

– POSITION PAPER –
FOREIGN INVESTMENT BY INSTITUTIONAL ENTITIES –
CURRENT STATUS, IMPLICATIONS AND PROPOSED
SOLUTIONS

1. Introduction

During 2001-2002 comprehensive reforms were instituted regarding investment rules for pension funds, provident funds and insurance companies. One of the main principles of these reforms was cancellation of the various quantitative barriers that had applied to investments by institutional bodies in various assets. Included in this was the cancellation of the quantitative barrier that had applied to foreign investments by institutional entities.

The theory underlining the cancellation of this barrier stemmed from the urgent need to reduce the geographic risk from the high dependence of these institutions on the local capital market and its performance. Canceling this barrier was a complementary measure to the reform instituted in recent years to the Supervision of Foreign Currency Law, which had also rescinded barriers concerning overseas investment by institutions.

Under the cancellation of the quantitative barriers, including the prohibition of financial investment abroad, various restrictions were introduced to ensure the stability of the institutional entities and the manner in which they managed their investments, as well as the ability required to make sound investment decisions. The purpose of these restrictions was to guarantee an entity's ability to properly and professionally cope with the various risks that typify the assets of such institutions.

At the end of 2005, a further amendment was instituted to investment rules by veteran pension funds. Part of this amendment rescinded the prohibition against investing outside of Israel, and instead the funds were permitted to invest a certain percentage of their assets in foreign markets as well.

The globalization and liberalization processes taking place in Israeli's economy, the growth in assets of institutional entities in recent years, the changes in investment rules, tax reform that came into effect in 2005 with regard to foreign investments by provident funds – all of these measures were aimed at encouraging managers of institutional entities to greatly increase the scope of their investment in foreign assets. This holds true both for monies from members and insureds, and nostro accounts of the insurance companies, which are supposed to cover their various liabilities.

Despite the changes mentioned above, the issue of geographic risk has yet to be resolved: there is still a high level of dependence on Israel's capital market, and institutional entities continue to stick close to the local market and invest the vast majority of their assets there. Thus, even if the distribution of these entities' monies

were to improve, it is still limited and certainly doesn't provide a real solution for the numerous risks that stem from the almost exclusive exposure in the local market. Furthermore, the claim has recently been raised that institutions prefer to focus mainly on yield, ignoring the geographic risk to a certain extent. There may be cases where institutional entities prefer to invest in the local market, which may give them a higher yield, while ignoring the geographical risk. This is compared with the alternative of investing outside of Israel, which may give them a lower yield but is better in terms of the geographic risk and allows them to reduce the fluctuations in their investment portfolio in times of crisis.

Statistical data, especially numbers that compare Israeli institutions with foreign institutions, indicate that the rate of foreign investment by Israeli institutions is low:

Table A: Scope of foreign investment by Israeli and foreign institutional entities, as of December 31, 2005

	<u>Total Assets (in NIS billions)</u>	<u>Rate of foreign investment out of total assets*</u>
A. Provident funds	237	6.1%
B. New pension funds	30	3.5%
C. Profit-sharing insurance policies	71	13.3%
D. Veteran pension funds	142	0.2%
Weighted average (A – D)		<u>5.2%</u>
Weighted average without veteran pensions (A – C)		<u>7.5%</u>
Additional data		
Investments by European pension funds abroad**		<u>26.5%</u>
Investment by American pension funds abroad**		<u>11.1%</u>
Mutual funds in Israel	125	<u>12.9%</u>

Insurance companies		
	<u>Total balance (in NIS billions)</u>	<u>Total</u>
Equity of insurance companies	13	<u>5.4%</u>
Investments in assets against equity of insurance companies	8	<u>8%</u>
	<u>Total balance (in NIS billions)</u>	<u>Share by reinsurers</u>
Assets against liabilities in general insurance	45	26.8% (of this, about 22% reflects the share of the reinsurers)
Investments in assets against liabilities in general insurance	29	7.2%

* When calculating the rate of investment abroad, investments in Israeli assets overseas were not taken into account.

