Chapter 5

Institutional Investors

The proportion of the savings that the public held in their asset portfolio by means of institutional investors[1] remained unchanged in 2004, and amounted to 37 percent at the end of the year (Table 5.1). The balance of institutional investors' assets increased during the year—in a continuation of the trend of recent years (except for 2002)—and totaled NIS 559 billion at the end of 2004 compared with NIS 505 billion at the end of 2003. The increase was recorded largely among the mutual funds and to a lesser extent, among the other institutional investors.

For the first time in a decade, the provident funds recorded a positive accrual in 2004. Three are three main reasons for this change: (1) tax considerations—earnings on old deposits in the provident funds remain exempt from tax, while alternative forms of investment are taxable; (2) the improvement in the state of the economy, as a result of which the public have less need to withdraw money for current consumption; (3) the expectation of a further improvement in the funds' performance.

The mutual funds continued to record a positive accrual, principally among the funds specializing in bond investments and those specializing in government bonds, although the amount accrued in all the mutual funds in 2004 was less than in 2003. This change was part of the adjustment of the public's asset portfolio: During a period of low interest rates on deposits at the banks, the public were inclined to seek alternative fixed-income investments. The advanced study funds and the pension funds for new members also recorded a positive accrual.

In 2004 the mutual funds directed the majority of their investments to equities and to CPI-indexed assets, most particularly at the expense of their investments in unindexed shekel assets, a development that increased the tradability of the asset portfolio. This change resulted inter alia from the low yields expected on unindexed shekel assets due to the end of the process of cuts in the Bank of Israel's interest rate and the abolition

[1] Mutual funds, provident and severance pay funds, advanced study funds, pension funds and insurance companies.

of the tax preference for certain shekel assets that was practiced until 2003 (Treasury bills and certain government bonds). In 2004 the other institutional investors[2] chose to increase their investments in corporate bonds, shares and foreign assets, mainly at the expense of their investments in shekel deposits. Behind this change was the decline in interest rates in the economy and the search for alternative forms of investment that would yield a higher return, the consolidation of inflation expectations close to the center of the price stability target, the relative stability in the exchange rate of the shekel against the dollar, the growth in private sector issues, and the upturn in prices in the equities market at the beginning and the end of the year. Also contributing to the redirection of sources from the banks to the capital market were the tax reform, the pension reform, and the banks' tighter credit extension policy that was reflected inter alia by increased investment in corporate bonds.

Savers' awareness of the superior performance of the private provident funds during recent years over that of the funds managed by the banks, was apparent in 2004 from the much more rapid transfer of money from the banks' provident funds and advanced study funds to private organizations. During 2004 the growth in the volume of assets managed by private companies encompassed the mutual funds as well. Even though the Bachar Committee's recommendations have yet to be implemented, the very fact that they have been published and the interest that the public have displayed in the matter appear to have increased savers' awareness of the relative efficiency of the private organizations.

Progress was made in a number of reforms relating to institutional investors in 2004. The most important among them is the reform of the capital market (the Bachar Committee's report), which is centered on the separation from the banks of the ownership and management of the provident funds, the mutual funds and the underwriting companies.

1. MUTUAL FUNDS

a. Main developments

The proportion to total mutual fund assets of the funds' assets managed by private companies rose from 10 percent in 2003 to 14 percent in 2004. The increase is attributed inter alia to the relatively high returns that the private funds achieved. The impact of this development grew following the publication of the Bachar Committee's recommendations and the interest that the public displayed in the matter (see section 5a).

[2] Provident and severance pay funds, advanced study funds, pension funds and the insurance companies.

Table 5.1
Institutional Investors: Main Developments, 2001–2004

(NIS billion, current prices)

	Matual funds	Provident and severance pay funds	Advanced study funds	Pension funds: Established	Pension funds: New	Life insurance schemes[a]: Guaranteed yield	Life insurance schemes[a]: Profit sharing	Total
Balance[b] (NIS billion, current prices)								
2001	63.0	123.8	48.0	109.4	10.6	40.5	33.5	430.5
2002	45.8	119.8	47.0	119.7	14.4	43.4	38.2	429.5
2003	83.2	134.7	54.7	120.6	19.0	42.6	49.8	504.6
2004	101.1	145.7	61.7	124.5	23.8	43.6	58.2	558.6
Percent of total institutional investors' savings[c]								
2001	14.7	28.8	11.1	25.4	2.5	9.4	7.8	100.0
2002	10.7	27.9	10.9	27.9	3.4	10.1	8.9	100.0
2003	16.5	26.7	10.8	23.9	3.8	8.4	9.9	100.0
2004	18.1	26.1	11.0	22.3	4.3	7.8	10.4	100.0
Percent of public's asset portfolio								
2001	5.3	10.3	4.0	9.1	0.9	3.4	2.8	35.8
2002	3.8	9.8	3.9	9.8	1.2	3.6	3.1	35.2
2003	6.1	9.9	4.0	8.8	1.4	3.1	3.6	36.9
2004	6.7	9.6	4.1	8.2	1.6	2.9	3.8	36.9
Net accrual (NIS billion, current prices)								
2001	15.4	–4.1	2.6	–2.9	2.6			13.6
2002	–14.9	–3.0	–0.7	–3.2	3.1			–18.7
2003	30.7	–2.8	0.9	–4.3	3.5			28.0
2004	13.9	1.3	2.7	–4.2	3.8			17.5
Real yield (percent)[d]								
2001	3.8	6.4	6.9					
2002	–6.6	–6.9	–6.4					
2003	15.5	19.1	17.8					
2004	4.3	8.2	7.8					

[a] The balance of assets of insurance schemes does not include fixed assets, receivables, and postponed purchase expenses.
[b] The assets of every institutional investor *minus* its investments in mutual funds.
[c] Including mutual funds and advanced study funds defined as savings with a short-to-medium-term investment horizon, provident funds, pension funds, and insurance schemes defined as institutional-contractual savings with a long-term investment horizon.
[d] The real yield of the provident and severance pay funds does not include the yield of the central severance pay funds which were 6.7 percent in 2001, –7.0 percent in 2002, 18.8 percent in 2003, and 7.7 percent in 2004.
SOURCE: Mutual funds' reports to the Bank of Israel, and the Capital Market, Insurance and Savings Division in the Ministry of Finance.

The distribution agreements that the banks and the private mutual fund management companies signed in 2004 also contributed to the transfer of money to the private funds. The growth in the proportion of the private funds' assets came at the expense of the three largest banking corporations' share in total mutual fund assets, which fell from 79 percent at the end of 2003 to 76 percent at the end of 2004. The proportion of mutual funds managed by the small banks (10 percent) remained unchanged for the second consecutive year. However, the mutual fund industry is still notable for a high degree of concentration. The three largest banking corporations, for example, run the 10 largest funds, which manage 22 percent of total mutual fund assets.

Although the concentration index—the normalized HHI index[3]—of the mutual fund industry showed a minor decrease in concentration, falling by a percentage point compared with the end of 2003 due to the increase in the private companies' share at the expense of the three largest banking corporations' share, it is still high.

b. The development of assets

The balance of the mutual funds' assets rose from NIS 83 billion at the end of 2003 to NIS 101 billion at the end of 2004—an all-time record (Table 5.1).

The growth in the mutual funds' asset balance in 2004 reflected mainly the NIS 14 billion net positive accrual (excess of deposits over withdrawals) as well as the 4.3 percent real yield recorded on the funds' assets. The net positive accrual in the funds in 2004 marked a continuation of the trend of recent years, except for 2002 when the trend reversed. The amount accrued in 2004 was less than in 2003, when a particularly large accrual was recorded,[4] but similar to that in previous years (Table 5.1).

The flow of money into the mutual funds in 2004 was not uniform. Most of the positive accrual was centered among the funds specializing in bond investment and funds specializing in government bond investment. Among the funds specializing in foreign currency investment, a negative accrual was recorded (Figure 5.1b). A small accrual compared with the previous year was recorded among the funds specializing in investment in unindexed shekel assets. Also contributing to the growth in the funds' overall asset balance was the increase in the assets of the funds specializing in equities and of the funds specializing in investments abroad. This increase mainly reflected these funds' positive accrual. Large fluctuations were apparent in the development of assets in the course of the year (Figure 5.2).

c. Development in mutual fund assets by specialization group

In 2004 the growth in the mutual funds' asset balance encompassed most specialization groups, and reflected mainly a growth in the funds' activity and partly an increase in yields.

