

Contractual savings institutions in Israel



CONTRACTUAL SAVINGS INSTITUTIONS IN ISRAEL IN 2004 AND THEIR LONG-TERM DEVELOPMENT¹

The array of financial institutions in Israel includes the banks, which dominate the activities in the financial sector, the institutional investors, mostly comprised of the long-term contractual savings institutions – provident funds, pension funds and insurance companies engaging in life insurance – and other financial bodies (mutual funds, portfolio managers, underwriters, etc.).

In recent years, the importance of the non-banking financial institutions has increased, particularly the importance of the contractual savings institutions. This development is due to the public's increased awareness of the importance of long-term savings, inter alia, thanks to the increase in the variety of products available to the public, and thanks to a certain upgrading of the financial markets in Israel.

Thus, the value of the contractual savings institutions' asset portfolios rose by about 7% in 2004, and its composition changed slightly: the weight of earmarked bonds (non-negotiable credit to the government) decreased and investments were diverted to the negotiable market – mainly to private bonds and stocks. However, the upsizing of this component was affected during the past year (as in the preceding year) by rises in the securities' rates compared to the yield that such an investment had gleaned in alternative channels.

These developments should contribute to an increase in the return to investors or to individual savers. These developments also add a significant factor to the Israeli capital market, which should contribute to the development of the economy, by diversifying and decentralizing the financial sector, while reducing the government's direct involvement in financial market activities. The legislature enacted in order to carry out the recommendations of the Bechar Committee, which severs the banks from the provident funds and mutual funds, is likely to prevent abuse due to potential conflicts of interest in the financial bodies' activities. Furthermore, competition and transparency have been enhanced, thanks to the significantly improved regulations regarding fair disclosure that were implemented during the past year. All these measures advance the development of a more efficient and modern capital market.

1. This chapter was written by the Information and Development Department

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001 Introduction

The financial intermediation system includes commercial banks, institutional investors – provident funds, pension funds, insurance companies – as well as direct transactions amongst the public *inter se*, through intermediaries, mutual funds and portfolio managers. In recent years, the non-banking financial institutions (NBFIs) – and particularly the institutional investors (mainly those managing long-term contractual savings), such as pension funds, provident funds and insurance companies² - have become an important component of the financial sector. This development is in line with the significant changes that took place in recent years, which led to the expansion and deepening of the financial markets.

The shifting of financial intermediation from the banks to the capital market and to other financial intermediaries is customarily called “disintermediation.” This phenomenon, which is part of the financial growth of modern economies, gives its indications both on the side of the banks’ sources and on the side of their uses. Thus, an increasing number of depositors has been opting to invest much of its money in alternative assets to bank deposits, including direct investments in the stock exchange and deposits with non-banking financial intermediaries – insurance companies, provident funds and pension funds. Many business firms are recruiting capital on the stock exchange through securities or from other financial intermediaries, who use the funds accruing with them instead of obtaining credit from banks³.

The increase in the substitutions between the types of financial instruments reflects the integration of the financial services, within which scope financial institutions (banking and non-banking) are expanding their financial services and providing for a wider variety of customers’ needs, beyond the traditional scope of their businesses.

The background to the development of alternatives to banking intermediation includes the economic growth in developed countries, the increase in publicly held assets and the rising complexity of the capital and money markets around the world. These have led to a rise in the public demand – by both companies and individuals – for more types of services and

2. Although mutual funds are considered institutional investors, due to their characteristics, investments through them are not defined along with contractual savings: the majority of investments in mutual funds is short-term and, therefore, the assets contained in them are characterized by relatively high liquidity.
3. The NBFIs can use the monies accruing with them for investing in securities as well, and thus, can compete with the banking financial intermediaries.

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financial assets. The rise in the demand has propelled the expansion of the financial sector and has accelerated financial innovation. Significant changes have occurred on the supply side as well: the rapid advancement of technological innovation has significantly reduced the cost of executing information-intensive operations, has diminished the banks' relative advantage in this field, and has enabled different types of companies to supply financial services to the public with a wide variety of yield, risk and liquidity levels, and to compete with the banks. This phenomenon has also forced the banks to change the composition of their operations – to base themselves less on their tradition capacity as recruiters of deposits and as credit providers, and to expand the variety of financial services they are providing to customers.

The scope and depth of the disintermediation phenomenon depend primarily on exogenous factors – the statutory framework and the regularization of the bodies' activities in the capital market – however, they also depend on endogenous factors: the depositors' considerations regarding the composition of their asset portfolios in terms of the yield, risk and liquidity; the financial intermediaries' considerations regarding the mix of the financial services they are supplying to the public, subject to the restrictions imposed on them; the business firms' considerations when choosing amongst the financial intermediaries for the capital market for financing their operations. The developments described above reflect the growing sophistication of the financial sector and a different and more efficient allocation of sources, which contribute to the welfare of the economy.

The development of the contractual savings institutions has a real, direct and indirect impact on the development and the efficiency of the financial markets within the scope of the disintermediation process, alongside their contribution to the economic growth of the economy. These influences reflect the main function that the institutional investors fulfill today in the financial markets, relating mainly to the changes in the supply sources in the economy, and particularly to the increase in the long-term supply sources. They are also consistent with the increase in the demand for capital-market-based instruments and with the development of the markets for trading in financial assets. Development of the institutions managing contractual savings increases the liquidity in the financial markets, and thus contributes to the deepening of these markets and to improving the financial structure of companies (and governments). The indirect impact of the development of contractual savings relates to the increase in financial innovation, which, in turn, has a positive impact on other financial intermediaries and business corporations.

During the last decade, reforms in the money and capital markets were instituted in Israel, which, *inter alia*, encouraged displays of disintermediation: the government's gradual exit from the capital market, the dismantling of statutory and regulatory obstacles in the financial markets, and mainly, measures to expand the non-banking financial intermediaries' freedom of action. All these helped to develop the capital market: the permission granted to institutional investors in Israel to increase their investments in stocks and private bonds has greatly increased the demand for them, while the easements granted to corporations when issuing securities has increases their supply.

These phenomena are reflected in the composition of the public portfolio of financial assets: the volume of publicly held securities has increased, while deposits in financial assets in banks (in shekel deposits and savings plans) have diminished. Nonetheless, the contractual savings institutions' share in the total financial activity has remained relatively stable. This stability does not necessarily mean that the activity by the contractual savings institutions is completely stable, since the entire asset portfolio has grown rapidly. Indeed, a substantial rise in the assets of the contractual savings institutions has been recorded in Israel in recent years, such as provident funds and pension funds, concurrently with the said stability in the weight of these institutions' assets in the total financial assets of the public.

Moreover, in recent years, a number of important reforms have been formulated, whose objectives are to enhance competition and improve the efficiency of the financial markets in Israel, by reducing the high centralization in them and by reducing the conflicts of interest inherent in the activities of financial intermediaries. The main reform is the reform in the capital market (the Bechar Committee report). The legislative procedures required to implement this reform were completed in July 2005. It appears that the implementation of these reforms, and mainly, the implementation of the recommendations of the Bechar Committee, should increase the institutional bodies' participation in the financial markets and augment their share in the public portfolio of monetary assets. This development, which is expected to cause the creation of alternative channels to the banks, expresses the potential competition inherent in the financial system. Realization of this potential should increase the system's efficiency, and through this – accelerate growth, for the welfare of the public.

In the following chapter, the developments in the spheres of activities of controlled bodies will be analyzed, both during the period under review and over the long term. We will address four main aspects pertaining to the activities of the contractual savings institutions

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in general, and in Israel, in particular: the role of contractual savings and its contribution to the development of financial markets and to economic growth, including a discussion of its unique economic parameters (Section 2); the characteristics of the contractual savings market in Israel, the institutions operating therein and the changes in this sector (Section 3); a comparison of the main characteristics of contractual savings institutions in Israel with those in developed countries (Section 4); opportunities and threats that contractual savings institutions and policy-makers in Israel are facing, in light of the changes taking place in recent years in the financial system in Israel (Section 5).

2. Contractual Savings Institutions – Main Characteristics

Institutional investors (including contractual savings institutions) are counted amongst the group of financial institutions that specializes in the recruitment of funds by selling their liabilities, mainly to households, which are “savings units” (or surplus units). Opposite them, other financial institutions, mainly commercial banks, which specialize both in the recruitment of funds from “savings units” and in channeling them to “deficit units.” Moreover, the contractual savings institutions – similarly to other institutional investors, and in contrast to the banks – enjoy income originating from ongoing capital flows on a contractual basis, as well as from long-term liabilities (that is to say, without a risk of the monies being withdrawn early). The significance of both these parameters is a low risk relative to the liquidity risk to which they are exposed. However, in contrast to other types of institutional investors, contractual savings institutions enjoy tax benefits at the time of deposit, during the accrual stage and at the redemption stage; this, mainly because a majority of the assets accruing therein (individuals’ investments) are financing pensions, dependents’ allowances, disability allowances, severance pay and life insurance.

2.1 Contribution of contractual savings institutions to the development of financial markets and to economic growth

Contractual savings institutions fulfill an important role in the financial system; concurrent with the development of the financial markets, the volume of assets and their share in the public’s total assets tend to increase. As a rule, contractual savings instruments are considered illiquid instruments, and thus, they are available to the public only when certain events transpire, such as retirement, death or disability. Consequently, the savers cannot “run” to these institutions at any time and withdraw their savings⁴. It is for this reason that contractual savings institutions (such as insurance companies and pension funds) tend to adopt long-term investment strategies and keep a smaller share of liquid assets in their investment portfolios than banks and other institutional investors do (such as non-life insurance companies and mutual funds). In this way, contractual savings institutions increase the supply of long-term capital sources to the capital market – and by this, they are likely to assist in the financing of expensive projects, mainly for the long term. This development increases the demand for

4. Although, in certain instances, it is possible to withdraw from savings funds, this involves high transaction costs, since the savers in these frameworks receive tax benefits.

