GOVERNMENT OF ISRAEL
MINISTRY OF FINANCE

PRIVATE PENSIONS IN ISRAEL

ANSWERS TO QUESTIONS
FROM DISCUSSION NOTE OF JUNE 25, 2004

1. Licensing, supervisory methods and enforcement capacity

1.1 How is the licensing process? What are the documents required and how many licenses have been issued in the last 5 years?

New Licenses

No new licenses have been issued in the last 5 years. However:

- A number of pension plan management companies have changed owners;
- New supplemental plans (providing pensions on the basis of salaries in excess of 2 times the average national wage) have been established by already licensed pension plan management companies. Such plans are not entitled to subsidized, non-negotiable government bonds.

The Insurance Commissioner (referred to below as the **"Commissioner"**) recently received license applications for two new plans. Four existing plans are now undergoing ownership changes as a result of the 2003 pension reform.

Licensing Process

The pension plan management company must obtain an insurance license from the Commissioner.

Owners of the pension plan management company must obtain ownership authorization from the Commissioner.

The pension plan must obtain recognition of the Israel Income Tax Authority, as belonging to that class of provident funds that provide annuity benefits, in order to qualify for tax relief on contributions, investment income and annuity payments.

Documents Required for Ownership Authorization

The following information is required of each individual (non-corporate) owner of a pension plan management company:

- Declaration of all personal capital, debts and obligations, including supporting documents and certification by a certified public accountant;
- Israel Income Tax Authority certification of personal income in each of the preceding 5 years;
- Disclosure of business and financial arrangements with the pension plan management company, including services that will be provided, obligations, etc.;
- Disclosure of companies over which he/she exercises 10% or more control, supported by recent financial statements;
- Disclosure of business dealings during the preceding 10 years;
- Permanent business relationships;
- Disclosure of management of one or more of the following: insurance company; provident fund, pension plan, investment counselling firm and securities underwriting firm;
- Disclosure of each of the following, both at a personal level and regarding companies to which he/she has ties: indictments for criminal or civil offences, police investigations and bankruptcy or liquidation proceedings;
- Recommendations by bank managers;
- Police certification that there is neither a criminal record nor criminal proceedings underway;
- The level of required investment in the pension plan management company and its financing;

- Waiver of confidentiality with regard to information in the hands of the police, regulatory and tax authorities;
- Personal information, including education, citizenship etc.;

The following additional information is required of each corporate owner of a pension plan management company:

- Founding documents as filed with the Registrar of Corporations;
- Details of capital structure;
- Names of corporate officers;
- Disclosure of liabilities and guarantees;
- Financial statements for each of the preceding 3 years.

Documents Required for Insurance License

The pension plan management company must submit its founding documents including incorporation as a limited liability company.

Other Conditions for Insurance License

The pension plan management company must:

- Only engage in the management of pension plans (but may control subsidiary companies that manage provident funds);
- Maintain capital of at least $1.6 million (based on current exchange rates);
- Be governed by a board consisting of not less than 5 directors and not more than 9 directors, including at least 2 external directors;
- Establish investment and audit committees, each subject to oversight by the board of directors;
- Appoint an internal auditor.

1.2 What is the supervision approach used by the pension supervisory agency? Are there any risk-based techniques being used? If so, how is risk assessment process?

Direct supervision includes:

- Continuous monitoring of financial statements and information returns;
- Regular, on-site inspections of benefit rights, plan administration and investment management. Such inspections have generally been delegated to 3rd parties;
- On-site inspections of expenses incurred by pension plans established before 1995;
- Special audits for the investigation of possible statutory violations.

Indirect supervision includes regulations and Commissioner instructions regarding investments, disclosure to plan members, portability, permissible disability and survivor benefits, etc.

Risk-based techniques have not been used to date.

1.3 What are the criteria for application of penalties and intervention in the pension funds? Please describe how the supervisory agency enforces compliance with the regulations.

Penalties

A pension plan management company may be fined if it:

- Provides benefits that do not conform with the plan document;
- Changes premium or benefit rates without the prior approval of the Commissioner;
- Does not provide the Commissioner with a prescribed report within the time permitted;
- Issues misleading information to plan members or misleading advertising.

Intervention

Where the pension plan management company's solvency or management practice is in question, the Commissioner may:

- Limit the authority of any director, officer or employee;
- Suspend any director or officer for up to three months;
- Appoint a special supervisor of the board of directors and senior management;
- Appoint a special administrator and advisory committee to manage the insurer.

Compliance Enforcement

Pension plan management must submit:

- An annual declaration of compliance with income-tax regulations regarding the administration of the plan and the management of plan assets;
- Monthly investment statements that are reviewed by the Commissioner.