The asset balance of the funds specializing in bond investment and of the funds specializing in government bond investment rose considerably in 2004 and reached NIS 19 billion, 18 percent of the funds' total assets (Figure 5.1a). The growth in the funds' activity, as apparent from their NIS 8.0 billion accrual—a large part of the total net accrual of the entire mutual fund industry—resulted from the public's inclination to seek alternative fixed-income investments that yielded a higher return in a period of low interest rates on deposits at the banks and low earnings on unindexed

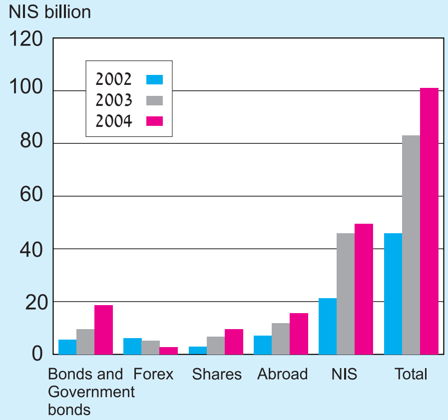
[3] The Herfindhal-Hirschman index, which measures the degree of concentration, is calculated by adding the square of each group's participation rate in the mutual fund market, and is normalized relative to the concentration index that represents uniform distribution. A rise in the index implies a growth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

[4] See the Monetary Department's Annual Report for 2003.

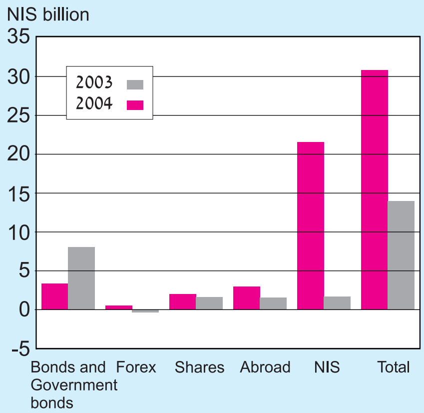
shekel investments. Apart from that, the government's reduced domestic borrowing and relatively low interest rates encouraged investors to look for investment alternatives with a higher yield than that on government bonds. Investors therefore increased their holdings of corporate bonds, the supply of which increased greatly during the year.

The asset balance of the mutual funds specializing in unindexed shekel assets, which account for the bulk of the mutual fund industry, rose slightly in 2004 and reached NIS 49.5 billion after doubling in the previous year (Figure 5.1a). An accrual of NIS 1.7 billion was recorded in these funds, following a massive accrual of NIS 21.5 billion in 2003. Due to the gradual rise in inflation expectations for a year ahead in the first five months of 2004, which led to negative yields on holdings of tradable unindexed shekel assets, the funds recorded net redemptions of NIS 3 billion in that period. Subsequently however, the positive accrual in the funds increased continually and totaled NIS 4.6 billion. The low level of the Bank of Israel's interest rate, in both nominal and real terms, and the abolition of the tax advantage that still existed in 2003 on investment in Treasury bills and in certain government bonds also contributed to reducing the feasibility of investment in funds specializing in shekel assets.

Figure 5.1
a. Balance of Assets in Mutual Funds, by Declared Specialization, 2002–2004 (end of year)

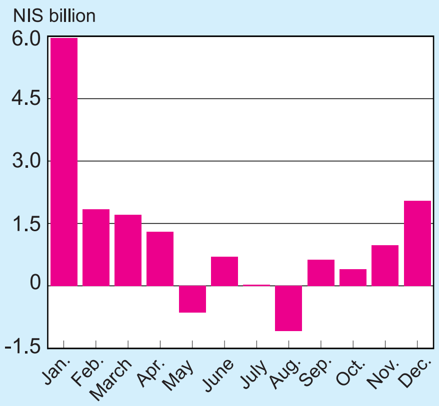


B. Accrual in Mutual Funds, by Declared Specialization, 2003 and 2004



SOURCE: Bank of Israel Monetary Department.

Figure 5.2
Accumulation in Mutual Funds, 2004



SOURCE: Bank of Israel Monetary Department.

The asset balance of the mutual funds specializing in equities continued to grow in 2004 and reached NIS 9.5 billion, 9 percent of total fund assets (Figure 5.1a). These funds recorded an accrual of NIS 1.6 billion during the year, following an accrual of NIS 2 billion in 2003 (Figure 5.1b). The accrual in the funds in the course of the year generally conformed to the development of prices in the equities market.

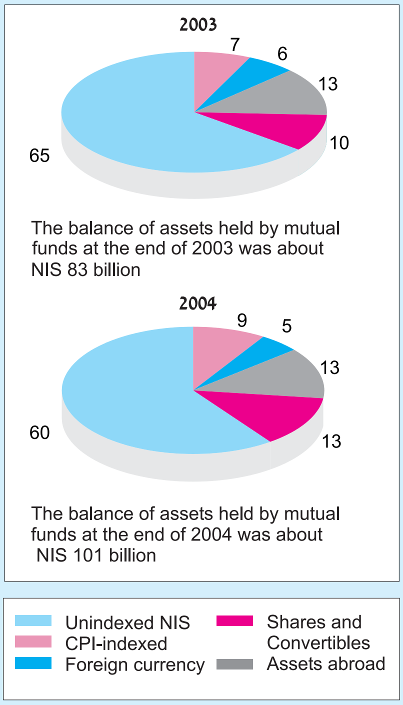
The asset balance of the mutual funds specializing in investments abroad continued to grow and reached NIS 15.7 billion, 16 percent of total mutual fund assets. The positive accrual in these funds, which was centered in the first four months of the year (redemptions were subsequently recorded), totaled NIS 1.5 billion (Figure 5.1b). The funds specializing in foreign currency investments recorded a negative accrual of NIS 340 million. This was due to the moderate appreciation of the shekel against the dollar from the beginning of the year. As a result, the foreign currency funds' asset balance fell for the second consecutive year in 2004, and reached NIS 2.7 billion at the end of the year (Figure 5.1b).

d. Distribution of the mutual funds' asset portfolio by indexation base

The mutual fund managers' investment preferences changed in 2004, mainly due to the differences in the yields achieved on the different forms of investment, which led to an inflow or outflow of money. The change in the mutual funds' asset composition by specialization bases reflects the change in their distribution by indexation bases.

The proportion of unindexed shekel assets in total assets fell from 65 percent at the end of 2003 to 61 percent at the end of 2004, although it remained much higher than the proportions of the other components. The decrease is attributed to the low yield expected on these assets due to the end to the downturn in the Bank of Israel's interest rate, and the abolition of the tax advantage that still existed in 2003 on investment in Treasury bills and certain government bonds, reducing the relative feasibility of investment in these assets. The decrease offset the increase in the proportion of this component during the previous year. The proportion of foreign currency indexed assets also fell slightly

Figure 5.3
Composition of Mutual Funds' Assets, 2003 and 2004
(percent)



SOURCE: Bank of Israel Monetary Department.

as a result of the moderate strengthening of the shekel against the dollar (Figure 5.3). The proportion of shares in the portfolio continued to rise in 2004, mainly due to the accrual in the funds specializing in equities and as a result of the upturn in share prices in Israel and abroad (Figure 5.3). The proportion of CPI-indexed assets rose as well and reached 9 percent due to the gradual increase in inflation expectations during the first five months of the year (Figure 5.3). The proportion of assets invested abroad remained unchanged compared with 2003 (Figure 5.3).

An examination of the composition of the shekel assets held by the mutual funds shows a large increase in the proportion of Treasury bills, which reached 52 percent of total shekel assets compared with 40 percent at the end of 2003, and a smaller increase in the proportion of deposits and cash at the expense of the share of other shekel assets (*Gilon* and *Shahar* bonds). The process of change in the composition of shekel assets at the mutual funds, which shortened the duration of these assets in the portfolio, is mainly attributed to the end to the reduction in the Bank of Israel's interest rate, which increased the feasibility of investment in short-term assets, the relatively low interest rates on shekel deposits, which reduced the relative attractiveness of investment in them, and the growth in the Bank of Israel's supply of Treasury bills in line with their increased usage as a market tool for the management of monetary policy.

e. Distribution of the mutual funds' asset portfolio by taxation tracks

Under the Income Tax Ordinance as amended in accordance with the recommendations of the Rabinowitz Committee, in 2003 the mutual fund industry was split into three types of funds that differ from each other in their taxation conditions—exempt funds, liable funds and mixed funds. (See the Monetary Department's Reports in the Bank of Israel reports for 2002 and 2003.)

