportion of provident funds, advanced study funds and mutual funds was offset by an increase in the proportion of life insurance plans and new pension funds. However, the proportion of institutional saving in the public's asset portfolio was lower than at the end of the 1980s, when it exceeded 50 percent.

The public chose to withdraw money from the provident funds, the advanced study funds and the mutual funds in 2002. The continued withdrawal of money from the provident funds is attributed to the fall in prices in most forms of investment and especially in the equity market, which adversely affected the provident funds' yields. The withdrawals from the advanced study funds and the mutual funds during the year marked a change in trend compared with previous yields, and resulted from the negative real yield that the funds achieved in 2002 compared with a positive real yield in previous years.

During the first half of 2002, institutional investors channeled their funds into CPI-indexed and foreign currency indexed holdings, mainly at the expense of their investments in shares and unindexed holdings, emulating the trend apparent in the public's financial asset portfolio. This change resulted from the matching of financial asset holdings to developments in actual and expected inflation. During the second half of the year, this trend became less noticeable due to the decline in inflation expectations and to the stability in the markets. Institutional investors increased their unindexed holdings to some extent, at the expense of their investments in CPI-indexed holdings.

Until 2002, the overseas investments of the provident funds, pension funds and life insurance plans were restricted to 5 percent of their total assets. This limitation was raised to 20 percent at the beginning of the year, and was abolished completely on January 1, 2003.

1. THE MUTUAL FUNDS

a. The development of assets

The balance of the mutual funds' assets fell by NIS 17.2 billion to NIS 45.8 billion in 2002, following a growth in the funds' asset balance during the previous five years. The decrease in the funds' total assets resulted from net redemptions of NIS 14.9 billion, which were centered among the funds specializing in investment in unindexed shekel assets, and from the negative half a percent nominal yield on the funds' total assets.

Table 5.1
Institutional Investors: Main Developments, 2001–2002

	(NIS billion, current prices)							
	2001				2002			
	Balance	% of asset portfolio ^a	Net accrual	Real yield %	Balance	% of asset portfolio	Net accrual	Real yield %
Mutual funds	63.0	5.3	15.4	5.3	45.8	3.8	-14.9	-0.5
Provident and severance pay funds	123.8	10.3	-4.2	6.4	119.8	9.9	-3.2	-6.9
Advanced study funds	48.0	4.0	2.5	6.9	47.0	3.9	-0.8	-6.4
Pension funds, established	109.4	9.1	-2.9		119.7	9.9	-3.2	
Pension funds, new	10.7	0.9	2.6		14.4	1.2	3.1	
Life insurance plans								
Guaranteed yield	41.5	3.5			44.6	3.7		
Profit sharing	37.4	3.1			41.3	3.4		
Total	433.8	36.2	13.4		432.6	35.6	-19.1	

SOURCE: Monetary Department, Bank of Israel.

The mutual funds' asset levels fluctuated sharply in the course of the year. During January and February, the funds — mainly those specializing in investment in bonds and foreign currency — recorded a positive accrual of NIS 15 billion. During the remaining months of the year, most of the specialization groups recorded redemptions. The volume of redemptions rose continually from March until June, when they peaked at NIS 7.2 billion (Figure 5.1). The trend of net redemptions continued during the second half of the year and encompassed nearly all the funds, although redemptions fell continually to NIS 500 million in November. The trend of net redemptions characteristic of the second half of the year continued in December, except at the funds specializing in unindexed shekel assets. These funds recorded a positive accrual of NIS 2 billion, reflecting the public's desire to invest in tax-exempt assets (see the discussion below).

Despite the redemptions recorded during 2002 and especially the redemptions at the shekel funds, the number of mutual funds increased to 584 compared with 526 in 2001 and 450 in 2000. The increase in the number of funds was recorded among those specializing in shekel assets and investments abroad, matching the trend of recent years. The number of funds specializing in investments abroad increased by 26, conforming to the NIS 2.7 billion positive accrual in their assets. The number of shekel

funds increased by 25, which did not conform to the trend of redemptions among these funds and was influenced by the tax reform that was due to go into effect in January 2003. In the course of the year, a number of funds were established that presented a policy of investing in tax-exempt assets, which include unindexed shekel bonds that were issued before the determinant date for the tax reform, May 2000, and series of Treasury bills that are exempt from tax until the end of 2003.

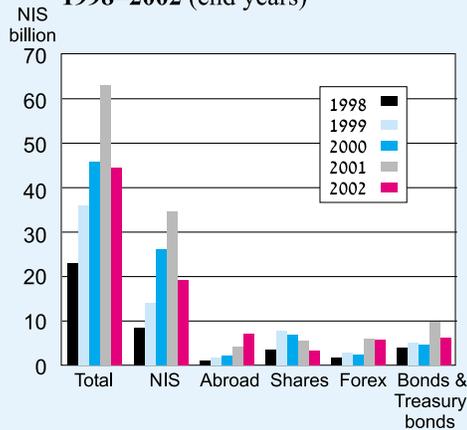
The concentration index — the normalized HHI index¹ — of the mutual fund industry remained at a high level during 2002, after rising considerably between 2000 and 2001 (Figure 5.2). The three largest banking groups, which manage the majority of mutual fund assets, held 78 percent of total mutual fund assets in 2002 compared with an average of 74 percent in 2000. Concurrent with this increase, the proportion of mutual funds managed by private companies fell to an average of 11 percent in 2002 compared with an average of 16 percent in 2000, while the proportion of mutual funds managed by the small banks remained unchanged for the third consecutive year. These developments indicate that the large accrual since 2000 was mainly recorded at the funds managed by the three largest banks, and that the withdrawals of money during 2002 were distributed in a roughly equal manner among all the different funds.

(1) Funds specializing in investment in shekel assets

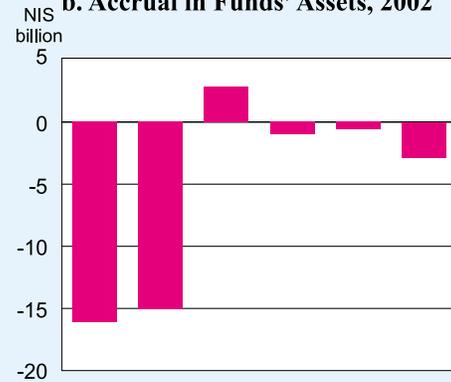
Mutual funds specializing in investment in unindexed shekel assets account for a large part of the mutual fund industry. These funds' asset balance at the beginning of 2002 reached NIS 34.5 billion, 55 percent of total mutual fund assets. In 2002, as inflation expectations rose together with the level of uncertainty in the economy, the accrual

¹ The Herfindahl-Hirschman index, which measures the degree of concentration, is calculated by adding the square of each group's participation rate in the mutual fund market, and is normalized relative to the concentration index that represents uniform distribution. A rise in the index implies a growth in concentration in the mutual fund industry.