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securities, and thus helps to increase the depth and liquidity of the financial markets.

The main difference in the impact on the money and capital markets, between directly investing in the markets and investing through institutional investors, is in the key characteristic of these investors (mainly, the contractual savings institutions). The latter constitute a large and efficient source of financial assets. Their economies of scale enable them to add, float and manage private savings for many households, while reducing the transaction execution costs and improving the risk diversification amongst the products, sectors and regions. In this way, it is possible to maximize the individual investors' yield on any given risk profile, and thus have an impact on the financial sector and contribute to improving its efficiency.

The institutional investors enjoy a relative advantage over individual investors in all matters pertaining to increasing transparency, supervision and control. Their relatively large size and influence in the financial markets helps to reduce the problem of information asymmetry: the contractual savings institutions want to ensure that their investments will generate the highest possible yields, and therefore, they take action to monitor their investee companies. In this way, they are helping to improve the professional management of business corporations and to create symmetries and constraints in them.

The role of institutional investors in the financial markets, and mainly the role of the contractual savings institutions in managing and controlling the longevity risk and other risks of the beneficiaries (of which less are sold), which entail considerable uncertainty, encourages financial innovation, and helps to develop advanced investment strategies, such as the use of hedging and derivative transactions. These create an opportunity for modernization of the securities markets.

Besides the contractual savings institutions' contribution to the development of the financial markets and their contribution to the improvement to individuals' welfare, mainly when they retire from the workforce, contractual savings constitutes a part of the national savings, which are used to finance investments, and thus, the development of these institutions contributes to economic growth. The vast volume of savings accruing in contractual savings institutions can increase the capital supply (mainly on a long-term basis) and reduce its price (the interest rate). This change is also consistent with the reduction in the State's risk premium. Moreover, a lower interest rate encourages investment and leads to economic growth. In relatively small financial markets, such as the markets characteristic of Israel, the

impact should be more evident, since they are becoming increasingly more sophisticated, due to the proliferation of investment possibilities.

2.2 Long-term savings – economic aspects

Long-term savings, which are being managed mainly by the contractual savings institutions, are a component of the consumption and savings plan in the household life-cycle. This type of savings has known behavior patterns. Households can save for a specific purpose, such as for the purchase of an apartment, for college tuition or in order to accumulate monetary reserves in preparation for retirement. The existence of financial assets also makes it possible to bridge between periods of reduced income by using past savings. The savings – whether compulsory or voluntary – through pension funds, provident funds or insurance plans, which accumulate over a lifetime, reduce the uncertainty about the future flow of income. The principal economic approach to explaining savings is the “life-cycle theory”: an individual expends a certain sum throughout his lifetime, has negative savings during his youth and old age, and produces his maximum savings during his years of employment, in the hope that it will be sufficient for subsistence when he retires.

The main, essential household savings are long-term savings, since their purpose is to ensure a regular flow of income during periods of unemployment (mainly after retirement). This type of savings is one of the social and economic objectives for the legislature. Encouraging retirement savings is in the public interest, and its objective is to prevent the elderly and the disabled from needing social and welfare assistance from the society and from the State once they reach retirement age. The State believes that it is extremely important to assimilate the habit of saving for retirement amongst all economic levels of the public, since a portion of the public is not appreciating the importance of ensuring their subsistence in the future to a sufficient degree. It appears that this complacency is backed, to a certain extent, also by the expectation that the government will rush to their aid, if they have saved too little. The objective of the tax benefits on savings for retirement is to prevent insufficient savings for retirement, which would result in some individuals becoming a burden on the entire society.

Retirement savings in general is a special topic on the economic agenda, since the planning horizon that it involves is mainly long term – in contrast to other topics, such as the government’s fiscal policy and monetary policy, whose ramifications are mainly short-term,

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and partially, moderate-term. While the ramifications of decisions in the realm of pensions is significant in the economy only in the long term, the degree of certainty involved therein is relatively high, since the growth rate of the population and its future needs when reaching the age of retirement are more or less known. Another salient point in the discussion of long-term savings, and the future thereof, is its importance to the entire population. Every person foresees that he will reach retirement age and will need support, yet when making his decisions, he is also affected by the repercussions of the functioning of the pension system today, for example, by the way money is allocated from his wages to his pension, by the taxes he is paying to the government, by government support of his pension rights and by the allowances being paid to his family.

The functions of the long-term savings system legitimize public involvement in this household sphere. The government's intervention in contractual savings institutions has a twofold origin, both legal and institutional: in the labor laws that regulate employer-employee relations, and in the income tax laws that define a set of bodies for long-term savings – such as provident funds, pension funds and life-insurance plans – which are entitled to tax relief. The tax benefits have been prescribed by law, and are given in the form of deductions, credits and exemptions (at the deposit stage, during accrual or a combination of the two). Since the legislature subsidizes a portion of the cost of savings by reducing the tax burden on the saving public, it created many rules for approving such bodies and their management, rules for ways to invest the monies accruing therein and for depositing and withdrawing monies in and from them.

3. The Contractual Savings System in Israel

Contractual savings institutions encompass nearly all the activities of the NBF system. Although the diversity between them is great in terms of the parameters of savings, accruals and yield rates, they may also be viewed as one entity, since all contractual savings institutions serve as a long-term savings track, which is entitled to tax benefits.

3.1 The system's parameters

Contractual savings institutions focus mainly on saving for retirement and on insurance coverage of such risks as death, disability, work disability, critical illnesses and long-term care. State authorities are encouraging the activities in contractual savings, mainly by way of tax benefits and labor law regulations; and these, along with the individuals' income bracket and their employment status, constitute main considerations for customers when choosing savings products. The demand for contractual savings products is also influenced by other factors, including the public's awareness about purchasing savings for the long term, management fee rates, product quality and various regulatory amendments.

The principal products being offered in this field are the various types of life insurance, pension funds and provident funds. In life insurance, the products being offered include a savings component or death-risk insurance, or a combination of the two, and components covering other risks ("riders" in insurance jargon) may be added to them. The insurance policies are offered to individual insureds, to employers in favor of their employees, and to groups of insureds ("collectives"). The pension plans integrate savings and death-risk insurance, while the provident funds offer savings only. The main parameter differentiating between life insurance products, pension plans and provident funds is the type of engagement. In life insurance, the insurance company's undertaking *vis-à-vis* the insured is a contractual undertaking that is anchored in the insurance contract – the policy – while in pension funds and/or in provident funds, the members' rights are anchored in the fund's regulations, which may be amended from time to time⁵.

In an insurance contract, the insurance company takes it upon itself to pay the insurance

5. One must keep in mind, of course, that insurance policies (as well as the regulations of the various funds) are subject to changes in the legislative arrangements, mainly in contract law.

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benefits upon the occurrence of the insurance event, even if exogenous changes have taken place, for better or for worse, that it did not take into account within the framework of the assumptions that constituted the foundation for the policy when it was issued (such as a rise in the life expectancy and an amendment to the disability percentages and to the definitions thereof). A pension fund, on the other hand, is a type of mutual insurance amongst the members. The actuarial assumptions constituting the foundation for the members' rights are reviewed periodically according to the actual situation, and, if any change has occurred in them, for better or for worse, the members' rights are amended, and they share in any surplus in the fund or together bear the burden of any actuarial deficit therein. In a provident fund, as previously mentioned, there is no insurance risk component, and the members are entitled to the actual yield attained, net of the management fee.

Text box B-1**The structure of long-term savings in Israel**

In Israel, as in many other countries, pension savings is comprised of three principal pillars:

The first pillar is national, and includes the old-age pension of the National Insurance Institute, which ensures a minimal level of income at the age of retirement, for various disabilities, and more, and is uniform, regardless of the amount allocated before retirement. Most of the allowances that the National Insurance Institute pays are at a fixed sum for all insureds, and their rates relative to the average wage in the economy, reached about 16-27 percent of the average wage in the economy. The allocations constitute a certain percentage of the income (up to a certain maximum). The National Insurance Institute's old-age pensions ensure a minimal income for the purposes of basic subsistence, but are inadequate for a reasonable standard of living for an individual and for a family at retirement age. Consequently, households must save in additional channels and make sure they have made a rational distribution of their income over their lifetime. The savings in the second pillar, and, to a certain extent, in the third pillar, have been designed for this purpose.

The second pillar is based on allocations by employees and employers, and their purpose is to create an alternative income to wages after retirement. The government is involved in this pillar as well: the government encourages it by way of many and diverse tax benefits to the saving public, by protecting an interest rate, etc. In Israel, the pension funds, provident funds and life insurance plans comprise this pillar. The pension funds and provident funds, which engage in the area of social security, resolve only a portion of the problems of economic security that a person faces when trying to provide for his future and for the future of his family. Parallel to them, and serving to supplement them, the life insurance channel helps to resolve the problem of economic uncertainty and of providing for the economic future of an individual and his family. The life insurance channel was designed to resolve a few key problems that a person will face when the time comes: death, old age and/or retirement, disability, work disability and health-related aspects. Today, it is still not compulsory to participate in this pillar in Israel (in contrast to what is customary in many countries), but those that do save in this channel enjoy tax benefits.

The third pillar is private household savings. This is long-term savings, but not necessarily for the purpose of accumulating a pension. Provident funds are the most popular in this field in Israel. This pillar also enjoys tax benefits.

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The deposit rates eligible for tax benefits in retirement savings plans vary according to the pension intermediary or the savings framework (pension fund, provident fund and life insurance plans)⁶. The height of the eligible deposit varies according to the savings track that the employee chose (pension or benefits), according to the status of the depositor (employee or employer), according to the purpose of the deposit (severance pay or pension) and according to the pension intermediary (Table 1)⁷.