In 2004 certain fund managers decided to change their tax status from the tax track of 'liable funds' to the track of 'mixed funds'. This was because the liable funds track conferred them with tax exemption on capital gains from unindexed assets only until the end of 2003, and only until that time did the managers of these funds have the one-time opportunity to change their tax status. As a result of the change, the share of funds classified as liable funds in the total balance of mutual fund assets fell from 80 percent at the end of 2003 to 65 percent at the end of 2004. Nevertheless, they still manage the majority of mutual fund assets, since households prefer to avoid tax settlement with the authorities, and in view of the fact that a mixed fund has a tax advantage over a liable fund as well as the advantage of being able to postpone a tax payment until the date when a participation unit in the fund is sold. The investors in the liable funds appear to be households or customers that have no additional securities investments, and therefore do not need to offset losses from future earnings and between different forms of investment.

The asset balance of the mutual funds classified as mixed funds accounted for 33 percent of total mutual fund assets at the end of 2004 compared with 17 percent at the end of 2003. Nearly all the new funds that were established in the course of the year had the status of mixed funds. This is because funds with this status solve the two main problems that exist with the other funds: (1) The rate of tax in them is not as high as in exempt funds, and is identical to the rate of tax that would have been paid had the investment been made directly; (2) An investor in these funds can offset losses between all the securities that he holds.

The asset balance of the exempt funds accounted for 2 percent of total mutual fund assets at the end of 2004. Most of these funds specialize in investment abroad (mainly in foreign securities) because the 25 percent capital gains tax charged from those holding units in an exempt fund at the time when participation units are sold is less than the 35 percent rate of tax applicable to direct investment in foreign securities. Investment in other assets (that are not foreign securities) via an exempt fund is not worthwhile, since with direct investment in them or investment via a fund with another tax status, the rate of tax is lower. Under the tax reform that went into effect in January 2003, from the beginning of 2007 the rate of tax imposed on capital gains and interest income from foreign securities, currently 35 percent, will be reduced to 15 percent, and will thereby be equalized to the tax rates applied in Israel. Towards the end of the year, legislation was completed that brought forward the date for the equalization of the tax rates to the beginning of 2005. As a result of this change, many of those investing abroad, principally via the exempt funds, will pay more tax. They will therefore sell their participation units in these funds by the end of that year, and will prefer to invest abroad directly or via a mutual fund in another tax track.

Under the changes that were made for the purpose of bringing forward the date for equalizing the tax rates on foreign securities, the managers of the exempt funds were given the opportunity to change their tax status to "mixed fund" by the beginning of 2005.

An examination of the accrual in the mutual funds by tax tracks shows that in 2004 a positive accrual was recorded only in the funds classified as mixed, while a negative accrual was recorded in the other funds.

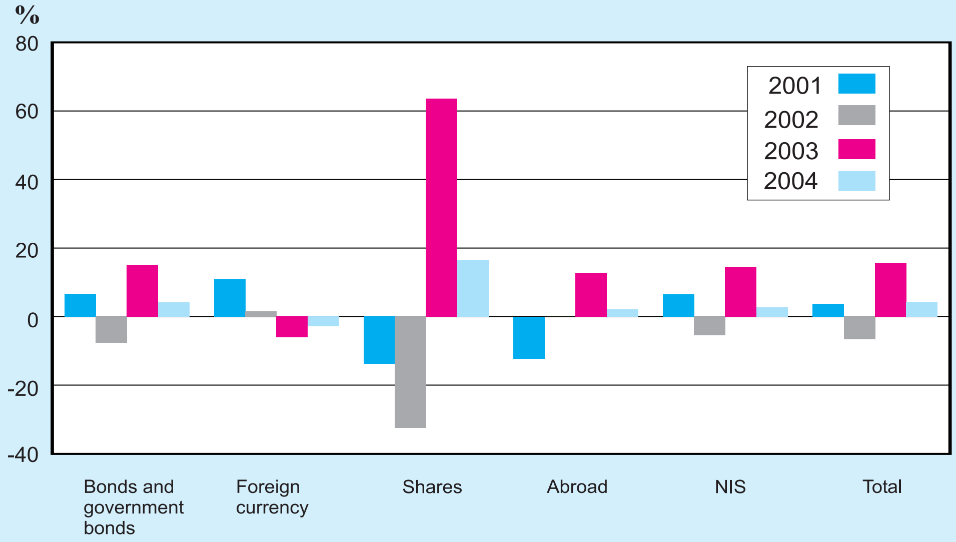
f. Yield developments

The mutual funds' assets yielded a real return of 4.3 percent in 2004, compared with 15.5 percent in 2003 (Figure 5.4). The mutual funds' positive real return reflects a positive real yield on most of the specialization bases, with the exception of funds specializing in foreign currency investment, which recorded a negative real yield of 2.8 percent. The highest yield—16.4 percent—was achieved by funds specializing in equity investment (Figure 5.4).

A comparison of the investment feasibility in the mutual funds by the different specialization tracks based on the Sharp index,[5] which takes into account the investment's level of risk, shows that the funds adopting a flexible investment policy achieved the highest excess yield—3.8 percent—which is comprised of a relatively

[5] The Sharp index represents the mutual fund asset portfolio's yield in excess of the yield of a risk-free asset—Treasury bills—per single unit of risk.

Figure 5.4
Real Rates of Return of Mutual Funds, by Declared Specialization, 2001-04



SOURCE: Bank of Israel Monetary Department.

high yield and level of risk. With the funds specializing in equities, the excess yield was 3.3 percent; the yield itself was higher, and the risk was also higher. In funds specializing in investment abroad (excluding those investing in Israeli shares abroad), in those specializing in CPI-indexed assets, in those specializing in government bonds and in those specializing investment in unindexed shekel assets, the excess yield in 2004 was negative (less than the yield on a risk-free asset). The highest negative excess yield—4.8 percent—was recorded in the funds specializing in foreign currency investment.

The professionalism of the funds' management was tested further by making a comparison between the actual yield of the flexible mutual funds—those whose managers are free to select the composition of their investments—relative to the yield on a theoretical portfolio, which assumes a fixed asset composition from the beginning of the year that is invested in the appropriate market indexes, and represents the yield that the assets would have produced without any activity by the managers in the course of the year. Such a comparison shows that in 2004, in contrast to the previous years, the fund managers' activity provided investors with an (albeit very small) incremental yield of 0.5 percentage points.

g. Other developments in the mutual funds industry

Continuing the trend of recent years, the mutual funds industry was notable for an increase in the number of funds in 2004. In the course of the year 145 funds were established, making for a total of 793 funds in the industry at the end of the year. Most of the increase during the year was in the specialization bases of investment in foreign securities (mainly investment in bonds in international markets), investment in unindexed shekel assets and investment in equities. Prominent among the new funds that were issued during the year were two new specialization bases—investment in bonds in Far East markets (China, Japan) and investment in the shares of real estate companies. At the end of 2004, 42 mutual fund managers were operating. Two mutual fund managers of private companies ceased to operate during the year, and the funds that they managed were transferred to other fund managers. Three new private managers joined the industry, and two mutual fund management companies merged.

Regulatory procedures

The Securities Authority approved a draft amendment to the Mutual Funds Law, in a manner that will make it possible to market foreign mutual funds in Israel. This will provide the investor public in Israel with more convenient access to foreign markets, and could contribute to increased competition in the mutual fund industry in Israel. At present, the investor public are able to purchase mutual funds in Israel that are listed abroad but operate in Israel like any Israeli mutual fund. The Securities Authority will not supervise foreign funds, and will rely on the supervision of the funds in their host countries. Under the draft amendment, it will be possible to market in Israel only a foreign fund that was established in a country where the Securities Authority is convinced that the laws and supervisory procedures applying to fund managers provide adequate safeguards for the interests of the investor public. According to the draft amendment, the foreign funds that will be offered in Israel will be similar in their principal elements to Israeli funds (for example, they will be obliged to hold tradable securities only, the revaluation of the assets in them will be carried out on a daily basis in accordance with the prices that are determined in the course of trading, and they will be obliged to diversify their assets). This is in order to prevent unfair competition with mutual funds that are managed in Israel.