Figure 5.1
Mutual Funds
a. Balance of Assets in Mutual Funds,
by Declared Specialization Bases,
1998–2002 (end years)



b. Accrual in Funds' Assets, 2002



SOURCE: Based on data from the Monetary Department, Bank of Israel.

trend typical of these funds during recent years changed completely, and the funds recorded net redemptions of NIS 13 billion during the whole of 2002 (Figure 5.1). The first signs of an end to the previous years' positive trend emerged in December 2001 and January 2002, when a small overall positive accrual of NIS 270 million was recorded. The redemption trend began in February 2002 due to fears of higher inflation and peaked at NIS 3.6 billion in June. This trend resulted from the rise in the inflation rate and the increased expectations of a rise in the Bank of Israel's interest rate, leading to negative yields on holdings of unindexed shekel assets. As a result, investment in these assets, which had

been favored during previous years, was no longer attractive. Due to the successive increases in the monetary interest rate, which stemmed the upsurge in inflation that occurred in the first half of the year, the pace of redemptions fell off from July and declined to NIS 700 million in October. During the last two months of the year and especially in December, a positive accrual was recorded due to the public's preference for investment in tax-exempt assets,² and to assessments that the Bank of Israel would begin to reduce the monetary interest rate during the subsequent months. This restored the attractiveness of investment in unindexed shekel assets.

(2) Funds specializing in investment in bonds

The asset balance of mutual funds specializing in investment in corporate and government bonds and in government bonds alone reached NIS 9.7 billion at the beginning of 2002 and accounted for 15 percent of total mutual fund assets. Major changes occurred in these funds' asset balance during the year. During January and February, a large positive accrual of NIS 11.5 billion was recorded, as the public adjusted the composition of their asset portfolio in response to the large cut in the monetary interest rate at the end of 2001, which greatly reduced the earnings on deposits at banks. But from March and until June, the continued rise in inflation expectations and the further deterioration in the state of the economy led to a fall in yields on CPI-indexed and unindexed bonds. These developments spurred a trend of redemptions at

Figure 5.2
Normalized HHI Index of
Concentration in Mutual Fund
Industry, 2000–2002



SOURCE: Based on data from the Monetary Department, Bank of Israel.

² Tax-exempt assets include unindexed shekel bonds that were issued before the determinant date for the tax reform, May 2000, and series of Treasury bills that are exempt from tax until the end of 2003.

the bond specialization funds, which more than offset the positive accrual that was recorded at the beginning of the year. The redemption trend continued during the second half of the year, albeit to a lesser extent, and the funds' asset balance at the end of 2002 reached NIS 5.5 billion.

During January and February, funds investing in corporate and government bonds, and in government bonds alone held 23 percent and 50 percent respectively of their total assets in CPI-indexed assets. In March, these funds increased their holdings in CPI-indexed assets to 35 percent and 54 percent respectively, at the expense of unindexed shekel assets. The increased proportion of CPI-indexed holdings in the funds' assets reduced their exposure to the inflation rate, in which the element of uncertainty had increased, and thereby slightly reduced the level of risk in their asset portfolio. The funds' holdings of CPI-assets were reduced to some extent in November and December due to forecasts of low and even negative price indexes, which reduced the attractiveness of investment in CPI-indexed assets.

(3) Other funds

A positive accrual was recorded among funds specializing in investment in foreign currency during December 2001 and the first four months of 2002. In April, these funds' asset balance reached NIS 8.2 billion. Net redemptions were recorded among the funds in June and July, when their asset balance fell to NIS 6 billion and remained around this level during the second half of the year.

Funds specializing in investment in foreign securities recorded a positive accrual for the fifth consecutive year, during which time this accrual increased. These funds' asset balance reached NIS 7.2 billion at the end of 2002, compared with NIS 1.7 billion at the end of 1999. The growth in the asset volume of mutual funds specializing in foreign assets constitutes part of the gradual change in the public's financial asset portfolio, which was made possible as a result of the liberalization of the foreign currency market in Israel. An examination of the composition of the assets of these funds shows that the proportion of shares traded abroad fell to an average of 20 percent of total assets in 2002, compared with an average of 56 percent in 2001 and 2000. Concurrent with this decrease, the proportion of bonds traded abroad increased and reached an average of 53 percent of total assets in 2002, compared with 12 percent in 2001 and 4 percent in 2000. This development conformed to the increased attractiveness of bond holdings during 2002 that resulted from the large drop in share prices concurrent with the reduction in the interest rate, which raised the yields on bond holdings.

Among the funds specializing in investment in shares traded on the Tel Aviv Stock Exchange, the trend of net redemptions typical of recent years continued in 2002 and intensified, reaching NIS 1.1 billion compared with redemptions of NIS 270 million in 2001 (Figure 5.1). These funds' asset balance at the end of 2002 reached NIS 2.8 billion compared with NIS 7.6 billion at the end of 1999, when the balance reached its highest level of recent years.

b. Yield developments

The mutual funds yielded a negative real return of 6.5 percent in 2002, compared with a positive real return of 3.8 percent in 2001 and 4.4 percent in 2000. A negative yield was recorded among funds investing in bonds of different types and in particular, among funds investing in shares. However, a positive real return was recorded in funds that invest in foreign currency and foreign securities, a trend that matched the development of the shekel-dollar exchange rate and the inflation rate (Table 5.2).

When examining the yields of the mutual funds by specialization types, the usual practice is to compare their yields to the return on the indexes of the relevant assets — shares, bonds and the exchange rate. This makes it possible to examine the advantage deriving from the professional competence with which the investment portfolio is managed. It might be expected that the annual real yield of the mutual funds, in all areas of specialization and inclusive of portfolio management fees, will be higher than the yield on the relevant index or at least identical to it in every specialization group.

When examining the real yield of all mutual funds specializing in investment in shares, bonds and unindexed bonds, it can be seen from Table 5.2 that their yield was lower than the yield on the relevant index during each of the past three years.