6. The savings channels are also differentiated by the interest subsidy through earmarked bonds. Today, only those saving in pension funds are partially enjoying an assured interest rate on their deposits. This is in contrast to the members of provident funds and the insureds in participating life insurance plans, since the State stopped issuing earmarked bonds to them at the beginning of the nineties.

7. For an international comparison of the granting of tax benefits for individual pension funds, see Table 7.

Table B-1

Structure of the Tax Benefits in Provident Funds for Pensions and Benefits, January 2005

	Deposit Rate (percent)			Tax Conditions				
				Upon Deposit			Upon Withdrawal	
	Provident Fund for Benefits	New Comprehensive Pension	Life Insurance Policy	Tax Benefit	Maximum without splitting	Maximum with splitting	Tax Benefit	Maximum
Employer								
1. Severance pay	8.33	8.33	8.33	Exemption	None	None	Exemption	NIS 9,980 (for each year of work ¹)
2. Benefits	7.5	0	7.5	Exemption	NIS 7,100	Combined maximum equivalent to NIS 27,856	Exemption	None
or Pension²		7.5	7.5	Exemption	NIS 27,856	(four times the average wage in the economy)	Tax exempt as per Note ³	
3. Work Disability⁴	0	0	As per Note ⁴	Exemption	None	None		
Employee⁵	7	7	7	Pension Fund – 35% credit; Life Insurance & Benefits – 25% credit	NIS 7,100 (the maximum entitled income being wage income) ⁶	NIS 7,100 (the maximum entitled income being wage income) ⁶	Tax exempt as per Note ⁷	
Total	22.83	22.83	22.83					

- Pursuant to Section 47 7.a. (a) 1 of the Income Tax Ordinance.
- For a comprehensive pension, the employee must be in the annuity track.
- Tax exempt on 35% of the pension, up to the maximum entitled pension (today, NIS 6,840 – pursuant to Section 9.a. (a) of the Income Tax Ordinance, and this, only if the employee reached the new retirement age prescribed by law – 67 for men, 64 for women), or, alternatively, a full tax exemption on that part of the pension originating in deposits previously taxed (recognized pension) – whichever is higher.
- Previously, the allocation for insurance did not include work disability insurance; in order to purchase such insurance, the employer (usually) or the employee, were required to add another allocation (between 0.5% to 2.5% of the employee's income). As of January 1, 2005, the new insurance plans prescribe that work disability insurance may be purchased within the scope of the allocations for the insurance plan itself, solely the benefits component. This allocation will entitle the employee to a tax exemption up to the height of 35% of the premium for the benefits, net of expenses. If the percentage of the benefits component in the plan is 7.5% (the employer's allocations) and 7% (the employee's allocations), and work disability insurance was not purchased, the employee will not be able to receive an additional tax benefit for purchasing insurance coverage "exceeding" the aforesaid allocations.
- Furthermore, the employee is permitted a deduction (as well as a credit) at the rate of up to 7% of the wage that does not constitute the basis for the employer's deposits, up to a wage of NIS 7,100 per month.
- This sum is equivalent to 1/12 of the maximum entitled income, as defined in Section 47 (a) (1) of the Income Tax Ordinance.
- This sum is tax exempt in the benefits track. Note 3 corresponds to an annuity track.

Source: The Tax Authority and the Capital Market, Insurance and Savings Division.

Contractual savings in Israel is conducted in two main tracks: (a) a capital track (with an option for severance pay) – a track in which, in instances defined in legislature, the monies accrued are received in a lump sum, for example, when the insured (or the member) reaches retirement age; if there are savings for severance pay, they are managed separately from the other savings, and the rules with respect to severance pay funds are applicable thereto. (b) an annuity track – a track that combines savings and insurance (old-age, disability and dependents), for which the trigger for receipt of the monies therein is an entitled event, as this term is defined in the insurance coverage purchased. These monies are received as a monthly payment and not in a lump sum, as is customary in a capital track. These tracks are offered by three contractual savings institutions: life insurance policies, which include a savings component, which enable the insured to choose in advance between a pension plan and a capital plan for the purpose of depositing the monies for benefits and severance pay; pension funds, which offer only an annuity track, and provident funds, which offer only a capital track.

Comprehensive changes have occurred in the field of contractual savings in recent years, mainly due to changes in government policy. At the foundation of the government's policy is the aspiration to encourage pension savings by the entire population in order to ensure that all citizens are able to live their lives with dignity after retiring. This change receives expression in the restructuring of the products in the field of long-term savings – that is to say, in the tax benefits and preferences given to savers, whose objective is to encourage pension savings⁸ - as well as in a number of draft laws regarding compulsory pensions. Other changes that have occurred in this field, and mainly, the acquisition of the companies managing the pension funds by insurance companies, have led to the public's increased awareness of the pension savings channels and their parameters. This development has strengthened the trends of proposing additional supplementary insurance policies ("insurance umbrellas") and of combining products in these fields. This trend is consistent with the increased integration in the supply of financial services.

The most evident advantage in retirement savings for the purpose of a pension is the element of a regular income supplement for the entire lifetime of the saver. During the period of

8. In recent months, changes in the tax rules applicable to long-term savings instruments have been implemented. Thus, it has been prescribed that the tax benefits for a capital deposit will be given only if the member exhausted his deposits to the pension pillar, or if he has a pension arrangement with his employer.

the allocation to the fund, the saver does not know how long he will live after retirement. Thanks to actuarial balancing, those whose lifespan is shorter subsidize *post factum* those with longevity, and thus, people who live long lives are ensured a pension that exceeds the pension that they could have saved by themselves. In other words: the insured purchases insurance services for a reasonable premium. In addition, the pension fund provides work disability insurance or death-risk insurance (payments to dependents).

3.2 The structure of the system

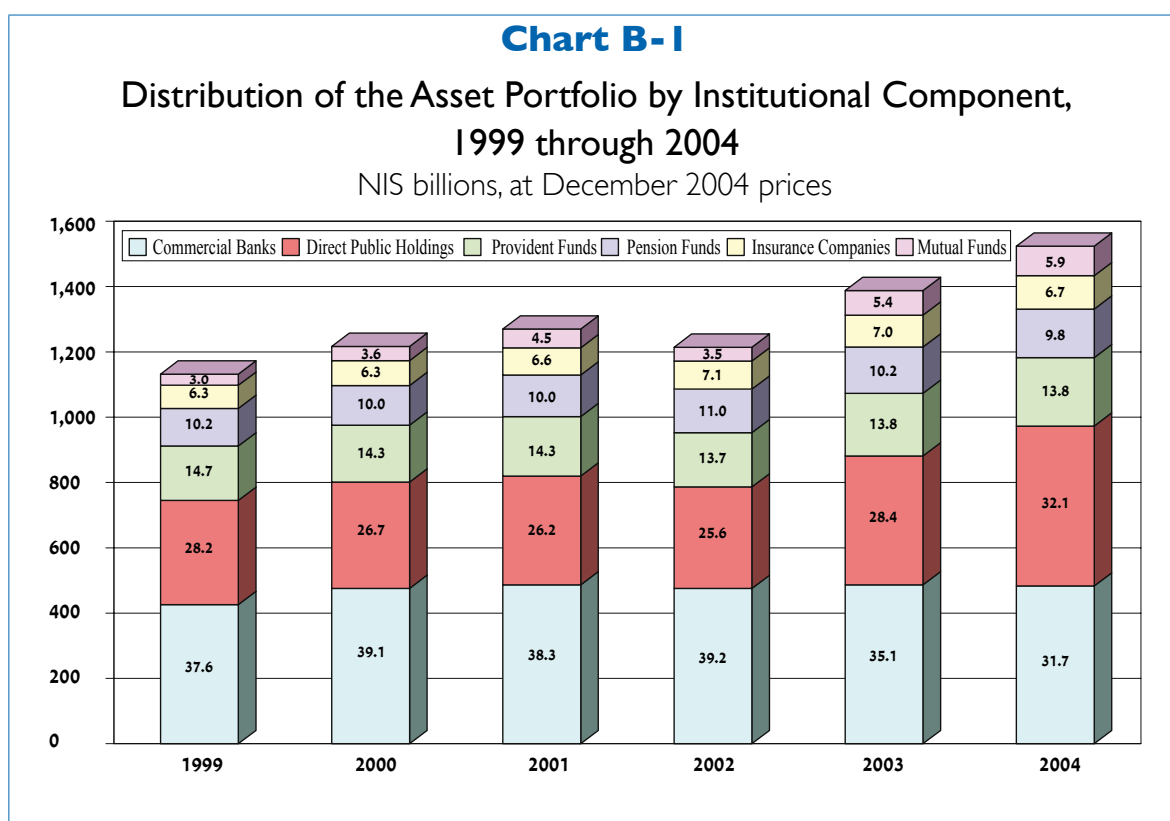
(1) Distribution of the balance sheet

The financial intermediaries who are managing the financial assets for the public in Israel are the commercial banks, the mutual funds and the institutional investors engaging in contractual savings – the provident funds, the pension funds and the insurance companies. The assets being managed by the institutional investors engaging in contractual savings for the public can be viewed as a distinct investment channel, since the public's considerations for investing in them are different from their considerations for investing in other channels.

In 2004, the value of the financial assets portfolio of the contractual savings institutions rose by about 7 percent, after a steep rise of about 12 percent in 2003, which, at the end of the year, reached approximately NIS 460 billion. However, its share in the public's total assets has remained relatively stable in recent years – about 30 percent of the portfolio (Chart 1). This outcome is explained by two principal developments that offset each other – the weight of the new pension funds and the “participating” life insurance plans rose⁹, opposite a drop in the weight of the old pension funds and of the assured-yield life insurance plans, which were closed to new members. Alongside this, similarly to the developments in previous years, the share of the banking intermediary has continued to shrink and, by December 2004, was about 32 percent of the portfolio, mainly due to the reduction in the share of the index-linked savings plans, which, during the past two years, have had negative accruals. The public holdings, directly and through mutual funds, have continued to rise: this year, they reached about 38 percent of the portfolio, compared to about 34 percent at the end of 2003, mainly due to the rise in the value of stocks in Israel and abroad – the result of the rises in rates during the year¹⁰.