The Securities Authority has approved draft amendments that will make it possible to operate a special fund. Apart from the activity currently permitted to a closed fund, a special fund will be allowed to engage in two additional types of activity: investment in hedge funds (up to 30 percent of the net value of the fund's assets and no more than 5 percent in a single hedge fund) and to conduct forward transactions in currencies (no more than 20 percent of the net value of the fund's assets). These funds will be traded in the stock market.

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

a. Main developments

The recommendations of the Bachar Committee (see Section 5a.) formed the background for developments in the provident and advanced study fund industry in

2004. Although the Committee's recommendations have yet to be applied, the very fact that they have been published and the public debate on the matter appear to have increased savers' awareness of the higher yields that the private funds achieved during recent years as compared to the yields of the bank funds. This awareness spurred the move of money from the provident and advanced study funds controlled by the banking corporations to those funds controlled by private organizations. As a result, the private managers' share of the provident fund industry increased. While in 2001 they managed 13 percent of the funds' total assets, at the end of 2004 their share had risen to 15 percent. However, the concentration in the provident fund industry is still very high, and the industry is under the almost complete control of the banks. The large and small banks are still managing the majority of provident fund assets—85 percent of the funds' total assets—and the remaining assets are managed by other organizations. The high concentration in the ownership and management of the industry, together with the banks' control of the funds' distribution system, impairs competition in the industry and the efficiency of the capital market, and creates a real potential for conflicts of interest between the activity of the banks and the activity of the provident funds that they control or manage (see section 5a).

b. The development of assets

The provident funds' asset balance totaled NIS 146 billion at the end of 2004 compared with NIS 135 billion at the end of 2003. The increase is attributed mainly to the 8.2 percent positive real yield on funds' investments, and partly to the NIS 1.3 billion positive accrual in the funds. The provident funds' asset volume is still high, and the funds are a substantial component of the public's asset portfolio and of institutional saving relative to other institutional investors[6] (Table 5.1). The funds are also a major investor and an influential factor in the capital market, as apparent from their large share of the government bond market (22 percent), the corporate bond market (19 percent) and the equities market (7 percent). All these data serve to emphasize that the funds are still a dominant and important component of long-term saving, due *inter alia* to the tax benefits conferred on those saving via the funds.

For the first time in a decade, the provident funds recorded a positive accrual in 2004. As stated, the accrual totaled NIS 1.3 billion. The amount of deposits increased and the amount of withdrawals fell slightly compared with 2003. There are several possible reasons for the positive accrual in the funds: (1) The directives of the tax reform that went into effect in January 2003 favored savers in the provident funds compared with alternative forms of investment, since a tax exemption was granted for old deposits in the funds (until the end of 2002). Accordingly, due to yield gap considerations, there is no incentive to withdraw money from the funds and invest it

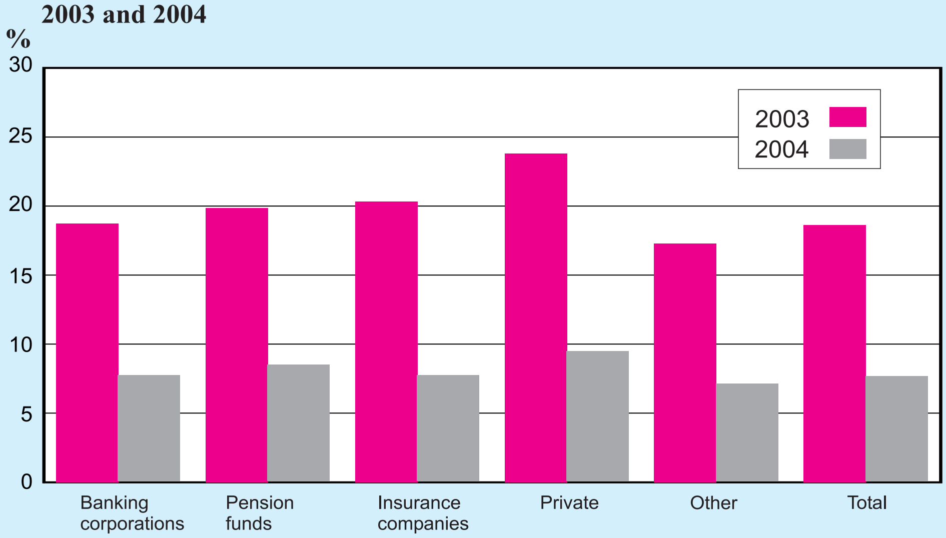
[6] Including mutual funds and advanced study funds that are defined as short-to-medium-term saving, and provident funds, pension funds and life insurance plans that are defined as long-term institutional-contractual saving.

in short-term fixed-rate shekel investments, such as deposits and mutual funds, which are taxable; (2) The improvement in the state of the economy, as a result of which the public had less need to withdraw money for current consumption; (3) The expectation of a further improvement in the funds' performance.

The yield achieved on provident fund assets in 2004 was lower than in 2003, because prices rose more moderately in all the securities markets than in 2003. A comparison of the provident funds'[7] performance by type of managing corporation shows that the funds managed by private organizations achieved the highest average yield among the managing corporations in 2004, as occurred also in 2003 (Figure 5.5). The risk of the privately managed funds, measured by means of the standard deviation of the monthly yields that the private funds achieved, was high in 2004 compared with the other funds. The provident funds' yields were notable for high volatility during recent years in line with market yields, as in 2004 when the yield was lower than in 2003. A rise in the provident funds' yield volatility increases the level of risk inherent in investment in them.

The asset balance of the advanced study funds totaled NIS 61.7 billion at the end of 2004 compared with NIS 54.7 billion at the end of 2003. The increase is attributed mainly to a net positive accrual of NIS 2.7 billion, and partly to the 7.8 percent positive real yield on the funds' assets. In the advanced study funds as with the provident funds, a lower real yield was recorded in 2004 compared with 2003 due to the more moderate

Figure 5.5
Real Rates of Return of Provident Funds,[a] by Type of Managing Corporation, 2003 and 2004



[a] Including pension and severance pay funds, the central severance pay fund, and advanced study funds.

SOURCE: The Capital Market, Insurance and Savings Division of the Ministry of Finance.

[7] Provident and severance pay funds, central severance pay funds and advanced study funds.

rise in prices in the different securities market. The funds recorded a negative accrual at the beginning of the year, while from March onwards deposits in the funds exceeded withdrawals and the accrual, although low, become positive.

c. Distribution of the provident and advanced study funds' asset portfolio

In 2004 the fund managers chose to continue scaling down the proportion of their investments in tradable government bonds while also reducing the proportion of investment in deposits, mainly in favor of increased investment in corporate bonds and shares and to a lesser extent, investments abroad and investment in Treasury bills (Figure 5.6). The proportion of tradable assets in the funds' portfolio remained practically unchanged compared with 2003 (66 percent). Since 1986, when the issue of earmarked bonds to the provident funds ceased, with the exception of 2002, the proportion of these bonds in the funds' asset portfolio has declined continually and in 2004 reached 3.4 percent.[8]

The increase in the proportion of corporate bonds in the funds' asset portfolio (Figure 5.6) is attributed *inter alia* to the growth in private sector issues that began back in 2002, as a result of the stricter credit terms imposed in the banking system. The volume of private sector issues grew even more in recent years, due to the decline in the interest rate in the economy and the decrease in the government's domestic borrowing. In addition, the changes in the provident funds' investment regulations that went into effect in October 2002 increased the flexibility of those investing in them. Institutional investors, including the provident funds, prefer to invest mainly in nontradable corporate bonds, despite the liquidity disadvantage inherent in them. This is because such investment is recorded in their books at adjusted cost, and does not expose them to yield volatility as is the case with investment in tradable bonds. This situation is due to change in April 2005 as a result of the new reporting directives issued by the Commissioner of the Capital Market, Insurance and Savings, whereby investment in nontradable bonds is to be recorded on the basis of market value (See Section 5c). The growth in the proportion of shares in the funds' asset portfolio derived from the rise in the market value of equities and from the increased holding of them. Concurrently, the proportion of investment in CPI-indexed deposits continued to decline due to the low level of the interest rate and the abolition (in 2003) of the tax advantage on investment in them relative to other forms of investment.