Table 5.2
Comparison of Real Yields in Specialized Mutual Funds
and Market Yields,^a 2000–2002

	2000	2001	2002
Annual yields in specialized mutual funds			
Shekel	9.7	6.3	-5.2
Bonds	1.4	4.6	-7.5
Government bonds	3.6	9.7	-7.8
Foreign currency	0.9	10.9	1.9
Shares in Israel	-16.0	-13.4	-32.3
Annual market yields			
Treasury bonds and unindexed bonds	11.0	7.6	-4.4
Government and corporate bonds	4.5	11.6	-5.9
Dollar exchange rate incl. interest	3.4	11.9	2.6
Share-Price Index	0.5	-8.2	-24.9
Difference between yields in funds and market yields			
Shekel	-1.3	-1.3	-0.8
Bonds	-3.1	-7.0	-1.5
Government bonds	-0.9	-1.9	-1.8
Foreign currency	-2.5	-1.0	-0.7
Shares in Israel	-16.5	-5.2	-7.4

^a For the calculation of market yield for each specialization, see note 3 in text.

SOURCE: Based on data from TASE and Monetary Department, Bank of Israel.

The difference between the yield of the different funds and their market yield,³ except for funds specializing in shares, ranged between minus 0.7 and minus 1.8 percentage points, similar to the negative differences recorded in 2001 and 2000. The implied volatility of the mutual funds' monthly real yields, a measurement of the investment risk, was similar to that of the index yields, which indicates that the fund managers built an investment portfolio with risk criteria similar to the relevant index. A comparison of the Sharp indexes⁴ between the yields of the different types of funds and the yields of the relevant market indexes therefore shows a similar pattern — negative differences reflecting mutual fund yields that are lower than the yields on the relevant market indexes.

The negative differences among funds specializing in shares traded on the Tel Aviv Stock Exchange were relatively large during each of the last three years, and in 2002 the difference was negative to the extent of 7.4 percentage points. A comparison of the yield of mutual funds specializing in investment in shares with the yield of the Maof (Tel Aviv 25) index rather than the General Share Index reveals a smaller negative difference, which is similar to the differences among other specialization groups. This shows that most of these funds' investments tend to consist of shares that are included in the Maof index in preference to other shares, a common phenomenon during a period of falling prices.

These negative differences, which were found at all the specialization groups and in each of the last three years, indicate that investment in financial assets via the mutual funds is preferable to direct investment in financial assets. It should be realized however that the advantage for the 'small investor' in investing in financial assets via the mutual funds derives from the funds' ability to manage a diversified portfolio while exploiting clear economies of scale. This is because such investors' ability to manage independently a diversified portfolio yielding a return similar to that of the relevant index, is limited. The small investor's limitation in this respect, which is common in developed countries as well, has created a demand for mutual funds that are committed to emulating the yield on the market indexes. These funds, which are called index funds, manage their assets without any investment management related considerations, enabling investors to achieve a return similar to that on the relevant index in return for minimal management fees.

³ The market yield for each type of fund is calculated in the following manner:

- a. Shekel funds — the average yields of the index of Treasury bill series and the index of unindexed bonds as published by the stock exchange, less the inflation rate.
- b. Funds specializing in bonds and government bonds — the yield of the general bond index as published by the stock exchange, less the inflation rate.
- c. Funds specializing in foreign currency — the change in the dollar exchange rate plus the average dollar interest rate, less the inflation rate.
- d. Funds specializing in shares in Israel — the yield of the general share index as published by the stock exchange, less the inflation rate.

⁴ The Sharp index represents the asset portfolio's yield in excess of the yield of a risk-free asset — in this case Treasury bills — per single unit of risk.

c. Distribution of the mutual funds' asset portfolio

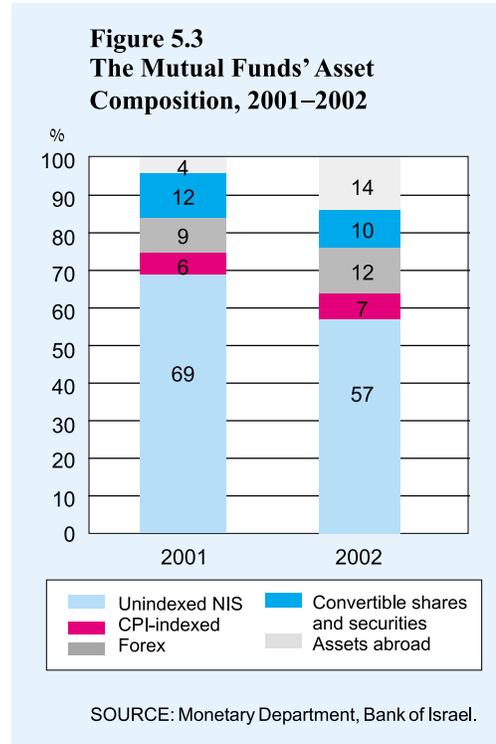
The proportion of unindexed shekel assets in the mutual funds' asset portfolio decreased in 2002, after the proportion of these assets had increased during the previous years. The proportion of share assets also fell, concurrent with an increase in the proportion of assets indexed to the consumer price index and to foreign currency as well as foreign securities (Figure 5.3).

The proportion of unindexed shekel assets fell from 69 percent of the funds' asset portfolio in December 2001 to 60 percent in December 2002. Among the unindexed shekel components of the portfolio, the proportion of floating-rate Gilon bonds increased during 2002. Since these are unindexed bonds with the features of CPI-indexed bonds, they reduced the portfolios' exposure to inflation risk. The change in the composition of the mutual funds shekel assets is attributed to the high level of inflation risk prevailing throughout 2002.

The proportion of shares in the portfolio continued to decline, from a level of 12 percent in December 2001 to 8.5 percent in 2002. The decrease resulted from the fall in share prices in Israel and abroad.

The proportion of CPI-indexed assets in the portfolio fluctuated sharply during 2002. This proportion rose from January to June and reached a level of over 10 percent of the portfolio, then fell again during the second half of the year to 6 percent, the level prevailing at the end of 2001. However, the proportion of foreign currency indexed assets increased throughout the year, and reached a level of 13.3 percent of the funds' total assets in October 2002. During November and December, the proportion of foreign currency indexed assets in the funds' portfolio fell slightly, to 12 percent, as a modicum of stability was restored to the foreign currency market.

The most significant development in 2002 was the growth in the proportion of assets that are traded abroad, which rose throughout the year and reached a level of 14.3 percent of the funds' total assets compared with 4.2 percent at the end of 2001. Together with the growth in foreign currency indexed assets, this increase pushed up the proportion of foreign currency denominated and linked assets in the portfolio to 26.5 percent, the highest level since the beginning of the 1990s.



d. Developments in the mutual fund industry

On July 24, 2002, the Knesset passed the Amendment to the Income Tax Ordinance as recommended by the Rabinowitz Committee. The Amendment contains regulations concerning the taxation of the provident funds that went into effect on January 1, 2003. Under the Committee's recommendations, the mutual fund industry will be split into three types of funds: exempt funds, liable funds and mixed funds.