9. In this section, the assets of the life insurance plans include only the investment assets, and these constitute, correct to December 2004, about 97 percent of the total assets of the life insurance plans.

10. After deducting the savings by individuals through mutual funds, the public's direct holdings in 2003 and 2004 constituted about 28 percent and about 32 percent, respectively, of the total asset portfolio.



Source: Data processed by the Information and Development Department for reports to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The various types of provident funds – funds for benefits and severance pay, study funds and other-purpose funds – are the main factor in contractual savings institutions in Israel; at the end of 2004, the assets in the provident funds totalled about NIS 209 billion, and constituted about 45.5 percent of the total assets attributable to contractual savings institutions (Table 2). At the end of 2004, 417 funds were operating in the provident fund sector, under the management of 75 bodies. The five major banking groups hold and manage most of the provident funds, however, pursuant to the laws legislated subsequent to the publication of the Bechar Committee report, the banks will be required to sell their holdings in the provident funds within three to six years.

The second largest type of institution in the field of contractual savings is the pension fund. The assets of the pension funds totalled about NIS 149 billion at the end of the year being reviewed, i.e., about 32 percent of the total assets in contractual savings (Table 2). The pension system in Israel is comprised of 18 old pension funds (which have been closed to new members since the beginning of 1995) – eight of which have been managed since

August 2003 by special managers; 19 new pension funds (which began operating in January 1995); and ten general pension funds that are not entitled to an issue of earmarked bonds. (The general pension funds were first approved in 2000.) During the past year, most of the companies managing the new and general pension funds (which had been under the control of the old pension funds, and for which a special manager was appointed) were sold to insurance companies. This development is expected to enhance and diversify the supply of services being offered to insureds.

The third type of institution in the field of contractual savings is the insurance company, operating in the field of life insurance. This year, 12 companies were operating in the life insurance line, out of a total of 25 insurance companies (Table 2); at the end of 2004, the assets of the insurance companies in the life insurance line totalled approximately NIS 102 billion, about 22 percent of the total assets attributable to contractual savings institutions. The activity in this field is conducted mainly through the five major insurance companies.

Concurrent with the engagement in the life insurance line, the insurance companies are also engaging in the non-life insurance line, within which scope the insurance companies are insuring physical assets, such as vehicles and residences against risks (fire, theft); this component also includes loss of profits insurance and credit insurance. However, the surpluses accruing in the insurance companies stem mainly from life insurance policies and from the savings associated with these insurance policies, and they are being invested – at least partially – in the capital market.

In recent years, the insurance companies have expanded the nature of their operations and began engaging in the supply of a wider variety of financial products in the economy. The process of removing the partitions between the financial intermediaries should increase the turnover amongst them and increase the competition between the contractual savings institutions *inter se* and between the contractual savings institutions and the banks.

Table B-2**Contractual Savings Institutions in Israel by Fields of Activity, 2004**

Type of Financial Intermediary	Type of Fund	Number of Institutions	Number of Controlling Bodies	Total Assets (NIS billions, at December 2004 prices)	Percent of Total Publicly Held Assets	Percent of Total Contractual Savings
Provident Funds	Benefits and severance pay	86	59	127.6	8.4	27.7
	Study funds	57	42	62.1	4.1	13.5
	Central fund for severance pay	41	39	18.9	1.2	4.1
	Other purpose	5	5	0.9	0.1	0.2
	Total	104	75	209.5	13.8	45.5
Pension Funds	Old	18	11	124.9	8.2	27.1
	New	19	11	23.9	1.6	5.2
	General	10	8	0.2	0.01	0.04
	Total	47	15	149.0	9.8	32.4
Life Insurance Plans	Participating	11 ¹	9 ¹	58.3	3.8	12.7
	Assured yield	12	10	43.7	2.9	9.5
	Total	12	10	102.1	6.7	22.2
Total				460.3	30.4	100.0

1. Excluding "AIG," because its life insurance policies contain only "pure risk" policies that do not including savings, as is customary.

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division, and for the Bank of Israel's Monetary Department data.

(2) Market concentration and competition

The contractual savings sector is characterized by high market concentration: the share of the two largest bodies in the total assets of each of the individual types of financial institutions ranges between 36.1 percent and 73.1 percent (Table 3). The reason for the high concentration in the activities in the field of contractual savings is that there are high entry barriers, which are mainly a result of institutional arrangements (such as relations with members or insureds) that were customary in the past. Another reason is apparently an expense structure having economies of scale.

Table B-3

Concentration of the Financial Sector by Financial Groups, 2004, percent

Type of Financial Intermediary	Type of Fund	Percentage of the Total Assets in the Financial Sector of the:		
		Largest Body	Two Largest Bodies	Five Largest Bodies
Banks¹	Total banking corporations	30.4	60.1	94.3
Provident Funds	Provident fund for benefits and severance pay	35.2	56.7	79.5
	Study funds	24.3	36.1	57.2
	Total Provident Funds ²	40.9	59.9	85.4
Pension Funds	New	50.3	73.1	95.5
	General	42.3	58.9	97.4
	Total New Pension Funds	50.2	73.0	95.5
Insurance Companies³	Participating Plans	34.7	57.8	96.6
	Total Life Insurance	35.4	58.5	96.8
	Total Insurance Companies	28.6	51.2	90.0

1. Also including financial institutions.

2. Including central severance pay funds and other-purpose funds.

3. Excluding data on Avner and Karmit.

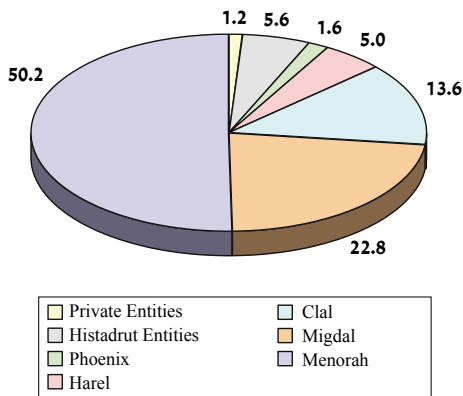
Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division, and data for the Monetary Department and Bank Control Department at the Bank of Israel.

This high market concentration is notable mainly in the field of the new pension funds, thanks to the large market share of the “Mivtachim Yoter” fund, which is controlled by the Menorah Insurance Company (Chart 2.A.). The life insurance sector is also characterized by high market concentration: the two largest insurance groups hold about half of all the assets, and the five largest groups about 90 percent (Chart 2.B.). The market concentration is also evident in the management of the provident funds – a field in which the main operators are bank subsidiaries, mainly of the five largest banking groups. These subsidiaries coordinate approximately 85 percent of all the assets of the provident funds (Chart 2.C.). Management of the provident funds by the banks involves many conflicts of interest, and therefore, within the scope of implementation of the Bechar Committee recommendations, the banks will be required to sell their holdings in the provident funds (and in the mutual funds) in the coming years. Comparison of the market concentration in the contractual savings institutions with the banking sector – the sector positioned in the center of the financial system in Israel – shows high market concentration in this sector as well; and thus, the five largest banking groups are managing about 94 percent of the banking system’s assets (Chart 2.D.).

Despite the high market concentration that characterizes each of the types of contractual

Chart B-2.a.

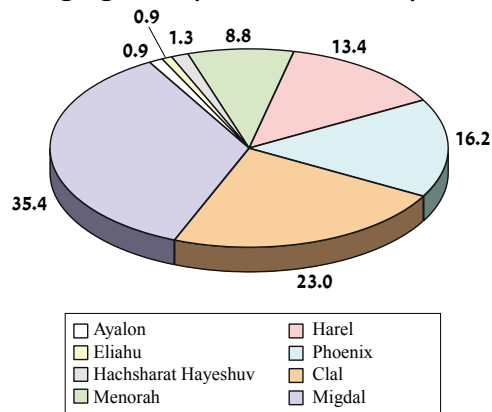
Distribution of the Assets of the New and General Pension Funds among the Fund Managers, 2004, percent



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

Chart B-2.b.

Distribution of the Assets of the Life Insurance Plans amongst the Plan Managing Companies^{1, 2}, 2004, percent

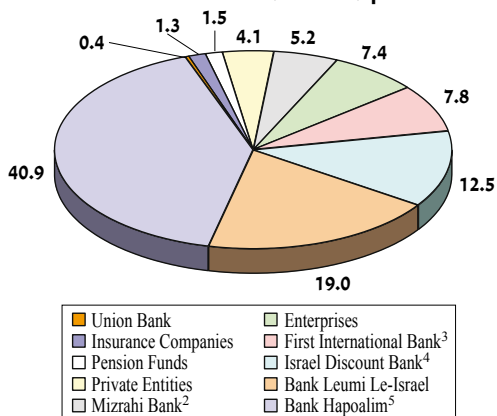


1. Data is on a consolidated basis.
2. The shares of IDI Direct and AIG reached about 0.1% and about 0.01%, respectively, of the total asset portfolio.

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

Chart B-2.c.