The changes in the composition of the advanced study funds' asset portfolio were similar to the changes in the provident funds' portfolio: The proportion of investment in equities and tradable corporate bonds increased, mainly at the expense of investment in CPI-indexed shekel deposits. Despite the similar tax benefits on both these forms of investment, there are differences between them, in the saving horizon, eligibility to save and in the extent of liquidity.

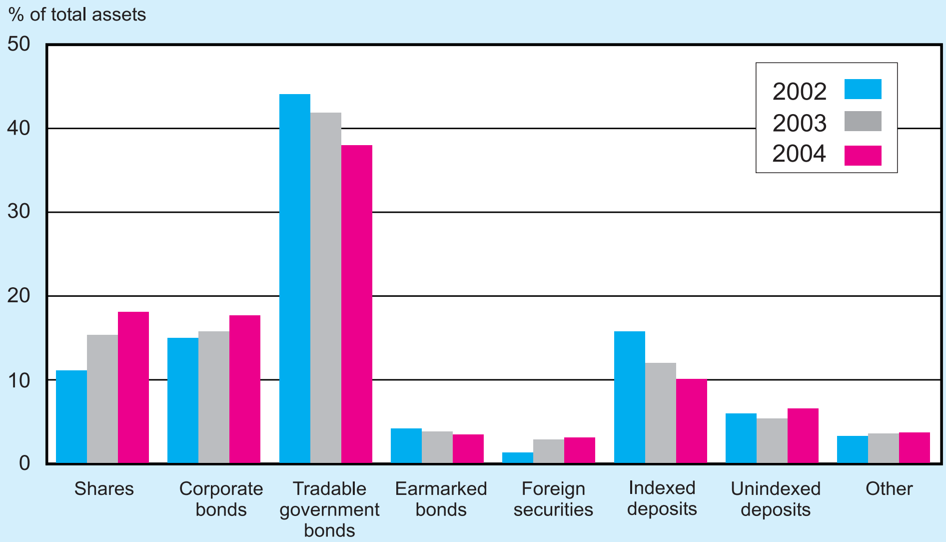
[8] This proportion is set to fall to zero at the end of 2006.

For the provident and advanced study funds (as well as for the pension funds), the equalization of tax rates (see Section 2e.) implies an exemption from tax on earnings from foreign securities[9] and the abolition of the currently existing tax discrimination. Accordingly, the reform is expected to mainly affect these institutional investors, and will be reflected by a gradual increase in their investments in foreign securities, principally foreign bonds.[10]

d. Regulatory procedures in the provident fund industry

In 2004 the Ministry of Finance issued directives, which went into effect in April 2005, regarding the transfer of members' money between provident funds. As an example, when a member wishes to transfer money between provident funds, the fund will be obliged to transfer the amount in question to the other fund within seven days. Members will be able to transfer money between provident funds once a month compared with once a year at present. This change is increasing members' flexibility in their ability to move from fund to fund, and should therefore increase the competition between the funds.

Figure 5.6
Distribution of the Provident Funds' Asset Portfolio, 2001–2003



SOURCE: Provident funds' reports to Finance Ministry and Bank of Israel.

[9] These investors currently pay tax at the rate of 35 percent on capital gains and on dividend and interest income from foreign securities.

[10] See Golan Benita and Haim Levy, "Potential impact of the abolition of the tax discrimination between Israeli securities and foreign securities on the composition of the public's asset portfolio", August 2004.

3. THE PENSION FUNDS

a. Main developments

The pension industry underwent a major transformation during the last two years, with control of the industry passing from the Histadrut Labor Federation to private hands, the sale of new pension funds to private entities, the transfer of the management of the deficit funds from the Histadrut to authorized managers, and the issue of a Finance Ministry directive for the management of the new pension funds as actuarially balanced yield funds. The industry also underwent structural changes, including more sophisticated opportunities for members to move between funds, the funds' exposure to investment in the tradables market by determining freedom of investment for them, and ending the issue of earmarked bonds, and a new pension fund was established. These changes could lead to a major change in the level of concentration in the industry, to an increase in the funds' professionalism and to the development of new market instruments.

b. The pension funds for established members

The asset balance of the pension funds for established members totaled NIS 125 billion at the end of 2004 compared with NIS 121 billion at the end of 2003, due to the guaranteed yield on earmarked bonds. In 2004 the asset balance of the established pension funds accounted for 8.2 percent of the public's financial asset portfolio, equivalent to 22.3 percent of total institutional saving assets (Table 5.1).

Since 1995, new members have not been allowed to join the established pension funds. As a result, the number of members in respect of whom contribution fees for these funds are charged is decreasing continually, and the accrual in the funds during recent years has been negative (Table 5.1).

In September 2003, in line with the reform of the pension industry, the issue of earmarked bonds to the established pension funds ceased, and it was stipulated that their issue to a fund will be resumed only when the ratio of such bonds in the fund's portfolio falls below 30 percent.[11] New investment regulations were also defined under the reform. These regulations include the funds' obligation to invest at least 50 percent of their total assets in tradable government bonds. As a result of these changes, the proportion of earmarked bonds in the portfolio fell to 83 percent in 2004 compared with 91 percent in 2003, although it is still the largest component in the funds' asset portfolio. Concurrent with this decrease, a slight increase was recorded in the funds'

[11] The issue of earmarked bonds to the established pension funds is due to be resumed only in 2012. This is when the total value of the earmarked bonds in a single fund falls below 30 percent of its total assets. In such a case, the fund manager will be able to purchase earmarked bonds to an amount that will bring their ratio to no more than 30 percent of the fund's asset portfolio. It was decided that in the future, Arad bonds will be issued to those funds without a discount, that is at an effective interest rate of 4.86 percent instead of 5.57 percent for the established funds.

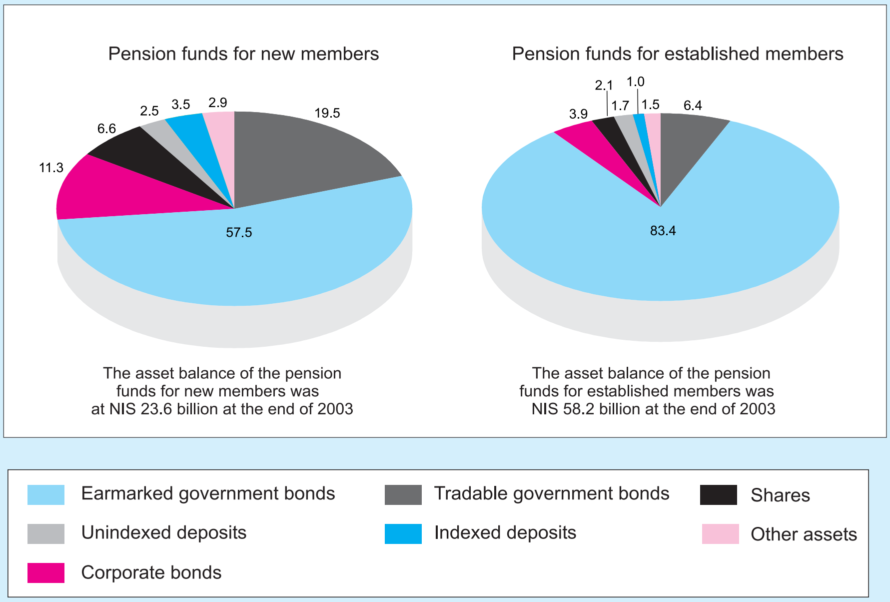
holdings of corporate bonds, mainly nontradable bonds, and in tradable government bonds and to a lesser extent in shares (Figure 5.7) and unindexed deposits. As in the past, the established pension funds still invest very little in tradable assets, whose proportion in the portfolio is now expected to gradually increase as the balance of earmarked bonds falls.

The cessation of earmarked bond issues to the established pension funds as well as to the new funds will contribute to a growth in the stock of tradable bonds. This development, together with the pension funds' more widespread involvement in the capital market, is likely to lead to increased competition in the bond market and to reduced volatility in the market.

c. Comprehensive pension funds for new members

The pension funds for new members that began to operate in January 1995 are focusing their efforts at bringing in new members, mostly young people, who have only just begun to save for a pension. This is leading to a gradual increase in receipts of contribution fees while pension payments from the funds are still low. The asset balance of the pension funds for new members totaled NIS 24 billion at the end of 2004 compared with NIS 19 billion at the end of 2003. These funds continued to record a positive net accrual in 2004 and during the year this accrual reached NIS 3.7 billion, slightly more than in both of the previous two years.