The Commissioner reviews any agreements between pension plan management and organized labor.

The Commissioner may appoint an external auditor to perform a special audit of a pension plan. The cost of this audit is borne by the plan.

A bill to expand Commissioner authority in matters of investigations and enforcement is likely to be approved by parliament. Violations of the Insurance Supervision Law and penal code would be investigated, insofar as they are within the realm of activities and entities that are already under Commissioner supervision.

2. Governance

2.1 What are the main governing and supervisory bodies of the fund (e.g. general assembly, trustees, board of directors, board of supervisors, pension fund managing company, monitoring commission, etc)? What is the general composition of the governing boards? Are there minimum number of members and criteria of representation for employers, employees, government and others?

Governing and supervisory bodies of a pension plan include the annual shareholders meeting, the board of directors, board-appointed investment and audit committees, operational management of the pension plan, internal and external auditors.

The board of director must consist of not less than 5 directors and not more than 9 directors, including at least 2 external directors. Organized labor representatives are prohibited from serving on the board, in order to prevent preferential treatment of represented members by comparison to other plan members. There are no other criteria of representation for employers and employees. Government is not represented on the board.

2.2. What are the legal provisions regulating auditory, custodian and actuarial services? Are pension funds required to appoint custodian agent, actuary, and auditor? Who appoints them? Are these persons/institutions internal or external to the pension fund? What persons/institutions can provide these services to pension funds? What are the main responsibilities of custodians, actuaries and auditors?

Audit Services

An internal auditor must be appointed by the board of directors. The auditor need not be an employee of the pension plan. Qualification requirements are specified in the Internal Audit Law. The internal auditor is required by the Insurance Supervision Law to check that pension plan management operates within the law, according to Commissioner instructions, efficiently and according to proper business practices.

External auditors are certified public accountants who are appointed at the annual shareholders meeting. They are required by Commissioner instructions to perform an audit of the annual financial statements of the pension plan, including assets and liabilities to members, retirees and beneficiaries.

Custodial Services

There are no legal provisions regulating custodial services to pension funds. Typically, a bank or member of the Tel Aviv Stock Exchange is appointed custodian by senior plan management.

Actuarial Services

The pension plan management company must appoint an actuary. Typically, the appointment is made by senior management, although consideration is being given to requiring appointment by the board. The "appointed actuary" need not be an employee of the pension plan.

Qualification requirements are not specified by current legal provisions, but will be included in amendments to the Insurance Supervision Law, soon to be submitted by the Commissioner.

Income tax regulations require the appointed actuary to perform an annual valuation of the pension plan. The actuary's report and opinion is published as part of the audited annual financial statements of the plan.

Peer Review

Starting in 2004, there are "peer review" requirements for the actuarial reports of insolvent pension plans that were established before 1995. Each plan must appoint an independent, external:

- Actuary to review the assumptions, methodology and controls employed by the appointed actuary;
- Data management expert to review the quality of membership data provided to the appointed actuary.

Similar requirement will be introduced to other pension plans in the near future.

2.3. How are conflicts of interests identified and addressed?

Potential conflicts of interest are addressed by the following requirements:

- Board of directors - as noted above, organized labor representatives are prohibited from serving as directors;
- Investment committee - a committee member may not also serve on the investment committee of any other pension plan, insurance company or provident fund;
- Chief executive officer - must submit an annual declaration of compliance with relevant income tax regulations. These include a fiduciary responsibility to plan members for the management of plan assets;
- Medical committee - each claim for disability benefits under the pension plan must be evaluated by a medical committee. Members of the committee must be independent of pension plan management;
- Actuarial report - the actuary must disclose any business ties to the pension plan;
- Commissioner - reviews reinsurance agreements; investigates complaints of plan members.

2.4. Are there any provisions regulating pension fund's administrative costs? In the case of the competition between pension plans established after 1994, is there any regulation regarding market strategies (e.g. marketing, minimum information standards)?

Administrative Costs

Annual administrative charges are limited as follows:

- For insolvent plans established before 1995, the sum of:
    a. 3.5%-4.0% of contributions, depending on the size of the plan;
    b. 1.5%-2.0% of pensions paid, depending on the size of the plan.

  Other percentages may apply, subject to Commissioner approval;
- For plans established after 1994, the sum of:
    c. 6.0% of contributions;
    d. 0.5% of the value of assets under management.

Market Strategies (Plans Established After 1994)

There is little regulation regarding market strategies. Promotional material is inspected by the Commissioner in response to consumer complaints.