Distribution of the Assets of the Provident Funds¹, 2004, percent

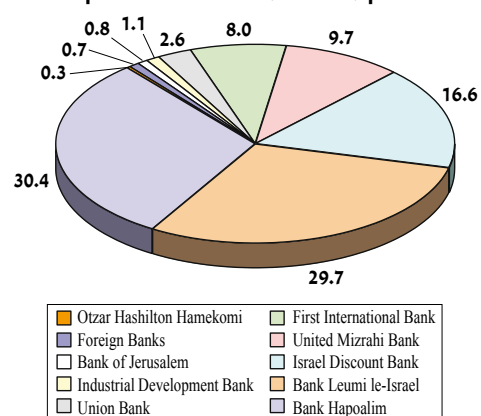


1. Under direct management (ownership of the provident funds), and under indirect management (management of provident fund investments).
2. The data on United Mizrahi Bank include the data on Tefahot Bank.
3. The data on the First International Bank include the data on U-Bank (formerly Investec Bank).
4. The data on Israel Discount Bank include the data on Mercantile Discount Bank.
5. The data on Bank Hapoalim include the data on Bank Yahav, Bank Otsar Ha-Hayal and Massad Bank.

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

Chart B-2.d.

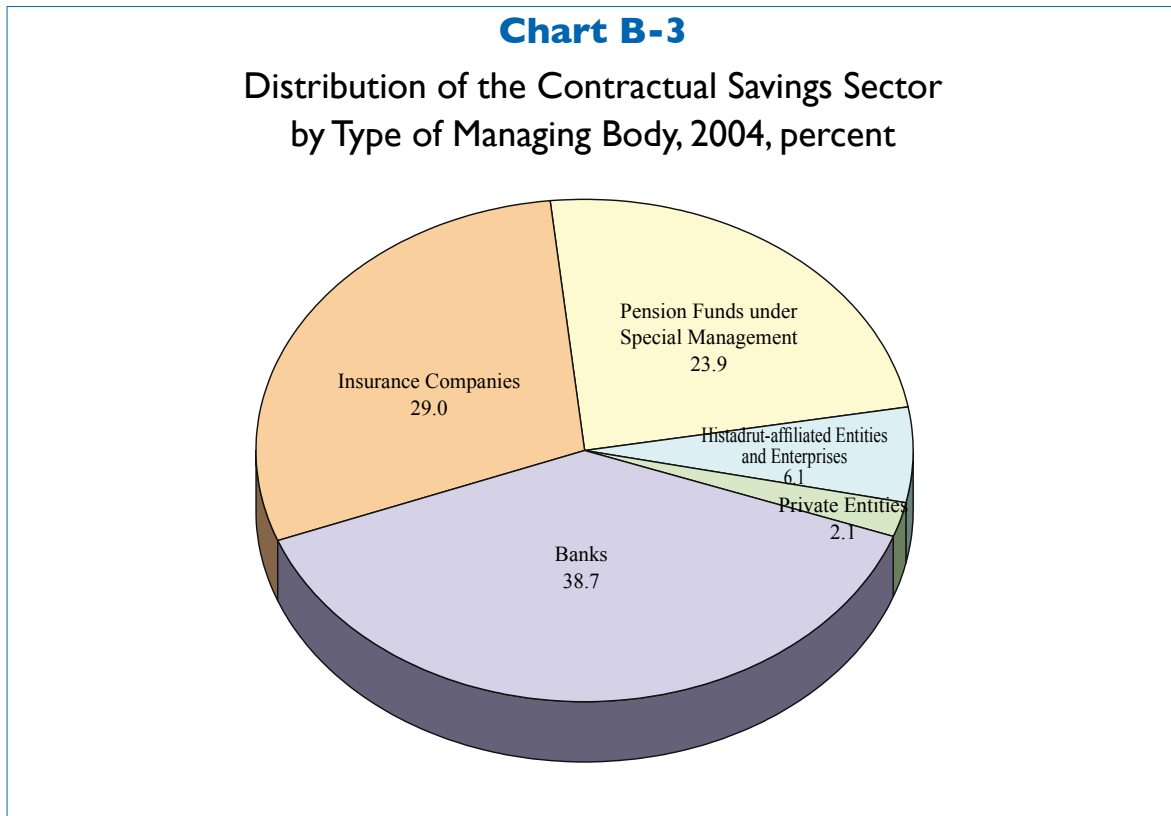
Distribution of the Assets of Banking Corporations^{1, 2, 3}, 2004, percent



1. Including financial institutions.
2. Data is on a consolidated basis.
3. The weights of the financial institutions – Gahelit and Hesech in the total asset portfolio reach about 0.05% and about 0.03%, respectively. The weights of Euro-Trade Bank and the Kupot Haoved Haleumi reach about 0.01% each, in the total asset portfolio.

Source: Data processed by the Information and Development Department for data for the Banking supervision Department at the Bank of Israel.

savings institutions separately, in the contractual savings sector as a whole, the level of concentration is relatively low; thus, for example, the insurance companies hold about 29 percent of the assets of the entire contractual savings sector (Chart 3), compared to the high concentration that characterizes each segment separately.



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The relatively low level of concentration in the contractual savings sector as a whole is affected mainly by the robust competition amongst the bodies offering long-term savings. This competition derives from the high interchangeability between the institutions, since they are supplying similar needs to the same target audience. The main parameters used to differentiate between the sector's products include the difference in the tax benefits granted for the various products, the practical feasibility of withdrawing capital, as well as the nature and scope of the associated insurance covers. However, amongst the contractual savings products and other financial products, mainly banking products (such as long-term deposits – in which the volume of use has dwindled in recent years), the interchangeability is at a lower level, since these products usually do not include two material elements existing in

contractual savings products – tax benefits and a combination of insurance coverage with savings (with the exception of provident funds).

(3) The structure of the balance sheet

The reforms in the capital market, which were formulated in recent years – which included increasing the free (and negotiable) portion of the long-term savings channels, have accelerated the process of perfecting the financial markets in Israel, and have gradually led to an expansion of the institutional investors' participation, and particularly, the participation by the contractual savings institutions in the capital market. This development, which has substantial competitive potential against the banking system, potential that is gradually but steadily being realized over recent years, is expected to receive expression with even greater vigor after the banking corporations sell their control in the provident funds (and in the mutual funds), in compliance with the laws legislated pursuant to the recommendation of the Bechar Committee.

The changes created in the parameters of financial intermediation in Israel in recent years are reflected in the contractual savings institutions' asset portfolio. The dominant component of their asset portfolio is still the credit to the government, whose weight in the contractual savings institutions' total asset portfolio reached about 58 percent in December 2004. However, the weight of this component has been gradually dropping in recent years, after the contractual savings institutions redirected their investments in earmarked bonds (non-negotiable credit to the government), which promised a high yield rate and had no risk, to the negotiable market (Table 4).

Table B-4

**Composition of the Asset Portfolio of Contractual Savings Institutions,
1996 through 2004**

Period	Total Assets	Government Bonds		Private Bonds		Stocks		Securities Abroad	Deposits		MAKAM	Other Assets
		Negotiable	Earmarked	Negotiable	Non-negotiable	Negotiable	Non-negotiable		Linked	Unlinked		
	NIS billions, Dec.2004 prices	percent										
1996	284	21.7	48.4	2.7	2.3	4.7	0.5	0.2	10.8	3.7	1.8	3.1
1998	322	22.9	44.3	2.6	2.6	5.8	1.1	0.4	9.4	4.3	2.3	4.1
2000	372	23.0	39.8	1.9	4.0	7.3	1.8	0.6	7.8	6.8	2.4	4.5
2002	385	23.7	40.5	2.8	5.7	4.7	1.7	1.2	7.3	7.8	1.3	3.2
2003	431	24.1	37.0	3.1	6.9	7.0	2.1	2.1	6.0	6.8	1.3	3.6
2004	460	25.0	33.0	3.7	8.4	8.9	2.2	2.2	5.2	7.2	1.9	2.4

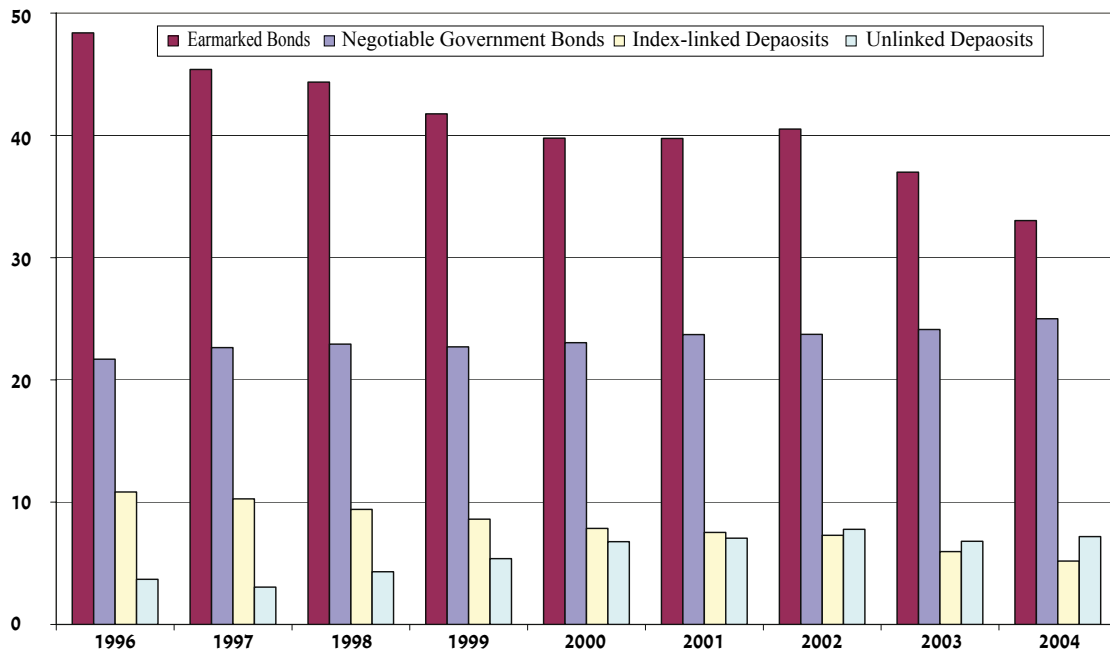
Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The drop in the weight of the earmarked bonds in the contractual savings institutions' asset portfolio is notable also in light of the increase in the weight of the negotiable government bonds in the asset portfolio (Chart 4), and is consistent with the government's declared policy, mainly in recent years. This policy, which encourages increasing the negotiability of the domestic bonds market in general and the government bonds market in particular, is also designed to increase the demand for the bonds, to cut the government's recruitment costs and to make it easier to develop the private bonds market, which is an important component of the bonds market¹¹. Thus, the ratio of negotiable debt to the total domestic government debt gradually increased over the past years. By December 2004, it reached about 61 percent (Chart 5) of the debt.