** Data was taken from Table 2.

Source: Figures from the Capital Market, Insurance and Savings Division

All of this highlights the need to discuss the question of whether the measures taken in recent years have removed the barriers that prevented institutional entities from increasing their investment abroad, and whether additional steps may be needed in order to apply a policy of broader distribution of investments by institutions overseas, both in terms of monies from their savers and in terms of their nostro accounts.

This document describes the implications of the low rate of foreign investment by institutional entities, and the risks this entails. The document also refers to the barriers that still exist and which limit foreign investment opportunities for institutional entities.

The final section of this paper contains a summary with a proposal for a decision on this matter.

2. Risks of excessive interdependence between the performance of the local capital market and the behavior of institutional entities

Israel's capital market has withstood several extreme events over the years, which have been characterized by a sharp drop in share prices:

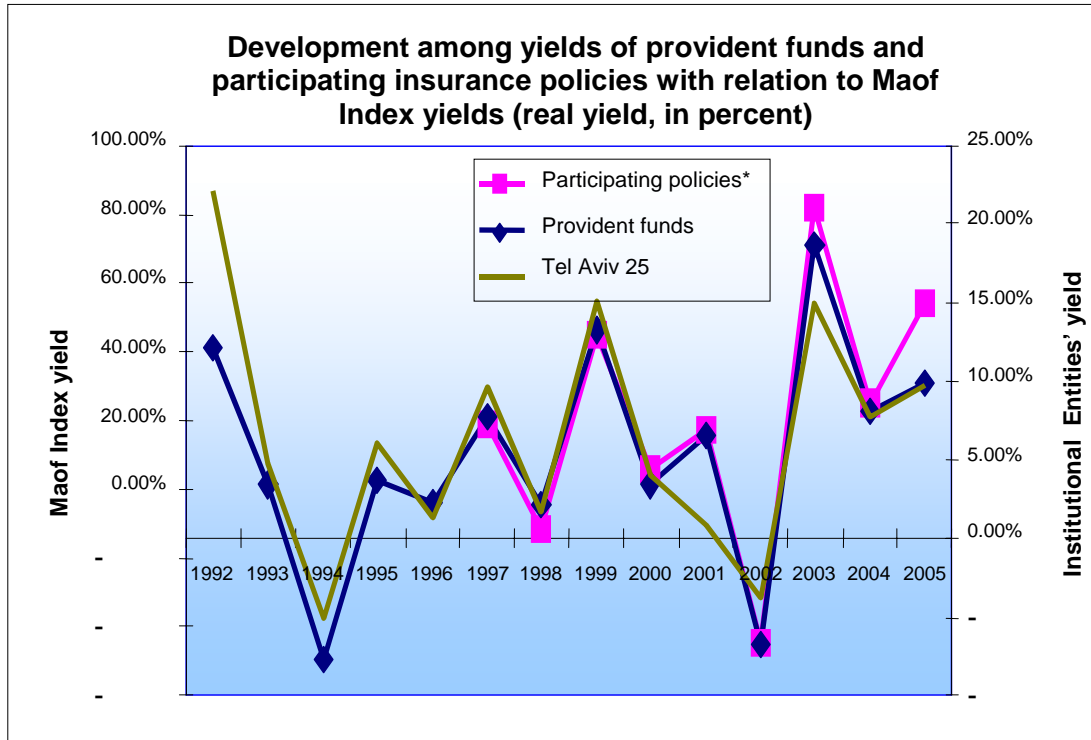
- A. In January-February 1981 there was a significant drop in the value of free shares. During this period these shares lost about 25% of their value in nominal terms (about 30% in real terms).

- B. "Bank shares price regulation" – the crash of October 1983 led to the closing of the Tel Aviv Stock Exchange and a halt in trading. That year, the price of shares of commercial banks dropped some 50.2% in real terms just around the time of the crash (until the crash, for the nine-month period preceding October 1983, these shares had risen by 8.6%). Other shares, not including the bank shares, dropped in real terms that year by 80.3%.