3. Investments

3.1. Please provide in details the quantitative investment restrictions applied to the different types of pension plans.

Non-Negotiable Government Bonds

Until 2003, every pension plan established before 1995 was required to invest at least 93% of its assets in non-negotiable government bonds. Every plan established after 1994 was required to invest 70% of its assets in such bonds.

Starting in 2003, no pension plan may invest in new issues of non-negotiable government bonds, until its existing stock of such bonds declines to 30% of its assets.

Plans Established Before 1995

After the share of non-negotiable government bonds in the investment portfolio of the plan reaches its ultimate level of 30%, the allocation of permitted investments will be as follows:

Percent of Plan Assets	Permitted Investment
30%	Non-negotiable, subsidized government bonds
50%	Negotiable government bonds
13%	Negotiable government bonds, loans and deposits rated A or above
7%	Subject to the same limitations described below for plans established after 1994

The above restrictions on investments other than non-negotiable government bonds are likely to be eased in the near future.

Plans Established After 1994

The following percentages apply to the total value of assets not invested in non-negotiable government bonds. At most:

- 5%-10% may be invested in a single corporation, depending on its credit rating;
- 10% may be deposited as collateral for options, futures and short-selling;
- 3% may be invested in a single real estate property.

The plan may not hold more than a 10% controlling interest in a single corporation.

There are no limitations on foreign investments in countries rated A- or above.

3.2 According to the report around 90% of the pension funds assets (established before 1995) are invested in non-marketable government bonds. Please specify the contents of the 2003 legal provisions oriented to diversify the pension fund portfolio.

Please refer to our answer to question 3.1.

3.3 In Israel, pension funds shall invest a minimum of 30 per cent of the assets in non-marketable government bonds with subsidized rate of interest. What was this subsidized annual rate in 2003? How do you valuate the non-marketable financial assets in the pension fund's account? Are there any other legal provisions mandating pension funds investments (e.g. infra-structure, social assistance, government projects)? Please justify why minimum limits have been adopted.

Maximum 30%

In Israel, pension funds shall invest a **maximum** of 30% in non-negotiable government bonds, as explained in our answer to question 3.1.

Subsidized Annual Rates

The current stock of non-negotiable government bonds bear an inflation-adjusted, annual yield to maturity of:

- 5.57%, for pension plans established before 1995;
- 5.05%, for pension plans established after 1994.

New issues will bear an inflation-adjusted, annual yield to maturity of 4.86%.

Valuation of Non-Negotiable Government Bonds

Insolvent Plans Established Before 1995

Beginning with the December 31, 2003 actuarial reports, non-negotiable government bonds are presented at "fair value". That is, inflation-adjusted, par values are adjusted by the present value of projected future differences between interest payments at 5.57% and interest payments at the "risk-free", valuation rate (4% per year for the 2003 valuation). This adjustment is calculated by the plan actuary using an asset and liability cash flow projection, in order to take into account any early redemptions that may be required for the payment of pensions. The adjustment also represents the present value of the future government subsidy embedded in the coupon yield of the bonds.

Other Plans Established Before 1995

Similar requirements will be introduced to these plans in the near future.

Plans Established After 1994

Non-negotiable government bonds will continue to be held at their inflation-adjusted historical values.

If instead, fair value accounting was adopted for such bonds, the following would result:

- Non-negotiable government bonds are purchased from the Bank of Israel at par value;
- The fair value adjustment described above for *Insolvent Plans Established Before 1995*, capitalizes the value of the government subsidy, thereby creating an immediate "investment return" at the time the bond is purchased;
- Eventually, 30% of current-year contributions to the plan will be invested in non-negotiable government bonds;
- Consequently, fair value adjustments would likely be a significant component of the investment return on current-year contributions to the plan;
- The overall rate of return on plan assets would then depend on the ratio of current-year contributions to total accumulated assets. Newly established plans would tend to report higher rates of returns than older plans. This result is undesirable, since plans established after 1994 compete for members partly on the basis of their investment returns.

Other Mandated Investments

There are no legal provisions that require pension fund investments in infra-structure, social assistance or government projects.

3.4 Why isn't foreign investment permitted?

Please refer to our answer to question 3.1.

3.5 Are there any initiatives oriented to implement socially responsible investment (SRI) criteria in the pension fund investment strategy?

There are no initiatives to introduce SRI criteria to the investment policy of pension plans.

3.6. Are the pension funds required to use asset-liability or a similar risk management model? Please specify.

Pension Reform and Risk Management

As noted under question 3.1 above, the proportion of pension plan assets to be invested in instruments other than guaranteed-yield bonds is increasing dramatically. Asset liability management and investment risk management will become correspondingly more important.