An 'exempt mutual fund' will be exempt from the payment of tax on all types of income. When participation units in the fund are sold, tax at the rate of 25 percent will be deducted at source from investors on the real capital gains obtained from the investment. This rate of tax is higher than that on most other forms of investment. The principal investors in funds of this type will be companies and institutions that engage in offset activity with the tax authorities on a permanent basis. These investors, who pay a high rate of tax as stated, will prefer to obtain an exemption from deduction of this tax at source and enjoy the option to offset profits against capital losses.

A 'liable mutual fund' will have to pay tax on all of its income from interest, capital gains and dividend.⁵ Investors will therefore be exempt from the payment of tax when redeeming units, and will also be exempt from tax on earnings that the fund distributes. Owners of fund units will not be entitled to any rebate from the tax that the fund pays in respect of a loss from other forms of investment. This option will be used by private investors who wish to avoid contact with the authorities, and by customers who do not invest in other types of securities, since they will be unable to offset losses between different forms of investment.

A 'mixed mutual fund' is intended to solve the two main problems existing with the first two options — the high rate of tax at an exempt fund and the problem of offsetting losses at a liable fund. A mixed mutual fund will pay tax only on earnings from foreign securities and from dividend obtained from Israeli companies. But when redeeming participation units, the owner of the unit will pay real capital gains tax of 15 percent, similar to the tax on capital gains from other securities. Concurrently, the fund will pay the taxes at rates exceeding 15 percent. The fund will pay 12 percent tax on dividend and 24 percent tax on real capital gains from foreign securities —an additional rate of tax that comes as an adjunct to the usual tax stipulations. The rate of tax that the fund and the unit's owner pay will therefore be identical to the rate of tax that would have applied in the case of a direct investment. A mixed mutual fund will be patronized by sophisticated investors who wish to offset losses between all the securities in which they invest. An annual report on this type of activity has to be submitted to the income tax authorities.

⁵ Tax on income from interest and capital gains is paid at the rate of 15 percent of the interest and real capital gains, or 10 percent of the interest and the nominal capital gains; income from the dividend of an Israeli company will be taxed at the rate of 25 percent; capital gains from foreign securities will be taxed at the rate of 35 percent.

2. THE PROVIDENT AND SEVERANCE PAY FUNDS (PROVIDENT FUNDS) AND THE ADVANCED STUDY FUNDS

a. Asset developments

Net withdrawals of money from the provident funds were maintained at a large scale during 2002, a trend that began in 1994. The continued trend of withdrawals is attributed *inter alia* to the provident funds' increased yield volatility, which was accentuated in 2002 by the downturn in prices among most forms of investment and especially in the equity market. As a result of the downturn in prices, the public became more aware of the level of risk inherent in the funds (as detailed in the Monetary Department's Annual Report for 2001), which was reflected by the negative accrual in the funds. This was despite the funds' marketing efforts, prompted by the tax reform, to persuade the public to deposit money in them at amounts that would be exempt from tax before the determinant date went into effect.

Despite the persistent withdrawals from the provident funds, their asset balance is still high and the funds are among the most dominant investors in the capital market. The provident funds' dominant position is apparent from their share of the CPI-indexed government bond market, which amounted to 47 percent in 2002, and their stock of equities, which amounted to 9 percent.

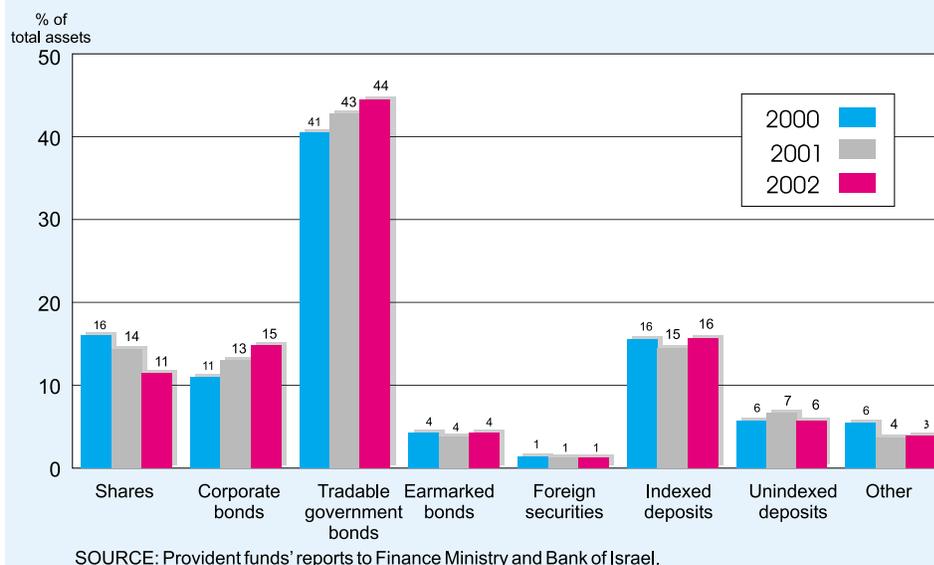
The balance of the provident funds' assets totaled NIS 120 billion at the end of 2002 compared with NIS 124 billion at the end of 2001, a real decrease of 9 percent. The decrease resulted from NIS 3 billion of net withdrawals, and from the negative yields that the funds achieved. Over NIS 40 billion has been withdrawn from the provident funds since 1994. As a result, the proportion of the funds in the public's asset portfolio has decreased (Table 5.1). However, the funds still constitute an important component in long-term saving due to the tax benefits that are granted to those saving via the funds.

The real yield on the provident funds' investments in 2002 was negative (-6.9%), compared with a positive yield of 6.4 percent in 2001 (Table 5.1).

The balance of the advanced study funds' assets fell by 8 percent during 2002 and totaled NIS 47 billion at the end of the year, following the increases that were recorded in previous years (Table 5.1). This new trend resulted from net withdrawals of a billion shekels, mostly during the first half of the year. The withdrawals partly derived from redemptions from the advanced study funds for the self-employed, which were first authorized six years ago and had reached maturity. The withdrawals also resulted from the negative (-6.4 percent) real yield on the funds' assets in 2002, compared with a positive yield of 6.9 percent in 2001 (Table 5.1).