Figure 5.7
Distribution of Pension Funds' Assets, 2004 (percent)



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

From January 2004, under the reform of the pension industry the issue of earmarked bonds was ceased to the new pension funds as well.[12] As with the established pension funds, it was stipulated that their issue to a single fund will be resumed only when the ratio of such bonds in the funds' portfolio falls below 30 percent. Accordingly, the proportion of investment in *Arad* earmarked bonds fell from 67 percent in 2093 to 54 percent in 2004 (Figure 5.7). This was mainly in favor of an increase in these funds' holding ratio of tradable government bonds, nontradable corporate bonds, shares and to a lesser extent, in shekel bonds and assets abroad (Figure 5.7).

The application and integration of the new investment regulations determined for the new pension funds under the pension reform that was approved in 2003—regulations that increase their investment flexibility—will lead to a gradual growth in holdings of new forms of investment. This will increase the competition in the capital market and produce an alternative long-term source of finance for the banking system.

d. The general pension funds for new members

In 1999 the establishment of new general pension funds that are not entitled to earmarked bonds was approved. These funds are intended to provide a pension accrual facility for savers wishing to pay in an amount to the funds in excess of the permitted ceiling for provision to a new pension fund (up to twice the average wage in the economy). It is also possible to make one-time provisions to an unlimited amount to such a fund, which is not permissible in the case of pension funds that are entitled to earmarked bonds.

The asset balance of these pension funds totaled NIS 190 million at the end of 2004 compared with NIS 160 million at the end of 2003. Approximately half of the total is invested in tradable government bonds, and the remainder in corporate bonds (15 percent), shares (14 percent) shekel deposits (13 percent, of which 8 percent in unindexed deposits compared with 22 percent in 2003), and other assets.

e. Structural developments in the pension industry

The pension fund reform that went into effect in January 2003 included the processing of the actuarial deficits of the deficit funds and the transfer of their management from the Histadrut to managers authorized by the Finance Ministry. The management of two factory funds in deficit was also transferred to authorized managers. Accordingly, at the end of 2004 the asset volume of the funds run by authorized managers reached 88 percent of the funds' total assets. The transfer of the deficit funds to authorized management entities resulted in the offer for sale of the new funds controlled by the established deficit funds controlled by the Histadrut. The proceeds from their sale will therefore be used to reduce the actuarial deficits of the parent funds. By the end

[12] The issue of earmarked bonds to the new pension funds was resumed in 2005, to those funds in which the total value of the earmarked bonds has fallen below 30 percent of its total assets. The bonds issued were of the Arad series, issued without a discount, that is at an effective interest rate of 4.86 percent instead of 5.05 percent for the new funds.

of 2004, five new pension funds had been sold to insurance companies and brokers. Three of these are large funds that hold 78 percent of the total assets of the new pension funds. The insurance companies are expected to be major players in this industry due to their experience of over a decade in investing money in the capital market, and the pension funds will be able to benefit from this infrastructure. The insurance companies' purchase of the pension funds will enable the companies to offer their insured parties a broader basket of products, which will include combined insurance and pension products.

In line with the changes in the new pension funds' investment regulations and the funds' management regulations, in April 2004 the Ministry of Finance issued updated management and reporting directives for the new pension funds. The new directives provide regulatory coverage for the operation of the new pension funds as actuarially balanced yield funds. This will assure a balanced pension system, increase competition in the pension industry, make it easier to move money between the new pension funds, lead to greater professionalism in the management of the funds' investments, and provide greater flexibility in the selection of the pension product. The new directives prescribe *inter alia* a new mechanism for charging management fees in the new pension funds.

In October 2004, the Finance Ministry issued new directives whereby members of a new pension fund will be able to transfer from one fund to another within a short period of time. This could increase the competition in the pension industry, and enhance insured parties' position as well as the pension product and the level of service that the funds provide to insured parties.

4. THE LIFE INSURANCE PLANS

a. Main developments

The reform in the structure of the life insurance plans and the composition of commissions in the industry went into effect in January 2004. Until the reform, policies were not sufficiently transparent in order to highlight the distinction between the saving, risk and expense components, and the customer did not know how much of the premium that he had paid was allocated to the purchase of saving, or for the coverage of risk and expenses and commissions to the insurance companies. Part of the growth in premiums was used to cover commissions to agents, which were determined as a function of the risk component in the insurance. Agents thereby had an incentive to sell policies with a large risk component, without reference to the customer's requirements. In addition, since the insurance companies offered the agents incentives for selling new policies (volume commissions), the agent encouraged members to move to a new insurance plan once every few years, even if the members' rights were compromised as a result.

Set out below are the changes in the structure of the plans and the composition of commissions with effect from January 2004.

1. Due disclosure to the insured party: In every insurance plan, a distinction has to be made between the saving component, the risk component and the expense component, in order that the insured party will be able to decide on the structure of the plan that is suited to his requirements. For example, a single person may decide that he does not need to purchase a risk component in the insurance. The transparency is intended *inter alia* to develop competition with respect to the level of expenses and to increase the insurance suitability.

2. Change in the structure of management fees: A more rational commission structure was determined, and due disclosure was required with respect to the level of the commission paid.

3. Regulatory coverage of fines for breaking life insurance plans: The damage to the insured party resulting from the breakage of an insurance plan has been reduced. As an example, it was determined that an insured party breaking an insurance plan in the first year will receive 85 percent of the balance of the saving and the refund will increase by 3 percent annually. An insured party breaking an insurance plan after the fifth year will therefore be entitled to the full amount of the saving.

4. Amendments to the capital regulations: The use of saving funds to finance loans to agents has been prohibited, and the insurance companies have been permitted to finance these loans only from their equity capital or from loans from the banks.

5. Twisting circular: It was stipulated that whenever an insured party transfers to a new policy, the differences between the policy that he holds and the new policy, including the damage that will be caused to him as a result of the transfer, must be explained to him. The agent must sign the insured party on a document that explains to him the differences between the plans.

Set out below are the anticipated effects on the insurance industry of the reform in the life insurance plans:

- The saving component in insurance polices will be increased, at the expense of the part directed to risk and expenses, which will be reduced.
- The increased transparency in the composition of the premium is expected to lead to a growth in competition in the industry for the expense component in the premium, and to increase the insurance suitability for the members.
- The reduction in the expense component in the premium is likely to adversely affect the insurance companies' premium income, and lead to a considerable reduction in agents' commissions.
- The decrease in the expense component in the premium is expected to increase the relative attractiveness of saving via the insurance companies. The pension reform has created business opportunities for the insurance companies, which in 2004 purchased four new pension funds that were offered for sale. It is also expected that the insurance companies will increase their marketing of pension products.

b. The guaranteed-yield life insurance plans

The asset balance of the 'guaranteed-yield' life-insurance plans totaled NIS 44 billion at the end of 2004, similar to the balance at the end of 2003 (Table 5.1). Since these plans have been closed to new members since 1991, their share in the public's asset portfolio and total institutional saving has declined continually from that year.

Plans of this type are entitled to issues of *Hetz* 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 their assets, amounting to 67 percent, are invested in earmarked bonds, and only the remaining assets are placed in other forms of investment (Figure 5.8).