- C. The stock market crisis in 1994 led to a real decline in the Maof Index of 37.4%, and the General Share Index also dropped (in real terms) by 47.1%. That year, provident funds posted a **negative** gross real yield of about 7.7%.

- D. The stock market crisis of 2002, the bankruptcy of the Bank of Commerce and the Industrial Development Bank, the increase in the banks' loan loss provision that threatened the stability of the entire banking system – all of these jeopardized the robustness of the Israeli economy during that period of time. The Maof Index dropped in real terms by 31.7% that year, and the provident funds and insurance companies posted a **negative** gross real yield of 6.79% and 6.62%, respectively.

Studying the correlation between the yield on participating life insurance portfolios and the share price index between 2003-2004 gives us a statistical correlation of 80%. If we examine the correlation with the provident funds, we see an even higher rate of 90%. The results of this correlation are reflected in the following graph, which demonstrates the excessive interdependence and the high correlation.



* Participating policies – Data as of 1997

These figures indicate the powerful relationship and the interdependence between the performance of Israel's capital market and the behavior of institutional entities. This interdependence when the Israeli economy is growing (as has been the case in recent years) is quite positive and produces positive yields to savers and companies. On the other hand, the occurrence of extreme events such as those described above, or others, such as a mass terrorist attack or an earthquake, could cause a significant shock to the capital market, instability in the markets and a mass wave of withdrawal by savers, which would worsen the crisis even more. From here it is only a short distance to severe damage to public savings and a genuine crisis in the savings market, which would immediately hurt savers in general, and retirees in particular, most of whom depend on these funds for their livelihood.

An extreme event would also have a significant impact on Israel's **entire** insurance industry: both on savings of insureds and on the company's ability to properly cope with an Israeli stock market crash.

Not only would pension savings absorb heavy losses, but the insurance company would also have to contend with additional damage to its nostro accounts: both in terms of realizing its undertakings if an insurance event were to occur (for example, in the case of an earthquake), and coping with significant losses in equity, which would have trouble keeping up with the company's liabilities.

Such events are unforeseeable, and even if the probability that they will happen is low, the institutions must deal with them.

Institutional entities abroad

Support for the importance of sending investments abroad can be found by looking at the rate of investment by foreign institutions outside their native countries. Foreign

pension funds in Europe invest an average of around 26% of their assets outside their own countries, **3.5 times** the rate at which Israeli institutions invest in other countries. These figures point to the fact that there is a tendency among European nations to increase their foreign investment over investments in local markets, in an effort to reduce the interdependence between the performance of the local stock market and the value of the institutions' assets in that country, and to significantly reduce the geographic risk by building an effective, more decentralized and global portfolio. This tendency is particularly striking, given the fact that most of these countries are larger than Israel, scattered over a wider territory and with a far lower security risk. We may assume that these markets are better equipped to handle various acute events.

However, in the United States the rate of investment is smaller – 11%, but still higher than in Israel. Moreover, in absolute terms we are talking about a very high figure of about \$660 billion out of a decentralized industry that is estimated at \$6 trillion. Among the American funds we can note the Calpers Fund, one of America's largest pension funds, which invests around 22.5% of its assets abroad.

**Table B: Investments by pension funds outside the native country, 2001
(in percent)**

	Bonds	Stocks	Total
Foreign pension funds			
Austria	5.3	11.0	16.3
Belgium	14.1	32.7	46.8
Denmark	0.6	11.0	11.6
Finland	0.0	0.8	0.8
France	5.9	2.3	8.2
Germany	2.6	5.8	8.4
Ireland	7.4	32.2	39.6
Italy	3.1	0.3	3.4
Holland	16.1	25.5	41.6
Norway	0.0	2.2	2.2
Portugal	10.0	13.0	23.0
Spain	10.6	8.6	19.2
Sweden	4.9	1.8	6.7
Switzerland	15.2	14.9	30.1
United Kingdom	3.8	23.1	26.9
Total Europe	7.3	19.2	<u>26.5</u>
Australia			<u>18.0</u>
Japan			<u>18.0</u>
United States	1.1	10	<u>11.1</u>
Israel (figures taken from Table A)			<u>7.5</u>

Source: The Asset Management Industry in Europe: Competitive Structure and Performance Under EMU by Ingo Walter, New York University and INSEAD.