Distribution of the asset portfolio of the provident funds and the advanced study funds: The proportion of tradable government bonds, which are an important component of the funds' asset portfolio (44 percent) rose during 2002 concurrent with an increase

Figure 5.4
Distribution of the Provident Funds' Asset Portfolio, 2000–2002



in the proportion of corporate bonds (mainly non-tradable bonds) and CPI-indexed deposits, most notably at the expense of the share and unindexed deposit components of the portfolio (Figure 5.4). The decrease in the proportion of shares in the funds' asset portfolio resulted from the reduced value of shares in the market, and not from a substantial decrease in their share holdings. The increased proportion of corporate bonds and especially non-tradable corporate bonds in the funds' asset portfolio is attributed to the growth in private issues in the economy during the last two years. This growth resulted from companies' difficulty in raising bank credit, and from the banks' preference for the participation of institutional investors in project finance. The growth may also have derived from institutional investors' preference for non-tradable assets as a means of reducing the volatile component of their portfolio. The changes in the advanced study funds' asset portfolio during the year were similar to those in the provident funds' portfolio.

The development of the indexation composition of the provident funds' and advanced study funds' assets was not uniform throughout the year. During the first half of the year, the provident funds and the advanced study funds reduced the proportion of their unindexed shekel assets and increased the proportion of their CPI-indexed assets as a result of the rise in inflation expectations. When these expectations fell in the second half of the year, the funds increased their investments in unindexed assets, and reduced the proportion of their CPI-indexed assets. This development therefore partly offset the growth in the CPI-indexed component of the portfolio compared with December 2001.

b. Developments in the provident fund industry

(1) Structural developments

The provident fund industry is notable for the high concentration of the banks, which manage the majority of the funds' assets. The banks control and manage over 85 percent of all provident fund assets; the remainder are controlled and managed by other organizations, as in previous years. The high concentration and the restriction whereby members are permitted to change from fund to fund only once a year impairs the competitiveness and efficiency of the capital market. In addition, the banks' ownership of the provident funds and of the companies managing them inevitably involves potential conflicts of interest. Action must therefore be taken to gradually reduce the banks' ownership of the funds.

(2) Regulatory procedures

New investment regulations for the provident funds went into effect in October 2002. The new regulations reflect a change in concept, from a situation in which everything was prohibited except where explicitly permitted in a number of cases, to a situation in which everything is permitted except for a number of explicit restrictions. The majority of quantitative restrictions have thereby been abolished, and it is now possible to invest in all asset types subject to a number of stability-oriented restrictions (Box 5.2).

3. THE PENSION FUNDS

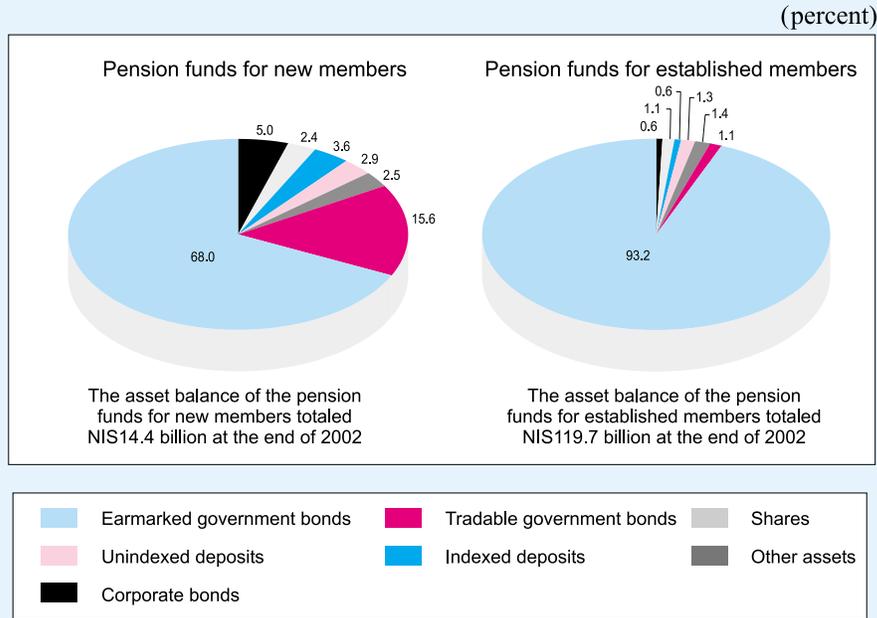
a. The pension funds for established members

The asset balance of the pension funds for established members totaled NIS 120 billion in October 2002, compared with NIS 109.4 billion at the end of 2001 (Table 5.1). The increase resulted from the guaranteed yield on earmarked bonds. Since 1995, new members have been allowed to join only the new pension funds and not the established pension funds. As a result, the provisions for the latter are gradually decreasing concurrent with a growth in the amount of remuneration paid to existing members. The closure of the established pension funds to new members led to withdrawals from these funds during recent years. A total of NIS 3 billion was withdrawn from them in 2002, similar to the level of redemptions in 2001. The pension funds for established members have actuarial deficits that were estimated at NIS 60 million⁶ at the end of 2001. The partial reform in the pension industry failed to deal with this major problem.

Under the Amendment to the Income Tax Ordinance (Regulations for the Approval and Management of Provident Funds), since October 2002 the pension funds for established members have had to invest at least 93 percent of their assets in Meiron

⁶ SOURCE: The Annual Report for 2001 of the Commissioner of the Capital Market, Insurance and Savings.

Figure 5.5
Distribution of Pension Funds' Assets, 2002



SOURCE: Based on funds' reports to Capital Market Section, Ministry of Finance.

earmarked bonds, which provide an effective annual interest rate of 5.57 percent. Under the old regulations, the funds were required to invest at least 93 percent of their assets in earmarked bonds, tradable government bonds, Gmul shares and land purchased before 1957. The change in the regulations restricted the funds' investment flexibility in tradable bonds. As in the past, the pension funds hardly invest at all in assets traded in the capital market, and the majority of their investments are in non-tradable assets.

In 2002, when the yields on tradable CPI-indexed government bonds rose to a level higher than the guaranteed yield on Meiron earmarked bonds (Table 5.3), the pension funds reduced their investment in earmarked bonds. From September, the average yield

Table 5.3
Difference Between Yields on Meiron Earmarked Bonds and Long-Term Indexed Galil Bonds, 1999–2002

	1999	2000	2001	2002	
				Jan-Aug	Sep-Dec
Average yield on Galil	5.1	5.4	4.8	5.0	5.7
Effective yield on Meiron	5.57	5.57	5.57	5.57	5.57
Difference	0.5	0.2	0.8	0.6	-0.1

SOURCE: Monetary Department, Bank of Israel.

on long-term CPI-indexed tradable bonds was higher than the effective interest rate paid on Meiron earmarked bonds. As a result, from the beginning of October 2002 the established pension funds greatly reduced their purchases of Meiron earmarked bonds. These purchases fell to an average of NIS 200 million during the last quarter of the year, compared with an average of NIS 700 million during the first nine months of 2002. The proportion of earmarked bonds to the funds' total assets amounted to 95 percent in 2001 and until August 2002, similar to that in previous years, and from October fell to 93 percent (Figure 5.5). Since they are required to invest at least some 93 percent of their assets in earmarked bonds as stated, the funds are restricted in the extent to which they can diversify their investments.

b. The pension funds for new members

The pension funds for new members began to operate in January 1995. These funds focus on attracting new members, mainly young people who have just started to save for a pension. This is leading to a gradual increase in the funds' income from management fees, while their expenditures on pension payments are still low. The asset balance of the pension funds for new members totaled NIS 14 billion in October 2002 compared with NIS 11 billion in December 2001, a real increase of over 20 percent and the net accrual in them amounted to NIS 3.1 billion, compared with NIS 2.6 billion in 2001 (Table 5.1).