No government tenders for the early redemption of earmarked bonds owned by these insurance plans were held in 2004, after these tenders had existed on a large scale during the previous years. This was because in the prevailing market conditions, it was not worthwhile for these insurance plans to redeem earmarked bonds and move to investment in tradable bonds.

c. The profit-sharing life-insurance plans

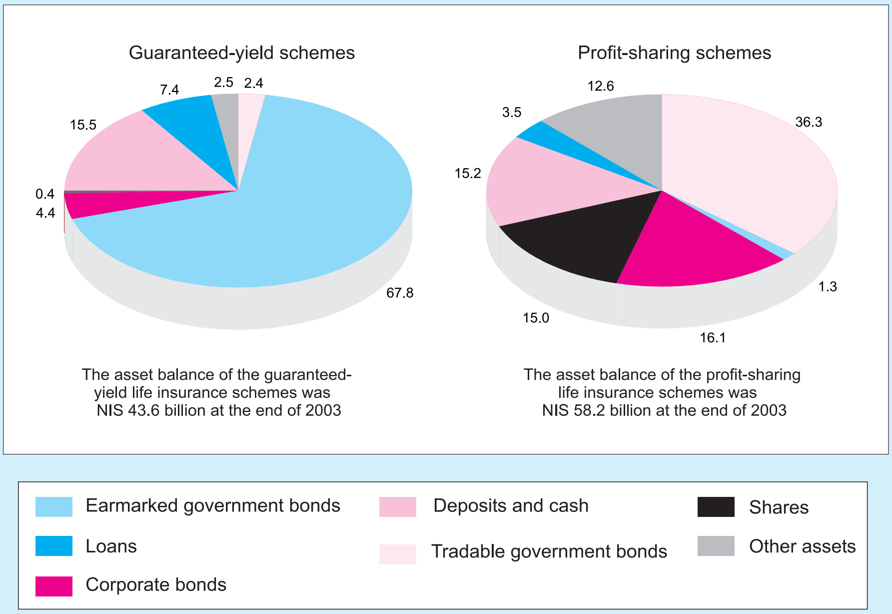
The proportion of 'profit-sharing' life insurance plans, which have existed since 1999, is continuing to increase gradually in the public's asset portfolio, in total institutional saving and among the total assets of the insurance plans (Table 5.1).

The asset balance of profit-sharing life insurance plans totaled NIS 58 billion at the end of 2004.[13] These plans achieved a gross nominal yield of 8.6 percent in 2004 compared with 21 percent in 2003. Since the plans are not entitled to invest in earmarked bonds, most of the accrual in them is invested in the tradable capital market. This situation is reflected by the composition of their asset portfolio and their relatively large share of the government bond market (8 percent) and the corporate bond market (6 percent). However, their proportion of the equities market is still relatively low (2 percent).

An examination of the composition of the profit-sharing insurance plans' asset portfolio shows that the majority of their investments are tradable government bonds, corporate bonds, shares, deposits at the banks and cash (Figure 5.8). The insurance plans' increased purchase of nontradable corporate bonds during the last three years led to a substantial growth in their proportion in the asset portfolio, to 12 percent at the end of 2004 compared with 3 percent at the end of 2001. This development is attributed to the increased amount of capital that firms raised by means of corporate bond issues in that period, as well as these investors' preference for nontradable bonds despite their liquidity disadvantage. This is because such investment is recorded in their books according to adjusted cost, and does not expose them to volatility like investment in tradable assets. This situation could change in view of the Commissioner of the

[13] Not including other assets: fixed assets, amounts receivable and deferred purchase expenses.

Figure 5.8
Distribution of the Assets of Life Insurance Schemes, 2003 (percent)



SOURCE: Capital Market, Insurance, and Savings Section, Ministry of Finance.

Capital Market, Insurance and Savings' new reporting directives whereby investment in nontradable bonds also has to be recorded on the basis of market value (see Section 5c). These investors were also able to increase their holdings of corporate bonds, mainly nontradable bonds, due to the changes in the insurance companies' investment regulations that went into effect in April 2001. Under these new regulations, most of their investment quotas in specific assets were abolished, which enables them to increase their investment in corporate bonds.

The insurance companies have been permitted to invest abroad since 2001. In 2004 the companies increased their investments abroad by NIS 950 million, compared with a growth of NIS 3.4 billion in 2002 and 2003 together. As a result, the proportion of this component in the profit-sharing insurance plans remained almost unchanged compared with the end of 2003 (10 percent).

5. REFORMS AND CHANGES AFFECTING INSTITUTIONAL INVESTORS

Progress was made with a number of reforms relating to the activity of institutional investors in 2004. The most important of these is the reform of the capital market (the report of the Bachar Committee). The reforms are part of a range of reforms relating to the pension system that have been implemented during recent years, or that are in the process of implementation or formulation, and which are directed at increasing competition and efficiency in the financial markets in Israel (the tax reform, the 'market-maker' reform and others). Set out below are the main elements of the reforms:

a. The reform in the capital market (the Bachar Committee)

The report of the team concerned with the reform of the capital market (the Bachar Committee) was submitted to the Finance Minister in September 2004. The report contained recommendations that the government approved, subject to a number of reservations, and the recommendations are due to be embodied in the legislation necessary for implementing them. The reform is aimed at increasing the competition in the capital and money markets (in the management of the public's assets and in the area of credit) by reducing the high degree of concentration in the markets and reducing the conflicts of interest that are inherent in the activity of financial intermediaries, and thereby contribute to more rapid growth and the public welfare.

The Bank of Israel, the Finance Ministry and the Securities Authority have adopted the team's recommendations as a single entity.[14]

The following is a summary of the main elements of the recommendations detailed in the report, together with their expected implications for the financial markets and the banking industry in Israel. Full details of the report are available on the Finance Ministry's Internet site www.mof.gov.il.

1. Increasing competition in the capital market

The central element of the reform is the recommendation that the banks gradually sell their entire holdings in the provident funds (within three years) and in the mutual funds (within four years). The team adopted the position that a growth in competition in the capital market should be based on three main processes:

- Increasing the competition in the management of the public's financial assets—reducing the concentration in the control and management of the public's investments by diversifying the management of the different forms of investment.
- Increasing competition in the area of credit—reducing the concentration in the area of credit by creating alternative, non-bank sources of credit.
- Increasing competition in the households sector—directing the banking system to providing better service to the households sector by exposing them to alternative asset management and credit supply systems, developing alternative forms of investment to those offered by classical banking, and expanding the range of entities that supply life insurance and pension products.

[14] The team concerned with the reform of the capital market was comprised of representatives of the Finance Ministry (the Ministry's Director-General, the Commissioner of the Capital Market, Insurance and Savings, and the Legal Counsel), the Securities Authority (the Chairman of the Authority), the Bank of Israel (the Deputy Governor and the Supervisor of Banks), the Attorney-General's Office (the deputy to the Attorney-General) and the Anti-Trust Commissioner.

The separation between the banks and the provident and mutual funds is expected to lead to the development of the nonbanking finance market, which in turn will lead to a diversification of the sources of credit, a decrease in the cost of credit, a considerable increase in investors' financing ability and the creation of a credit alternative for firms. The cross subsidization between households and businesses in the pricing of credit will thereby be reduced. In addition, the diversification of activity will contribute to the development of market discipline, by making it easier for savers to leave entities that act against their interests and move to competing organizations. This separation could improve the manner in which bank credit is managed, an improvement that will be reflected in the pricing and allocation of sources, as well as by a decrease in the interest spread between borrowing and lending activity. The development of a nonbanking finance market will also help the banks to avoid concentrating the credit portfolio in the hands of single customers, and to reduce their risk exposure in the finance of long-term projects. Moreover, an increase is expected in the competition for improving the quality of service that the provident funds and mutual funds offer to savers.

In order to allay fears that the new institutional network will also be subject to a high degree of concentration and will prevent the development of competition, it is proposed that the control and holding of a particular ratio of the means of control of an institutional entity will be made conditional on the receipt of a permit, in accordance with certain considerations. It is also proposed to restrict the market segment of a purchasing entity in the area of long-term saving, to 15 percent in the case of provident funds, new pension funds and the profit-sharing life insurance portfolio, and to 20 percent for mutual funds.

2. Reducing conflicts of interest

As stated, one of the objectives of selling the banks' holdings in the provident funds and the mutual funds is to reduce the conflicts of interest embodied in the banks' activity with their customers. In order to achieve this objective, it is proposed to enact legislation that will define two areas of activity that require training and licensing and that are subject to supervisory arrangements—advice and marketing with respect to pension products and financial products. The organizations operating in the capital market will be required to choose between engaging in marketing and advice, in accordance with restrictions and conditions that will be defined in the team's report. It is also proposed that the banking corporations that are required to sell their ownership in the provident funds and the mutual funds will engage in advice alone and not in marketing, and that institutional investors that produce and own financial and pension products will engage in marketing alone and not in advice.