11. During the last two years, the Ministry of Finance has instituted many reforms, which are intended, *inter alia*, to streamline the public expenditure and to enhance the competition in the economy. Within this framework, a reform was instituted in the government bonds market, whose purpose is to cut the government's capital recruitment costs, to enhance the competition, transparency and financial stability, as well as to encourage foreign investors to become active in the local capital market. Within the framework of the reform, the Government Loans Law was amended, pursuant whereeto, the Ministry of Finance (and not the Bank of Israel, as had been the case previously) would issue the negotiable government bonds and the earmarked bonds. The reform includes the introduction of primary dealers, including bodies from abroad, who are to operate in the primary and secondary markets and who are to undertake to supply buy and sell price quotes in the major series of government bonds in a new trading system that is to be established.

Chart B-4

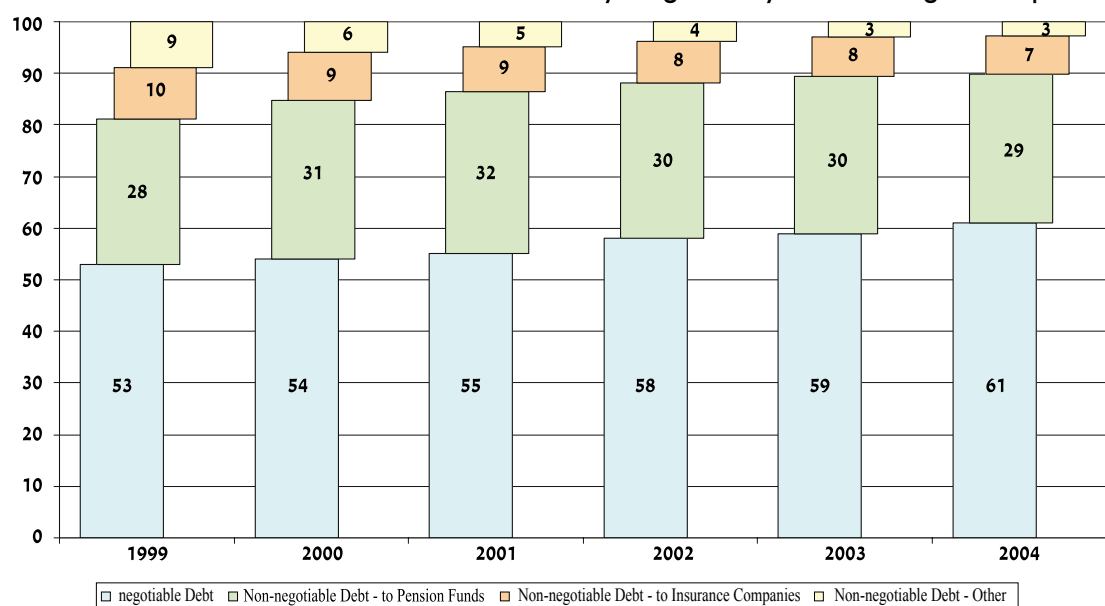
Weight of the Government Bonds and Deposits in Banks in the Total Assets of the Contractual Savings Institutions, 1996 through 2004, percent



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

Chart B-5

Distribution of the Domestic Government Debt, by Negotiability, 1999 through 2004, percent



Source: Data processed by the Information and Development Department for the Government Debt Management Unit's data.

These positive trends, which are evident mainly in the pension funds, derive from the reforms instituted during recent years in the capital market, within which scope, the issuance of earmarked bonds was curtailed. This development motivated the contractual savings institutions to channel their investments to the capital market. Thus, the weight of stocks and private bonds (negotiable and non-negotiable) in the contractual savings institutions' asset portfolio increased from about 5 percent in 1996 to about 12 percent in 2004 (Chart 6). These impacts are expected to intensify in the future, with the implementation of new regulations that the Capital Market Division has issued in order to change the method of revaluating non-negotiable assets. Within the scope of the new regulations, the credit assets being held by the provident funds and the pension funds will be revaluated on the basis of their fair economic value ("market value") and not according to the "adjusted cost" method, which does not take into account fluctuations in the market prices and in the risk premium of the debt owners. This process is expected to have a positive impact on the markets, by augmenting the fair disclosure, transparency and informational efficiency in the market – some of the conditions for sustaining an efficient capital market.

The weight of the linked deposits in banks dropped from 10.8 percent in 1996 to 5.2 percent in 2004. This decline, which characterizes the public asset portfolio in general in recent years, derives, *inter alia*, from the tax reform in the capital market, which came into effect in 2003, from a downtrend in the interest in the markets, from adjustment of the financial assets to the expected reduction of the inflation and from rises in the prices of stocks and bonds in Israel and abroad. And indeed, during the past two years, certain progress has been made in the field of the contractual savings institutions' investments in securities abroad. However, the weight of the contractual savings sector's assets is very low, about 2.2 percent (a phenomenon called "home bias"¹² in the literature), *inter alia*, due to the tax discrimination that had been practiced in the past, between their investments in Israel and their investments abroad. The elimination of the tax discrimination in 2005 is expected to enable contractual savings institutions to diversify their assets more widely, while reducing their dependence on the narrow domestic markets.

12. The strong tendency of investors to invest in local assets.

Chart B-6

Weight of Stocks, Private Bonds and Foreign Securities in the Total Assets of the Contractual Savings Institutions, 1996 through 2004, percent



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The composition of the contractual savings institutions' asset portfolio indicates the method of investment of the members' or insureds' monies accruing in them, and reflects, to a certain extent, also the policy of the institutions' managers when choosing the various assets, regarding the latent risks in them. The composition of the asset portfolio derives from the internal apportionment of the asset holding ratio in the contractual savings institution, which was determined by its investment manager, and, in some of the institutions – also apportionment of the balances of the assets previously purchased within the scope of arrangements that no longer exist, mainly the obligation to invest in earmarked government bonds. The investment rules prescribed by the Ministry of Finance also have an impact on the composition of the asset portfolio – however, during recent years, as part of the process of liberalizing the financial markets, the Capital Market Division has revised its policies, within which scope, the contractual savings institutions were given almost absolute freedom to make their own investment decisions, and the Division's supervisory intervention was

minimized. These amendments are consistent with the changes that have been implemented in recent years in the work of the regulators in developed countries – a transition from direct and individual supervision to indirect supervision. Accordingly, on the one hand, most of the existing limitations on the investment quotas have been removed, and most of the responsibility for managing the investments has been delegated to the institutional bodies. On the other hand, the disclosure and reporting directives have been broadened, while obligations and restrictions have been imposed on the institutional bodies regarding how they manage investments, and regarding the qualifications of those involved in making investment decisions.

The amendments to the investment rules and the implementation of similar restrictions on all institutional investors have created a trend in recent years whereby the composition of the unrestricted investment portfolio in the various bodies, and mainly, amongst the new pensions funds, has converged into the two other channels (provident funds and life insurance plans). Thus, for example, in 2000, the rate of the pension funds' holdings of government bonds (the largest component of their investment portfolio) reached about 53 percent, compared to about 45 percent and about 42 percent in the life insurance funds and in the provident funds, respectively (Table 5). In 2004, this percentage dropped to about 42 percent, similarly to the holding rates customary in the provident funds and slightly more than in the life insurance plans. The trend of convergence is evident also in most of the other components of the investment portfolio, for example, in the deposits in banks and in stocks, which is expected to enhance the competition amongst the institutional bodies, such that the differences in the yield rates achieved amongst the instruments will mainly be a function of how well they are being managed.

Table B-5

Composition of the Investment Portfolio in the Provident Funds, Pension Funds and Life Insurance Plans, 2000, 2002 and 2004, percent

Period	Financial Intermediary	Government Bonds ²	Deposits in Banks	Corporate Bonds ²	Stocks ²	Investments Abroad
2000	Provident Funds	44.8	21.3	11.0	16.0	3.0
	New Pension Funds ¹	53.0	10.0	11.7	8.0	1.3
	Participating Plans	42.2	15.2	3.9	14.3	6.0
2002	Provident Funds	48.1	21.6	14.9	11.0	1.2
	New Pension Funds ¹	49.2	20.0	15.6	7.6	0.6
	Participating insurance Plans	36.5	21.1	10.2	12.1	5.5
2004	Provident Funds	41.3	16.5	17.6	18.0	1.4
	New Pension Funds ¹	42.1	13.0	24.4	14.3	0.0
	Participating Plans	36.7	15.2	16.1	15.0	0.0

1. Excluding earmarked bonds.

2. The data on the government bonds (with the exception of the pension funds), the private bonds and the stocks include the negotiable and non-negotiable components.