3. Motives and barriers that prevent investment overseas

A) The “home bias”

Foreign investment offers institutional portfolios variety, it distributes the risk and improves their ability to cope with extreme events that may occur in the local market. Furthermore, going abroad allows these entities to specialize in markets with characteristics that differ from the local Israeli market, while becoming familiar with new financial instruments that are available overseas but not in Israel.

At this point in time, due to a variety of reasons, managers of institutional entities do not really have the ability to learn more about different capital markets around the world directly, on their own.

There are several explanations for this: Legal barriers (which, as stated, were only loosened a few years ago) that severely restricted the scope of foreign investment by institutions; taxes that applied for years to provident funds and pension funds relative to the investment income realized from foreign assets; and, of course, the positive incentive of the relative advantage to any institutional entity, whether Israeli or foreign, that invests in its own local market.

This relative advantage is, of course, only natural and is common among the most advanced markets around the world, including the American market. This advantage derives from the Israeli investment manager’s intimate knowledge of the norms and laws in his own country, and the close physical connection between the Israeli investment manager and the Israeli capital market, the way this connection logically occurs between any “foreign” investment manager and his own “foreign” capital market.

Not surprisingly, this relative advantage disappears when it comes to foreign investment, where the Israeli institution does not live and “breathe” the economic-political reality or link between this reality and the capital market. Naturally, the institutional entity loses its “home bias” in foreign markets, and thus its understanding of and familiarity with the foreign market overseas is disadvantaged in comparison with the advantage it has in the Israeli capital market.

B) “Double” management fees for managing savers’ monies in provident funds and pension funds

1) *The need to invest overseas through third parties*

In 2002, as part of the sweeping reform in investment rules for provident funds and pension funds, regulations were introduced into the Income Tax Regulations – Rules for the Approval and Management of Provident Funds (5724-1964), (hereinafter: “The Provident Reforms”) stating that the management fees paid for the investment in mutual funds by an institution and the management fees paid to an outside portfolio manager for managing (in full or in part) the institution’s monies shall be included as part of the management fees the institutions collect from their members.

The rationale underlying the aforementioned provision was the desire to provide savers with full disclosure regarding payment for the “product” (yield) “produced” for them by the institutional entity. It should be remembered that the saver is the one who pays the management fees from the balance of his assets or deposits and the institutions serve as a trustee for the savers, thus they are fully entitled to know how

much they are paying, even if only indirectly, for the management of their investments. In this regard there is no difference whether the source of the investment is in Israel or abroad.

Nevertheless, the restriction on “double” management fees apparently became a “double-edged sword” with regard foreign investment. While the legislature is always at work to achieve maximum transparency in connection with activities by institutions in general, and the issue of management fees in particular, the barrier of “double” management fees restricts the institutions in terms of foreign investment and firmly establishes the risk involved in investments by institutional entities, especially in a single capital market.

At this point in time, the main option for institutions to invest abroad is through third parties, whose permanent residence is in a foreign country, in other words, through various types of foreign investment funds, overseas portfolio managers and foreign mutual funds.

But the barrier prohibiting “double” management fees as stated in the reforms greatly prevents institutional entities from large-scale foreign investment because it affects their profit margin. Payments to the foreign mutual funds and overseas portfolio managers (hereinafter: “Third Parties”) are offset from the management fee the institutional entity charges its members and come from “the institution’s pocket” while the risk from the lack of investment diversity falls on the saver. Thus, in essence, there is a barrier built-in to the Provident Reform that acts as a negative incentive for increasing the scope of foreign investment.