In order to prevent conflicts of interest, the team recommended a special remuneration model for those engaging in advice or distribution. Under this model, organizations engaging in advice, including banks, will be required to adhere to the following principles: They will not accept any remuneration from the owners of a financial or pension instrument for carrying out activity in their products; they will be entitled to charge a commission for conducting transactions in financial or pension products from the customer only ("transaction commission"). This recommendation provides a guarantee that the banking distribution system will be largely devoid of conflicting interests, and will enable customers to benefit from objective financial advice at the banks' branches.

The banks' control of underwriting activity constitutes another area of concentration in the capital market, and is an additional area of conflicts of interest (in that the banks act both as underwriters and as managers of the institutional entities involved in issues). In order to reduce the dominance of the underwriting companies controlled by the banks, it is proposed to prevent lender entities from serving as lead underwriters, and to impose restrictions on an underwriter when selling securities to related institutional entities. Implementation of the recommendation will enable the banks to continue operating in the area of underwriting on the conditions specified, and will prevent them from acting as pricing underwriters in those cases where a potential conflict of interests exists.

3. Regulatory coverage of the supervisory structure for nonbanking entities and the unification of norms for the management of the public's assets

The regulatory infrastructure and the supervisory structure for the capital market in Israel are notable for the absence of a complete and comprehensive legislative framework for the regulatory coverage of the provident funds' activity. On occasions, the diversification of the supervisory authorities leads to differing regulatory directives and to a lack of consistent supervisory policy for matters that are essentially similar. The team is currently concentrating on formulating recommendations concerning the desirable content and structure of the supervision in the money and capital markets, especially in view of the changes that are proposed under the reform. It is very important to build an infrastructure for regulation, supervision and enforcement in the institutional entities' activity that is as consistent and as uniform as possible. For without such an infrastructure, the reform of the capital market will not be complete.

In its recommendations, the team proposes that a provident fund law be enacted that will provide regulatory coverage for the supervisory and enforcement regulations applying to the provident funds. The provisions of such a law, as well as the existing directives concerning other institutional entities, will be adapted in such a way that the norms applying to the management of financial assets will be as uniform as possible, taking into account the special features of the different assets.

Opposition to the reform, mainly on the part of the banks, is based on the following assertions:

- The reform's potential for leading to increased competition is small since it totally excludes the banks from the area of institutional investors' activity.
- Implementation of the recommendation will not reduce concentration and conflicts of interest in the capital market, and will merely channel them elsewhere. This is in view of the fact that the insurance companies that are likely to take on the ownership of the provident funds already manage investment portfolios and underwriting

companies, and the concentration in the insurance industry is not less than that in the banking system.
- Taking away the management and ownership of institutional investors from the banks (which enjoy economies of scale in the management of financial assets) to nonbanking organizations (which are characterized by inefficiency in the supply of financial services due to diseconomies of scale) could increase the cost of financial services to customers (high commissions and management fees).

An IMF delegation that visited Israel in December 2004 praised the structural changes that were adopted in the Israeli capital market during recent years and expressed the belief that in view of these changes, the legislation for separating the banks from the provident funds and the mutual funds will be superfluous. The delegation also suggested that intervention in the markets by imposing restrictions on the banks by means of legislation could reduce the attractiveness of the Israeli market in the eyes of foreign financial entities.

b. Operation of a separate trading system for nontradable bonds by institutional investors

In May 2004 a separate trading system for institutional investors began to operate in the stock market, in line with the Bachar Committee's recommendations of August 2003. The new system makes it possible to develop a trading facility for non-convertible bonds issued in a private offering for institutional investors, excepting the mutual funds,[15] and which under the Securities Law cannot be listed for trading in the stock market because no prospectus for this purpose is published. Since the new system was first operated, NIS 4 billion of corporate bonds have been listed for trading in it, and the volume of transactions has totaled NIS 115 million (39 transactions).

The new trading system is intended specially for institutional investors and is managed under a track that has no connection with the normal trading system serving the general public, except for the joint use of the stock market's telecommunications and computer infrastructure. Since the publication of a prospectus, current reporting and the payment of a fee to the Securities Authority are not required when listing for trading in this system, the Authority does not supervise companies' reporting. The Authority does however supervise trading in the securities.

The securities that are traded in the new system are listed in the stock exchange clearing house, in a separate settlement system for nontradable securities (the 'Nesher' system). Orders to the trading system are submitted via stock exchange members, and the quotations and amounts offered are disclosed to the entire public, while the names of the buyers and sellers and the stock exchange members via whom they operate are blocked. Trading and settlement commissions for the securities traded in the new system are low relative to those for other tradable securities. The trading regulations

[15] If in the future the level of tradability and liquidity in the system proves to be high, the Securities Authority will permit the mutual funds to invest in securities that are listed for trading in this system.

in the system are as similar as possible to the trading rules for bonds listed in the stock market.

This trading system is expected to increase the liquidity in the private bond market, and to increase the usage of private issues as an instrument for raising capital from institutional investors (despite the change in the method of revaluating nontradable assets—see below). This is because it will make it possible to use a relatively inexpensive and rapid instrument for raising capital without investors having to forego the tradability and liquidity of the securities issued. The system will provide institutional investors with greater flexibility in managing these investments, since it will be easier for them to buy or sell securities after an issue. The issuing companies usually prefer to raise debt by means of a private issue because the process is more rapid and less expensive. In addition, if the mutual funds are in the future allowed to invest in the securities listed in the new trading system, the range of those investing in nontradable securities will increase, which will further contribute to the development of this market.

c. Change in the revaluation method for nontradable assets held by institutional investors

The investment regulations for the provident funds and the insurance companies prescribe directives for the revaluation of the assets held by institutional investors, as well as regulations governing their investment activity. The investment regulations state that the funds' assets are to be revaluated on the basis of fair value, in order to avoid the problems inherent in presenting assets at adjusted cost. The fair value is determined as the amount against which an asset can be replaced or a liability can be discharged in the normal course of business between a voluntary buyer and a voluntary seller, who have access to the information necessary for conducting a transaction. Although tradable assets in the funds' asset portfolio are currently revaluated on the basis of fair value, several types of nontradable assets still exist that are revaluated at adjusted cost. At the end of 2004, these accounted for 56 percent of institutional investors' assets.[16] The assets in question are deposits, loans, nontradable bonds and nontradable commercial papers.

Under the Finance Ministry's new reporting directives, the method of revaluating nontradable assets will be changed with effect from April 2005. All institutional investors will have to revaluate their nontradable assets in accordance with their fair economic value. The new method will apply to deposits, loans and nontradable bonds. The revaluation will be made only for assets that were issued or purchased after August 2003 (except for earmarked bonds in the established pension funds). The revaluation will be calculated by means of future cash flows that are expected from the assets and the discounting of each flow on the basis of the appropriate yield rate, according to the level of risk and period to maturity. The 'Sha'arei Ribit' ('Interest

[16] Provident funds, advanced study funds, pension funds and life insurance plans.

Rates') company that was chosen by the Finance Ministry, will supply quotations on risk-free interest rates and risk premiums for the purpose of revaluating nontradable assets for institutional investors. The new revaluation method based on fair value will enable members to obtain the closest value to the real economic value of an asset, and is likely to prevent investment decisions that are not a real economic basis, subsidization between members and other problems.

The new method assures full objectivity in all matters concerning the calculation of the fair value of similar assets. As a result, a deposit or loan that institutional investors granted to a corporation will be revaluated on the basis of uniform interest rates that are matched to that corporation in accordance with the interest rate quotations. In addition, the move to the new revaluation method is expected to reduce institutional investors' incentive to invest in nontradable assets in order to moderate the volatility in their returns.

d. Increasing the rate of deposits in pension saving instruments

As part of the government's policy of encouraging saving for retirement age, the income tax ordinances relating to an increase in the rate of deposits in pension saving instruments have been amended. The amendment permits an increase in the rate of deposits allowed for all pension saving instruments (provident funds, executive insurance policies that are approved as provident funds, and established and new pension funds), to a uniform rate of 7 percent of the employee's wage for deposits by the employee and 7.5 percent of the employee's wage for deposits by the employer. The amendment became effective from January 2005 and for established pension funds, from January 2004. The amendment means that it will be possible to increase tax-exempt saving, and thereby benefit from improved retirement conditions and from larger amounts of saving for pension purposes. The unification of the level of deposits in all forms of pension saving will also make it easier for members and employers to compare between the different forms of saving, and will increase the competition between those offering them.