Since 1995, when the government decided to close the established funds to new members, the proportion of funds for new members has increased in the public's asset portfolio, mainly due to the participation of new members in these funds (Table 5.1).

The funds are close to exhausting the entire investment potential permitted to them in Arad earmarked bonds that bear an effective real annual interest rate of 5.05 percent. Under the Amendment to the Income Tax Ordinance (Regulations for the Approval and Management of Provident Funds), since October 2002 the new pension funds have had to invest 70 percent of the value of their revaluated assets in earmarked bonds. (Under the old regulations, these funds were required to invest 70 percent of their net accrual in Arad bonds.) When the old regulations were in force, the funds for new members held 66 percent of their assets in earmarked bonds. In the course of the year, the earmarked bond component in these funds' asset portfolio gradually increased to 70 percent in October. As for the rest of the portfolio, 15 percent of the funds' assets were invested in tradable government bonds, and the remainder were invested in other assets (Figure 5.5). Following the reform in the pension industry, issues of earmarked bonds to the new pension funds increased from NIS 87 million in 1995 to NIS 2 billion in 2002.

The establishment of general new pension funds was approved in 1999. Since the general funds are not entitled to earmarked bonds, the level of salary that can be assured in them is restricted. These funds are intended for those wishing to pay into a pension fund, amounts that exceed the permitted ceiling for payments to a new pension fund

(up to twice the average wage in the economy). One-time provisions can also be made to such a fund, a facility that is not possible with pension funds that are entitled to earmarked bonds. The asset balance of these funds totaled NIS 100 million at the end of 2002. Half of this amount is invested in government bonds and Treasury bills.

c. Structural developments

Eighteen pension funds for established members, 20 new pension funds and 3 general new funds operated at the end of 2002, compared with 18 established funds and 17 new funds in 1999. Despite the pension arrangement that began in 1995 and led to the opening up of the pension fund industry to competition, concentration in the industry is still high. Over 90 percent of the funds' total assets are still managed by the Histadrut, and most of the new funds are managed by the same organizations that manage the established funds.

The Herfindahl-Hirschman concentration index⁷ of the new pension funds has remained at the high level of 0.3 since 1999, and reflects the high concentration in the pension fund market in Israel compared with other countries (0.03 in the UK and the USA). The main reason for the high concentration in the industry is the trade unions' control of the funds, the lack of freedom of choice, and the limited opportunity for moving from fund to fund. Action must be taken to gradually reduce the concentration in the industry.

(1) Regulatory procedures

See Box 5.2 for details of the new investment regulations since 2002.

In March 1999, a special collective agreement was signed between the employers in the civil service and the Histadrut labor federation concerning civil servants' move from a budgetary pension to an accrual pension. Under this agreement, new employees in the civil service will be unable to join budgetary pension arrangements and will be insured in an accrual pension fund. Veteran employees will continue to be insured in the budgetary pension as previously, for a component amounting to 60 percent of salary. The recognized salary base for pension purposes was increased from 60 percent to 80 percent. This will also apply to veteran employees who benefit from the budgetary pension, with the result that the additional provisions will be made to the new pension funds. In February 2002, the Civil Service Pension Law was amended with respect to the move to an accrual pension. Under the Amendment, the Finance Minister stipulated that with effect from April 2002, new employees in the civil service will accrue their pension rights in accrual pension funds. Employees' move to an accrual pension will lead to increased saving in the economy and the accrual of employee and employer provisions in the pension funds as compared with the previous situation, in which no

⁷ The index is calculated as the sum of the squares of the quotients obtained from dividing the amount of assets held by each entity by the total assets in the industry.

provisions were made for pension. The amount of provisions is estimated at tens of millions of shekels a year, and this amount will increase as the number of employees paying into the accrual funds grows. The move to an accrual pension will impose an additional budgetary burden on the government, due to the need to make provisions for pension rights on an ongoing basis, as well as pension payments for workers who have retired and who are benefiting from a budgetary pension. The government will have to increase its issues in the bond market in order to finance the additional provisions.

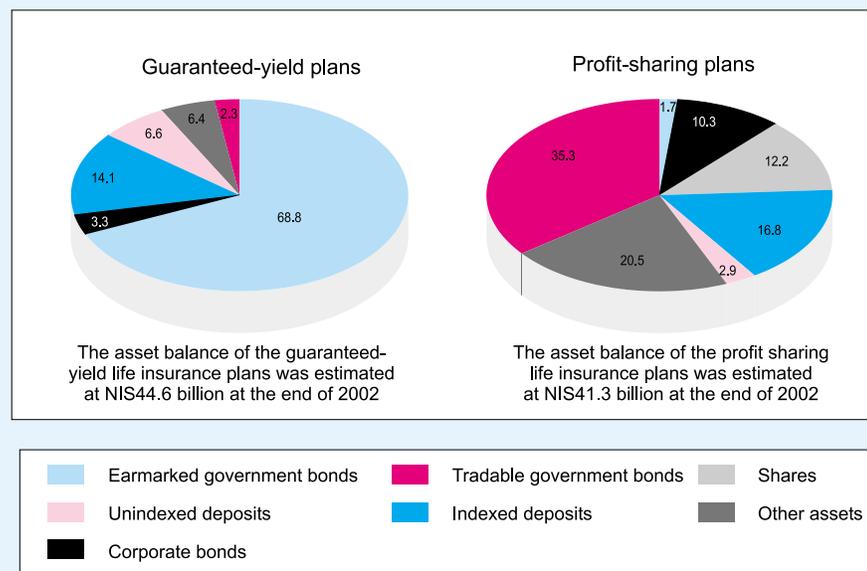
4. THE LIFE INSURANCE PLANS

a. The guaranteed-yield life insurance plans

The asset balance of the ‘guaranteed-yield’ life-insurance plans was estimated at NIS 45 billion at the end of 2002, a real increase of one percent compared with the end of 2001 (Table 5.1).