Indeed, one could argue that in certain types of savings, such as provident funds, where the average management fee is lower than the overhead fixed by law, the institution can increase the management fee it takes from those saving with it and thus finance the management fees they have to pay the Third Parties. But in reality, where the issue of management fees is a key parameter in the negotiations between an institution and its savers, the chances that such a situation would actually take place are small. It would appear, therefore, that the restriction prohibiting double management fees “disables” and disadvantages the considerations of the institutional entity, insofar as these relates to foreign investment.

This is certainly true for insurance companies and pension funds, where in some cases the fee collected is fixed by law.

The statistical data shown in Table A further supports this argument. Provident funds and pension funds the operate under the restriction prohibiting double management fees tend to invest less overseas, compared with investment by participating insurance policies, where such a barrier has not yet been legislated.

Nonetheless, we must take into account the possibility that some of the gap can also be explained by the taxes that were levied until the end of 2004 on the yield from provident fund and pension fund foreign investments.

2) Fear of massive sums of money being sent abroad

Allowing the option of double management fees can raise the fear that money will begin to be sent to foreign markets and that over time, the various sectors in the Israeli capital market would be able to provide financial resources for various purposes.

The relative advantage of institutional entities regarding their familiarity with the local market, and the fact that these entities are the largest providers of loans against

Israel's national debt, tend to lessen this fear. These facts provide a suitable basis for the belief that the majority of institutional investments will remain in Israel, just as the majority of investments among institutions in other countries remain in their own local market, despite the fact that these countries have the option of charging double management fees.

According to figures from the Accountant General, the balance of the government debt as of December 2005 (negotiable and non-negotiable) came to NIS 552 billion, where the negotiable local portion of this was around NIS 254 billion. Provident funds, pension funds and insurance companies held **47.5%** of the total negotiable debt at the end of the year.

The local non-negotiable portion was NIS 153 billion, where the pension funds and insurance companies held **94%** of this debt.

3) Net yield versus gross yield

The basic argument that is almost always heard from the institutions or the savers is that the bottom line is what counts, that is, what is the net yield to be added to the member's account after deducting all the various payments, whatever they may be – securities commissions, management fees and external management fees. Therefore, the barrier of “double” management fees takes a hefty and unnecessary price just when the saver is interested in the net yield, and not the difference between gross yield and management fees.

It is obvious to all that any rational saver would prefer paying double management fees in exchange for a higher net yield over paying a lower management fee for a lower net yield, assuming an identical risk in both cases.

It can further be argued that management fees paid to Third Parties are not particularly interesting, just as the public isn't really interested in knowing the management fees charged by the bank manager when he offers savings plans to the public. Just like the car buyer isn't interested – or is less interested – in knowing the price of the car before all of the taxes have been figured in.

Therefore there is no doubt that when an institutional entity transfers monies to external management, even for the purpose of distributing risk, it does so with the knowledge that the management costs, commissions and all other expenses will be lower than the yield on the investment made by the external manager – otherwise, what would be the point in doing so.

According to this approach, it is clear that when an institutional entity that doesn't specialize in a particular type of investment, gives money to an external manager that it believes does possess greater expertise in this area, it would only improve the saver's position and certainly will not hurt him by charging “double” management fees.

4. Summary

The capital market, in cooperation with other entities, has recently been very active in encouraging institutions to increase the scope of their foreign investments.

This approach primarily hopes to reduce the institutions' high dependence on the Israeli stock market, and to cope with the increased risk associated with investing in a single market – the local market.

The underlying assumption is that in order to successfully manage this risk, institutional entities must specialize and become more knowledgeable regarding investment instruments that don't yet exist in Israel, and should become more familiar with various markets with characteristics that differ from those of the Israeli market, which will enable them to vary the products in which the institutions invest, and better handle the geographic risk.