Insolvent Plans Established Before 1995

Commissioner instructions are being developed that will cushion the effect of actuarial losses that may arise from the mismatched durations of assets and liabilities, or from unanticipated rates of investment return. Such instructions will be introduced in time for the December 31, 2004 actuarial valuations.

Nevertheless, there remains an important role for pension plan managers in creating and executing optimal investment strategies.

Plans Established After 1994

These are defined contribution plans until the time of retirement. At retirement, the member's account balance is converted to an actuarially equivalent life annuity that is payable from the plan.

Commissioner instructions include a simple asset liability model for retirees and beneficiaries:

- Assets held against retiree and beneficiary liabilities must be segregated, in order to facilitate a separate, appropriate investment strategy;
- Dynamic interest rates must be used for the valuation of retiree and beneficiary liabilities.

Consequently:

- Even a naïve long-term investment strategy will generally produce a good match between asset and liability durations;
- Retirees and beneficiaries will be substantially immunized from interest rate risks.

Nevertheless, there is an important role for plan managers to optimize the level of immunization.

4. Rights of beneficiaries and information disclosure

4.1 How can members seek redress in case of damages (e.g. unpaid contributions, forfeit benefits, fraud, etc.)

The Salary Protection Law obligates a pension plan to sue any employer who fails to make required contributions.

In some cases, an employee who voluntarily terminates his employment will forfeit those contributions of the employer that were made on account of severance payments. Otherwise, benefits may not be forfeited.

In cases of fraud, members may seek redress from the Labor Court.

4.2. Are pension funds required to disclose to members a minimum set of information? Please state the type of information and regularity that the pension fund has to provide to participants according to disclosure rules.

Each plan member must be provided with an individualized annual statement. Existing requirements are being updated and harmonized with those of insurance savings policies and other provident funds. For pension plans established after 1994, draft Commissioner instructions would require the member's statement to include the following:

- Individual account balance;
- Estimated accrued pension based on conversion factors currently in effect;
- Contributions and benefit payments made during the year just-ended;
- Average rates of administration charges for the plan as a whole and for the individual member;
- Rate of return on assets for the plan as a whole and for the individual member, net of administration costs;
- A description of pre-retirement death and disability benefits.

Instructions concerning information to be provided to prospective plan members will be introduced by the end of 2004.

4.3. Is portability permitted between all types of plans (e.g. defined benefit, defined contribution, pre 1995, post 1994, etc)? If so, please explain how it operates.

Plans Established After 1994

Plan members may transfer accumulated assets between plans established after 1994.

Plans Established Before 1995

There are mutual agreements between most insolvent plans established before 1995 that enable members to transfer from one plan to another without loss of benefits.

In the past, it was possible for members of insolvent plans to transfer to solvent plans. A temporary Commissioner order prohibits such transfers. The prohibition will be removed in the near future.

5. Design issues and future developments

5.1. How are the pension plans for government workers and the provident fund structured? What are the regulatory and operational differences between these types of retirement savings vehicles and general pension funds?

Public Service Pension Plan

The public service pension plan is an unfunded defined benefit plan, financed from general government revenues on a pay-as-you-go basis. Plan benefits are relatively generous and defined in legislation. The plan is not subject to Commissioner supervision.

Most new public sector employees, including all new government workers, are ineligible to join the plan. They may join funded, private pension plans.

Provident Funds

Pension plans constitute a special class of provident funds; namely, provident funds that provide annuity benefits. Other provident funds are savings vehicles that do not contain an insurance element. As such, they do not require an insurance license or the administrative infrastructure of a pension plan. They are not eligible for non-negotiable government bonds, and offer somewhat different tax incentives to employers and employees.

5.2. Please provide more details on the current proposal to introduce a mandatory retirement savings component in the private pension scheme. What is the proposed design for the overall pension system? What type of institutions might operate the mandatory scheme? What are the proposed governance and investment regulations?

Objective
To assure a level of post-retirement income that is adequate and not excessive, for all working residents of Israel.

Target Population
Low-salaried employees for whom there would otherwise be no employer contributions to retirement savings.

Mandatory Insured Salary
Up to approximately the minimum wage (minimum wage is defined as 47.5% of the average national wage).

Institutions That Would Operate the Mandatory Scheme
Existing pension plans. Possibly life insurance savings policies and other provident funds as well.

Proposed Governance and Investment Regulations
No change to existing regulations.

Proposed Tax Incentives
No change to existing incentives.

Legal framework
New legislation or national collective bargaining agreements.

Funding
Employer and employee contributions; it is possible that employee contributions would be optional.