Plans of this type are entitled to issues of earmarked bonds that bear a CPI-indexed rate of interest of between 4 percent and 6.2 percent on 86 percent of the money accrued in them. Accordingly, the majority of the assets are invested in earmarked bonds, and only the remaining assets are placed in other forms of investment (Figure 5.6).

Figure 5.6
Distribution of the Life Insurance Plans’ Assets, 2002



SOURCE: Capital Market, Insurance, and savings section, Ministry of Finance.

The size of the government's tenders for the early redemption of earmarked bonds held by these insurance plans decreased in 2002. As a result, bonds were redeemed at the low amount of NIS 0.6 billion, compared with NIS 0.8 billion in 2000, and at a cumulative amount of NIS 2.9 billion during the years 1999–2000. The tenders for the early redemption of earmarked bonds are helping the insurance companies to reduce the proportion of non-tradable bonds in their portfolio and move to tradable investments, thereby increasing the sophistication of the local capital market. It is therefore important to increase the amount of these tenders as part of the desirable measure of rolling-over the debt (see Box 5.1 in the Monetary Department's Annual Report for 2001).

b. The profit-sharing life-insurance plans

The proportion of 'profit-sharing' life insurance plans is gradually increasing, both in the public's asset portfolio and among total life insurance plans (Table 5.1).

The asset balance of profit-sharing life insurance plans was estimated at NIS 41 billion in December 2002, a real increase of 4 percent compared with the end of 2001. The proportion to total assets of corporate bonds and foreign securities increased in 2002, at the expense of the proportions of shares and mutual funds.

The decrease in the proportion of shares in the funds' asset portfolio mainly derived from the decrease in their market value. The higher proportion of corporate bonds, principally non-tradable bonds, in these life insurance plans' asset portfolio is attributed to the increased issues of corporate bonds during the last two years. The increased issues resulted from the new investment regulations that went into effect in April 2001, which abolished most of the insurance company's investment quotas in specific assets, and permitted the companies to invest in any asset with the exception of a number of stability-oriented restrictions. Another factor contributing to the growth in corporate bond issues was the difficulty in raising bank credit, concurrent with the preference for the participation of institutional investors in project finance. The growth may also have derived from institutional investors' preference for non-tradable assets as a means of reducing yield volatility.

Since profit-sharing life insurance plans are not entitled to invest in earmarked bonds, most of the accrual in them is invested in the tradable capital market (Figure 5.6). This situation is reflected by their relatively large share of the securities markets—government bonds, corporate bonds, shares and investments abroad—compared with the guaranteed-yield plans.

However, their proportion in the equity market is still relatively low at 3 percent. Since 2001, the profit-sharing life insurance plans have been permitted to invest abroad. During 2002, the plans increased their investments abroad by 90 percent. In the first half of the year, due to the depreciation of the shekel, their investments abroad exceeded NIS 3 billion. But from July onwards, a result of the appreciation of the shekel at the time and the growth in the interest rate gap between Israel and abroad, their investments abroad fell to NIS 2.8 billion.

Box 5.2**The New Investment Regulations for Institutional Investors**

The investment regulations applying to the insurance companies, the provident funds and the pension funds have been changed during the last two years. The change in the investment regulations reflects a new concept whereby any investment is permitted except for investments that are expressly prohibited. (This compares with the original concept whereby everything was prohibited, except for what was expressly permitted.) In addition, quantitative restrictions on investments were lifted and stability-oriented restrictions were determined. The changes reflect a move from direct and individual supervision to indirect supervision. Most of the responsibility for investment decision-making and investment portfolio management was placed in the hands of the institutional investors, with a minimal amount of government involvement. However, the investment regulations governing the pension funds as a result *inter alia* of collective work agreements, still require the funds to invest the majority of the savings accrued in them in earmarked government bonds, an arrangement that impairs the functioning and efficiency of the local capital market (see Box 5.1 in the Monetary Department's Annual Report for 2001).

The main changes in the investment regulations that recently went into effect are as follows:

Insurance companies: Under the Insurance Transaction Supervision Regulations (Methods of Investment of the Insurer's Capital and Funds and Management of his Liabilities) concerning the insurance companies' investments, which went into effect in April 2001, insurers are permitted to invest in any assets except for a number of stability oriented restrictions. This compares with the old regulations that imposed quantitative investment restrictions on specific assets.

In November 2002, new investment regulations were published that increased the insurance companies' opportunities for extending loans against the profit-sharing portfolio. Before the amendment to the regulations, an insurance company was permitted to extend loans to a single borrower against its shareholders' equity and/or against profit-sharing life insurance liabilities up to a level of 15 percent of shareholders' equity, and to borrower groups up to a level of 30 percent of shareholders' equity. The regulations were changed in a manner whereby the shareholders' equity restriction will apply only to nostro transactions¹ while in the case of loans against the profit-sharing portfolio, a restriction up to a certain ratio of this portfolio will apply — up to 10 percent if the loan is given a rating of at least AA and at a lower percentage, the lower the borrower's rating.

¹ The insurance company's account.

Provident funds: An amendment to the Income Tax Ordinance (Regulations for Approving and Managing Provident Funds) went into effect in October 2002. The amendment permits the provident funds to invest in any asset subject to a number of restrictions aimed at maintaining stability and at governing the control of corporations. Under the new regulations, investment decision-making and asset and liability management is placed in the hands of the funds, with a minimum level of government intervention. Most of the restrictions on the funds' investment quotas have thereby been lifted, except for the restrictions concerning the manner in which investments are managed and the competence required of those involved in investment decision-making processes. In addition, the range of investment opportunities in tradable and non-tradable derivative assets has been increased, subject to stability-oriented restrictions, and the funds have been permitted to engage in the short sale of securities.

Under the Income Tax Ordinance (Regulations for Approving and Managing Provident Funds), 1964, which stipulated the types of assets and the ratios of these assets that the provident funds were permitted to hold, the opportunities for investing in derivative assets were very limited. This conformed to the concept whereby everything was prohibited except for what was expressly permitted.

Pension funds: Under the Amendment to the Income Tax Ordinance, since October 2002 established pension funds have been required to invest at least 93 percent of the revaluated value of their assets in earmarked bonds, in a deposit with the Accountant-General and in cash. The funds are entitled to invest the balance of their assets in Israel in accordance with the investment regulations governing the provident funds, subject to a proviso regarding risk dispersal.

Under the new regulations, new pension funds are required to invest 70 percent of the revaluated value of their assets in earmarked bonds, and the balance in accordance with the investment regulations governing the provident funds. Although a new fund is entitled to a permit for investing less than 70 percent of its assets in earmarked bonds, once it falls below this holding ratio, it cannot increase the ratio again. As a result of this restriction, the new pension funds in Israel invest the majority of the savings accrued in them in earmarked bonds, which bear a fixed real interest rate unrelated to market yields.