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

(4) Main developments in the contractual savings institutions

Following is a review of the principal developments in the contractual savings institutions during the past year:

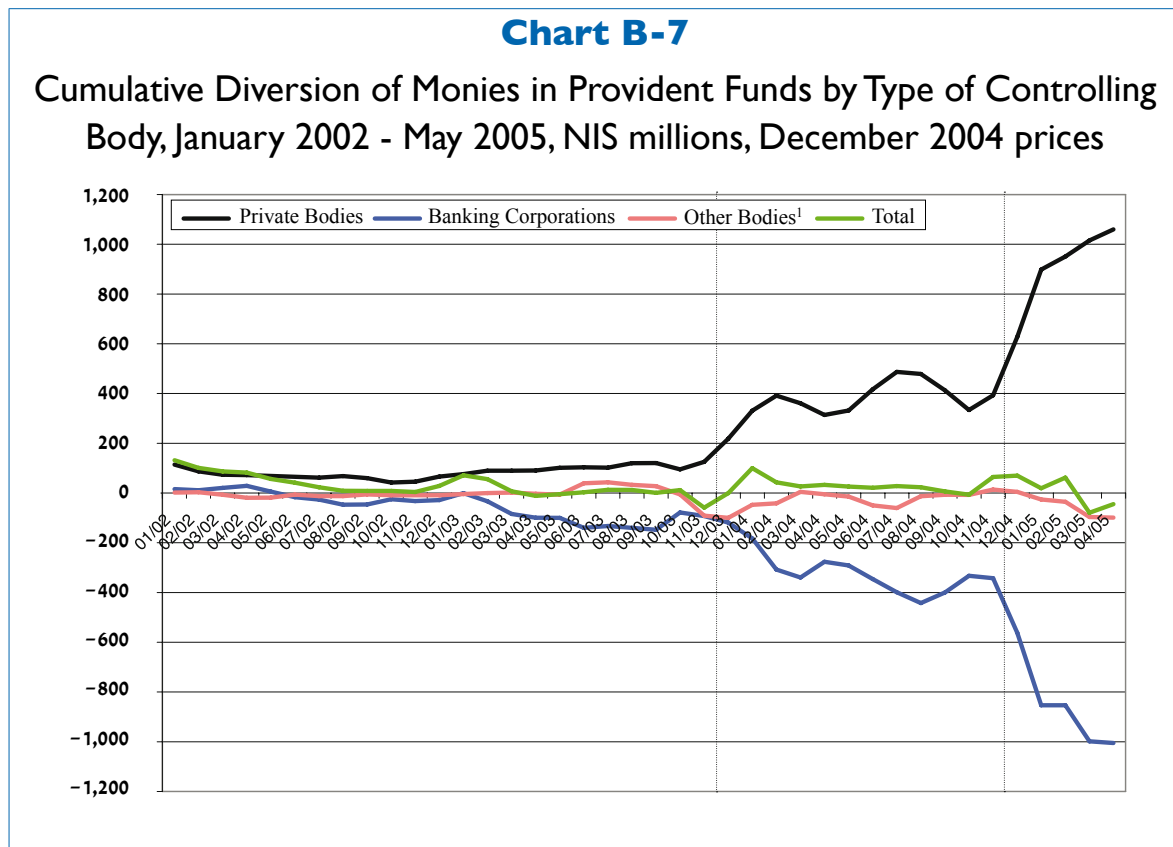
A. The provident funds and study funds¹³

Restructuring

In 2004 as well, the banking corporations continued to coordinate and manage the majority of the assets of the provident funds and the study funds. Nevertheless, during 2004, the slow erosion of their share in the funds' assets accelerated, and the share of the assets being

13. Although there is some difference in the saving parameters between the provident funds and the study funds, it is customary to view all of them as one unit, mainly because they operate by virtue of the same tax regulations.

managed by private intermediaries increased. For the sake of comparison, at the end of 2004, the assets of the private provident funds constituted about 4 percent of the total assets of the funds, while in 2003, they constituted about 2 percent. This change derives from the members' heightened consciousness of their monies, which received expression by the monies being shifted between the provident funds (Chart 7). Particularly notable is the shift from the bank provident funds to the private provident funds, in light of the high yields that the private bodies achieved in recent years, compared to the other managing bodies (mainly the banking corporations). Thus, for example, in 2004, the volume of net transfers to private bodies totalled about NIS 2.3 billion, compared to negative transfers totalling about NIS 2 billion in the funds managed by banking corporations.



1. The other bodies include mainly enterprises, insurance companies and pension funds.

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

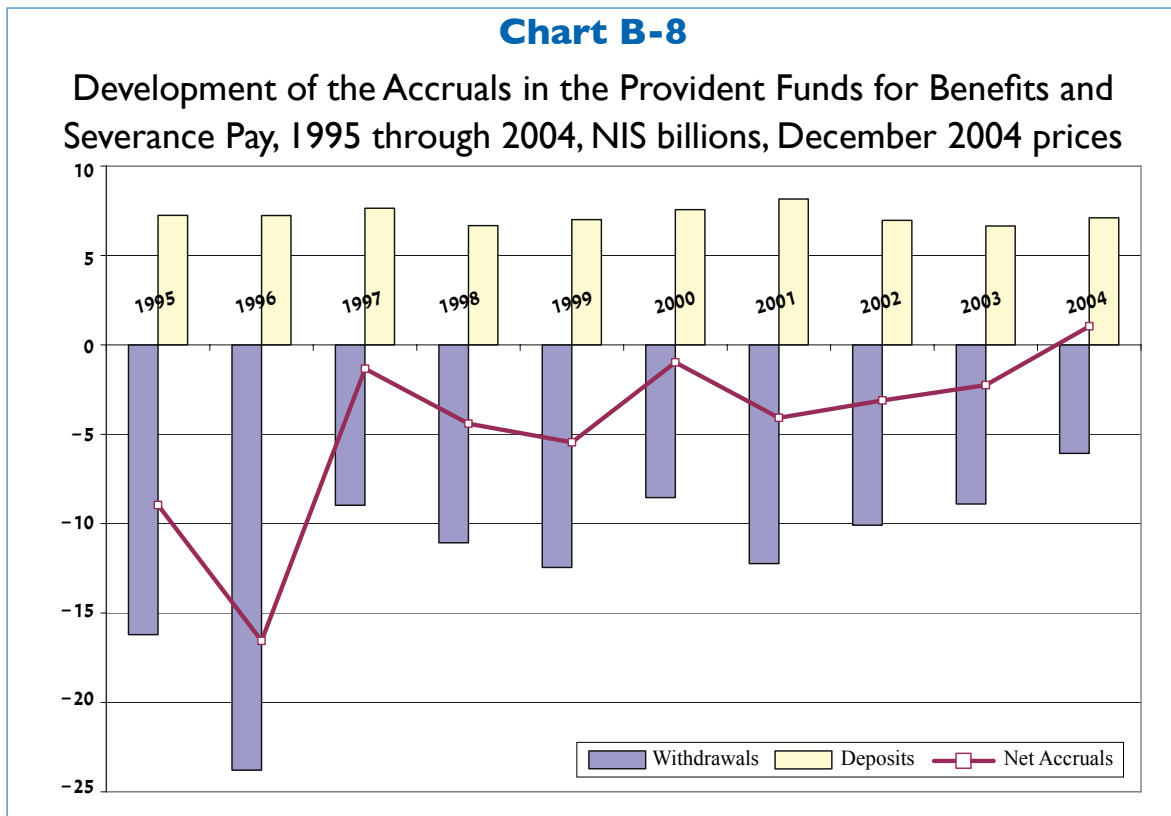
Notwithstanding the members' heightened awareness and their shifting between the funds, the banking corporations continued to hold about 86% of the assets. The problem of the

concentrated ownership of the provident funds (and of the mutual funds) by the banks, and the problem of the potential conflicts of interest between engaging in the field of banking and engaging in the field of provident funds (or in mutual funds), was addressed in the Bechar Committee's report, which prohibited the banks to hold the means of control or be interested parties in the funds. Implementation of this recommendation of the committee and its other recommendations, whose purpose is essentially to increase the competition in the credit field and in the household sector – which were approved by the *Knesset* in July 2005 – is expected to create an efficient and competitive capital market structure, which should accelerate growth in the economy, for the welfare of the public.

Alongside the reform in the capital market, activity in the provident funds sector should be affected both by the launching of the “Gemel-Net” system for comparing the performance of the provident funds, and by the wide-scale amendments instituted in 2004 in the Income Tax Regulations (Rules for Approval and Management of Provident Funds), which, *inter alia*, obligated the provident funds to calculate a daily yield, instead of a monthly yield, as had been the case previously. Within the scope of these amendments, obligations were imposed on the provident funds *vis-à-vis* the members, including the obligations of identification, issuing of notices, easements in the procedures for transferring money from one provident fund to another, and improving the format of the annual report to members. These changes, along with the change in the method of revaluating the non-negotiable assets held by the provident funds (and the other institutional investors), should reduce the distortions in the sector and help improve transparency and fair disclosure to the members. This will allow members to compare between the various funds, and between the funds and alternative savings channels, and thus, should heighten the competition in the financial markets in general, and in the provident fund sector in particular.

Main Developments

The provident funds are dominant in their activity as financial intermediary institutions for the purpose of contractual savings: in 2004, the balance of the assets in the provident funds for benefits and severance pay (hereinafter “Provident Funds”) constituted 9.7 percent of the public monetary asset portfolio – 32 percent of the aggregate assets held by the contractual savings institutions. The balance of the Provident Funds' assets totalled about NIS 147 billion at the end of 2004, compared to about NIS 136 billion during the corresponding period last year – a rise of about 8 percent. The rise this year derives mainly from the high yield on these assets – about 9 percent – and partially, from a positive accrual (deposits less withdrawals) of more than NIS 1 billion in the funds, for the first time in nearly a decade (Chart 8).