Moreover, foreign investment by institutional entities creates reciprocal relations with the foreign markets and exposes the Israeli capital market to foreign investors and other capital markets throughout the world. Increased foreign investment by institutions boosts the attractiveness of the local market and creates a mutual flow of foreign capital. This flow helps to advance and diversify the capital market, and contributes greatly to its stability.

But for the time being, it would appear that reducing the dependence on the local market is not a realistic possibility for the foreseeable future, and perhaps measures must be instituted that will guarantee implementation of a policy the Ministry of Finance hopes to achieve.

Maintaining the status quo has significant consequences for the value of the insurance companies' assets, the value of assets held by savers in pension savings plans, and the fluctuations in these assets. These would be reflected in unusual local events that could have a severe impact on the financial system in general, and the value of savings in particular, and the ability of the insurance companies to realize their insurance liabilities as needed. These effects must be minimized as much as possible.

5. Proposed decision

After weighing all of the arguments presented above, and in an effort to find the best and most balanced solution that would provide a practical solution for all of the issues raised regarding the existing barriers and restrictions on foreign investment by institutional entities, the following measures are proposed:

A. Regarding the role of the risk manager and investment committees:

1. The “nostro” investment committees¹ of the insurance companies, and the investment committees for members/insureds of institutional entities (provident funds, pension funds and participating insurance policies) should meet at least once every quarter to discuss ways in which the institution can cope with the various aspects of geographic risk inherent in the composition of the investments made by institutional entities. The minutes from such meetings should be sent to the board of directors.
2. The institution’s risk manager shall periodically examine the impact of the geographic risk on the financial robustness of the insurance company and the ability of the insurance company, provident fund or pension fund to cope professionally with the various risks that characterize their assets. When so doing, they should assess whether the institution’s policy, processes, controls and resources:
 - A) Are able to measure and monitor the geographic risk;
 - B) Enable the geographic risk to be dispersed, limited to a predetermined level, offset, or transferred to another entity;
 - C) Are suited to the purposes and circumstances of the institutional entity;
 - D) Are consistent and comply with the policies, process and controls pertaining to other essential risks;
 - E) Are effectively implemented.

The risk manager shall present his recommendations on the subject to the institution’s director-general and board of directors.

B. Regarding the investment of monies from participating insurance portfolios, provident funds and pension funds:

1. Management fees for investment through mutual funds or a foreign investment manager shall not be included as part of the management fees

¹ “Nostro” investment committees – the committee for the management of investments resulting from the various types of liabilities, except Type 20 liabilities, which are counted under Regulation 2 of the Insurance Transaction Supervision Regulations (Methods for investing the insurer’s capital and funds, and managing its liabilities), 5761-2001.

that savers pay to the institutional entity, and shall be classified as part of the external management commissions, but only under the following cumulative conditions:

- A) The permanent place of residence of the portfolio manager or mutual fund manager is outside of Israel.
- B) The main activity of the portfolio manager or the mutual fund manager is the financial management of entities whose permanent place of residence is outside of Israel.
- C) Most of the assets managed by the said portfolio manager or mutual fund manager are invested abroad.

In other words, even a mutual fund whose management company is in Israel and invests all or part of its monies overseas, management fee payments for this will be include as part of the management fees. A similar rule will also apply on an Israeli portfolio manager who invests abroad some or all of the assets he manages.

This ruling is understood as part of the desire to create **uniform and clear standardization** regarding payments paid to Israeli funds and Israeli portfolio managers of various types, and to establish and simple and convenient mechanism for implementing the said ruling.

- 2. The statement contained in Section 1 regarding the transfer of monies by an institutional entity to be managed by a portfolio manager or a mutual fund director who is a third party to the institution, will be permitted only if written permission is obtained in advance from most of the external representatives serving on the investments committee to carry out such action, and after other, similar alternatives have been examined.
- 3. The validity of this instruction shall be for a period of three years. At the end of that time this instruction will be re-examined, looking at the changes that have taken place during the interim.

The said reforms will soon be reflected in legislative amendments.