Under the previous income tax regulations of 1964, the established pension funds were required to invest 93 percent of their assets in earmarked bonds, tradable government bonds, Gmul shares and land that was purchased before August 29, 1957. With respect to the remainder, restrictions have been defined on investment types and the holding ratios permitted in them. New pension funds were required to invest 70 percent of their net accrual in

earmarked bonds. Permitted types of investments and holding ratios were defined for the remainder of their assets, and the new pension funds were permitted to invest only 5 percent of the balance in any other investment on the basis of their own considerations.

A general new pension fund, whose establishment was approved in 1999, is not entitled to earmarked bonds, and is subject to the investment regulations applying to the provident funds.

EVENTS IN THE CAPITAL MARKET¹ DURING 2002

January

Bank of Israel interest rate

- The interest rate was cut by 2.0% to a level of 3.8%.

Treasury bills

- The Treasury bill ceiling was removed. This makes it possible to replace the banks' non-tradable deposits at the Bank of Israel with Treasury bills that are traded in the stock market, thereby creating essential infrastructure for the development of the money market.

Institutional investors

- The permitted rate of investment abroad for institutional investors (provident funds, pension funds and life insurance plans) was raised from 5% to 20%. A decision was taken to remove this restriction at the end of the year.

The exchange rate

- The elasticity of the exchange rate was once again increased: The lower limit of the band of mobility was reduced by one percentage point, with the result that it will be fixed at NIS 4.1 in currency basket terms, and the slope of the band was changed to 0%.

The State budget

- The State budget for 2002 was updated and the deficit target was set at 3% of GDP (instead of 1.5%). A decision was taken to subsequently reduce the deficit, to 1% of GDP by 2005.

February

Bond purchase tender

- The introduction of a State tender for the sale of fixed-rate unindexed Shahar bonds, and the purchase of fixed-rate CPI-indexed Galil bonds at a given price.

March

Bank of Israel interest rate

- The interest rate was raised by 0.6% to a level of 4.4%.

¹ Unless stated otherwise, all the changes went into effect at the beginning of the liquidity month.

April

Pension funds

- The Civil Service Pension Law was amended in February 2002. The amendment related to the move from the budgetary pension to an accrual pension. Under the amendment, the Finance Minister announced that with effect from April 1, 2002, new employees in the civil service would accrue their pension rights in accrual pension funds, and not in a budgetary pension as previously.

May

Bank of Israel interest rate

- The interest rate was raised by 0.2% to a level of 4.6%.

Quota loans

- From April 29, 2002, the size of quota loans at interest rates of between 4.8% and 5.7% was increased from NIS 104 million at each quota to NIS 1,040 million.

June

Bank of Israel interest rate

- The interest rate was raised by 1.0% to a level of 5.6%.
- On June 11, 2002, the interest rate was raised again, by 1.5% to a level of 7.1%.

Quota loans

- In May, the size of quota loans was increased to NIS 1,040 million per quota. In June, the size of the loans was reduced to NIS 104 million per quota.

The State budget

- The Knesset approved an amendment to the State budget that was based on an increase in the deficit target from 3% to 4% of GDP.

July

Bank of Israel interest rate

- The interest rate was raised by 2.0% to 9.1%.

Term deposit tender

- As a result of the decrease in the overall volume of the term deposits that the Bank of Israel receives from the banking corporations, term deposit tenders for a period of a month at fixed and floating-rate interest were ceased. Term deposit tenders for a period of a week and a period of a day were retained, in accordance with current policy requirements.

The tax reform

- A bill embodying the Rabinowitz Committee's recommendations for implementing a reform in the tax system was approved. The reform, to be implemented on January 1, 2003, will lead to the imposition of tax on capital and savings, and will gradually reduce the tax burden on earned income (labor) until 2008. When the reform is implemented, earnings from the stock market and existing forms of saving will be taxed. The new tax arrangements will apply to the interest accrued from the determinant date on deposits, saving plans and tradable bonds that were deposited or issued after May 8, 2000. An international method of taxation will also be operated, whereby an Israeli resident will pay tax in Israel on income from abroad.

August

Secondary liquidity requirement on foreign currency deposits

- The secondary liquidity requirement on deposits from the public in foreign currency is 10%. At least half must be held at the Bank of Israel and the remainder can be invested abroad (via deposits at banks, governments or international bonds). The Governor of the Bank of Israel announced that from August 2002, the secondary liquidity requirement would be reduced by one percent a month until abolished. Half of the reduction in each liquidity month will be deducted from the part that is invested abroad, and other half will be deducted from the part that is invested in a deposit at the Bank of Israel. In December 2002, the secondary liquidity requirement amounted to 5%.

The stock exchange

- The stock exchange decided to permit trading in series of options and futures contracts on the shekel-dollar exchange rate with a term to maturity of up to a year. Long-term series — for the term of a year — will be opened every six months, in June and December.
- The stock exchange introduced the *Retsef Jumbo* system for conducting large transactions of over NIS 500 thousand. The system enables investors to agree among themselves the details of a transaction, the price and the quantity of securities required, and immediately thereafter to input buy and sell orders into the system. These orders can be submitted at the continuous trading stage and at the closing stage.
- The stock exchange introduced the *Retsef Karnot* system for transferring instructions for the purchase and redemption of mutual fund units via the infrastructure of the *Retsef* computerized trading system. The system enables stock exchange members to send mutual fund transaction instructions to the clearing-house in the same manner as trading orders are for transferred shares and bonds.

October

Bonds

- A new series of Galil bonds was issued for a term of 5 years.

Provident funds

- New investment regulations governing the provident funds were introduced. Most of the quantitative investment restrictions were abolished, and stability-oriented investment restrictions were determined.

November

Insurance companies

- The insurance companies' opportunities for extending loans to a single borrower or borrower group were increased, to up to 10% of an insurance company's liabilities in respect of profit-sharing plans. This is on condition that the borrower has a rating of at least AA. If the borrower's rating is lower, the size of the loan permitted will decrease proportionate to the borrower's rating.

January 2003

Bank of Israel interest rate

- The interest rate was cut by 0.2% to a level of 8.9%.

Options on the shekel-dollar exchange rate

- The Bank of Israel introduced a new series of options – put options for half a year on options that are sold in tenders: call options for half a year, and call and put options for three months.

February 2003

Treasury bill tenders

- The method of operating Treasury bill tenders was changed. The Bank of Israel will no longer publish the maximum yields determined for each tender, which are used for allocation purposes and for determining yields.