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

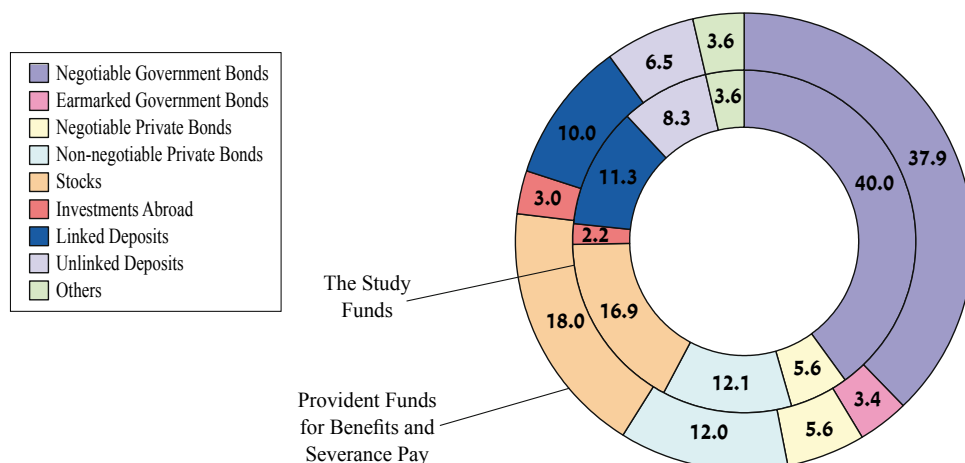
The positive accumulation is explained mainly by a drop in the volume of withdrawals compared to last year, following the directives of the income tax reform that took effect on January 1, 2003. These directives included the provision of a full exemption from tax on deposits deposited in funds up until that date, in contrast to the tax applicable to deposits in funds as of 2004. Therefore, there is little incentive to withdraw money from this channel and invest in other channels (such as mutual funds, savings plans or deposits), when the yield or the interest accruing in them would be taxable. Another factor that explains the positive accrual is a certain increase in the volume of deposits due to the high yield levels during the last two years, relative to the other investment alternatives, and the expectation of improved performance by the funds in the future. This expectation derives from the intensified efforts being exerted by the bodies operating in the field to improve their human resources and to better the results being achieved by the funds, and mainly, from integrating new investment channels (real estate funds, special bonds, hedging funds, etc.), which are customary in developed countries.

The Capital Market, Insurance and Saving Division

The principal developments in the composition of the Provident Funds' asset portfolio explain the rise in the yields that the Provident Funds produced during the past two years – notwithstanding the fact that the yield on the investments in the year under review was lower than the previous year, due to the moderate rises in the rates in 2004 compared to the sharp rises of 2003: during the last two years, the weight of the negotiable government bonds – the main component of the funds' asset portfolio – has been falling, concurrent with a rise in the weight of the stocks and private bonds, predominantly the non-negotiable ones, which intensified during the past year, especially at the expense of a portion of the linked deposits. The rise in the weight of the private bonds in the funds' asset portfolio is explained, *inter alia*, by the increase in the private issues in the economy during the last two years. This increase occurred due to companies' difficulties in raising bank credit, following the stiffening of the criteria for the provision of credit, and because institutional investors began opting to invest in non-negotiable assets in order to reduce the volatile component of their investment portfolios. However, with the implementation of the new revaluation rules prescribed by the Capital Market Division for non-negotiable assets held by institutional investors, the Provident Funds' exposure to the fluctuations characteristic of the financial markets is expected to increase. Furthermore, the ratio of the securities abroad rose this year – about 3 percent of the Provident Funds' total assets. It appears that this rise was a result of the funds' preparations for the expected elimination of the tax discrimination between foreign securities and Israeli securities.

Chart B-9

Distribution of the Asset Portfolio of the Provident Funds and the Study Funds, 2004, percent



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

Examination of the composition of the asset portfolio of the study funds shows a relatively similar picture in 2004: the volume of the study funds' asset portfolio reached about NIS 62 billion at the end of 2004, a rise of about 12 percent compared to December 2003. This rise derives from a positive accrual of about NIS 900 million during the year, which was also affected by the improvement in the employment situation, from a rise in the real wage, and from a high yield on the assets, mainly thanks to the rises in the securities rates. Thus, the weight of the stock component during the year rose significantly – from about 14 percent to about 17 percent at the end of 2004. Furthermore, the weight of the private bonds in the study funds' asset portfolio, as well as the weight of the unlinked deposits, rose, parallel to a drop in the weight of the linked deposits and the government bonds.

B. The Pension Funds

Restructuring

Many changes occurred in the pension funds market in recent years: the new pension funds changed from funds accruing rights to yield funds¹⁴, special managers were appointed for the old *Histadrut* pension funds in deficit (“the Pension Funds under Arrangement”), special agreements and benefits that these funds had given in the past were cancelled, and a uniform set of regulations was imposed on the funds. Furthermore, the maximum rate at which the pension funds (including the old pension funds not in a deficit) were allowed to acquire earmarked bonds was reduced to about 30 percent – a reduction that is sufficient to increase the pension funds' exposure to the capital market – and the government undertook to provide assistance of more than NIS 80 billion to the old deficit funds.

One of the functions of the special managers was to realize and sell the funds' assets. Accordingly, during 2004, the authorized managers of the old deficit pension funds sold the new pension funds that the funds owned. In this way, the new pension funds market, which the *Histadrut* had controlled until then, passed to the control of the insurance companies. From the three major new pension funds: the Menorah Insurance Company acquired “*Mivtachim Yoter*” (whose ratio of the total assets of the new funds was about 50% at the end of 2004);

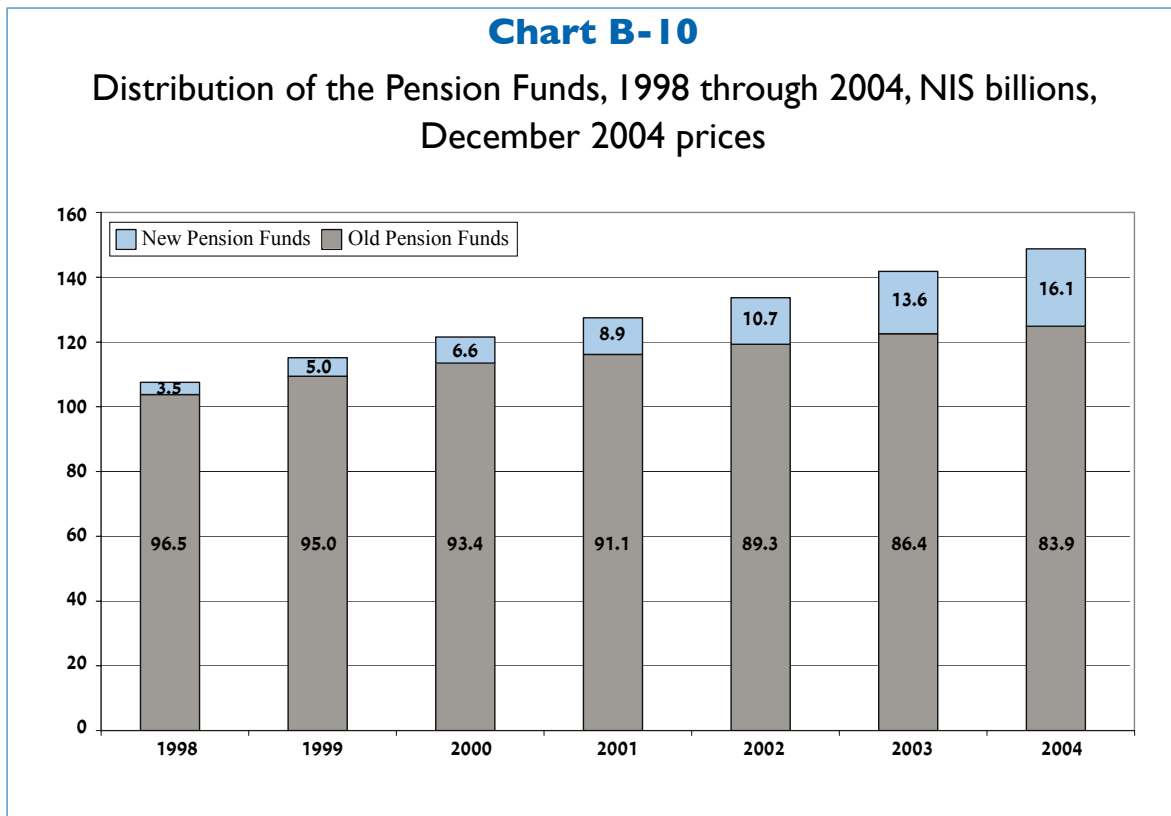
14. Up until the reform, pension funds accruing rights were customary. These funds accrued predefined rights for the members in respect of the entire accrual period, in the form of monthly pension allowances based on a graduated accrual bracket in the fund, according to the age and gender of the member, as a percentage of the insured's wages. These rights do not change, except for the purpose of actuarial balance. As opposed to these, yield funds are funds conferring rights to the members that derive from the money accruing in their personal accounts, and which can change at any time depending upon the monetary accumulation.

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the Migdal Insurance Company acquired “*Makefet HaHadasha*” (about 18%); and the Clal Insurance Company acquired “*Meitavit*” (about 11%). The proceeds received from these sales were added to the assets of the selling old funds for the benefit of all insureds of each fund. Against the backdrop of this process of selling the new funds, insurance companies acquired a few small pension funds that were operating in the market¹⁵, and thus, at the end of 2004, the insurance companies commanded about 93 percent of the volume of assets of the new pension funds (both the comprehensive and general ones).

By acquiring the new pension funds, the insurance companies have also acquired vast potential exposure to new customers, who did not have access to insurance companies before then, for example, due to their being affiliated with workers’ committees or other organizations. Now, the insurance companies are able to supply these customers with flexible and integrated financial products in all their long-term savings channels, and to add associated insurance products. The impact of the restructuring of the ownership will intensify in the future, the larger the new funds’ share will grow, compared to the old pension funds, which are closed to new members. The percentage of new funds in the pension funds’ total assets is relatively low in the sector (about 16% in December 2004, Chart 10).

15. Thus, for example, Harel Insurance Investments acquired the companies managing the “*Netivot*,” “*Manof*” and “*Atidit*” pension funds, while the Migdal Insurance Company acquired the control in the company managing the “*Te’utza*”.



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

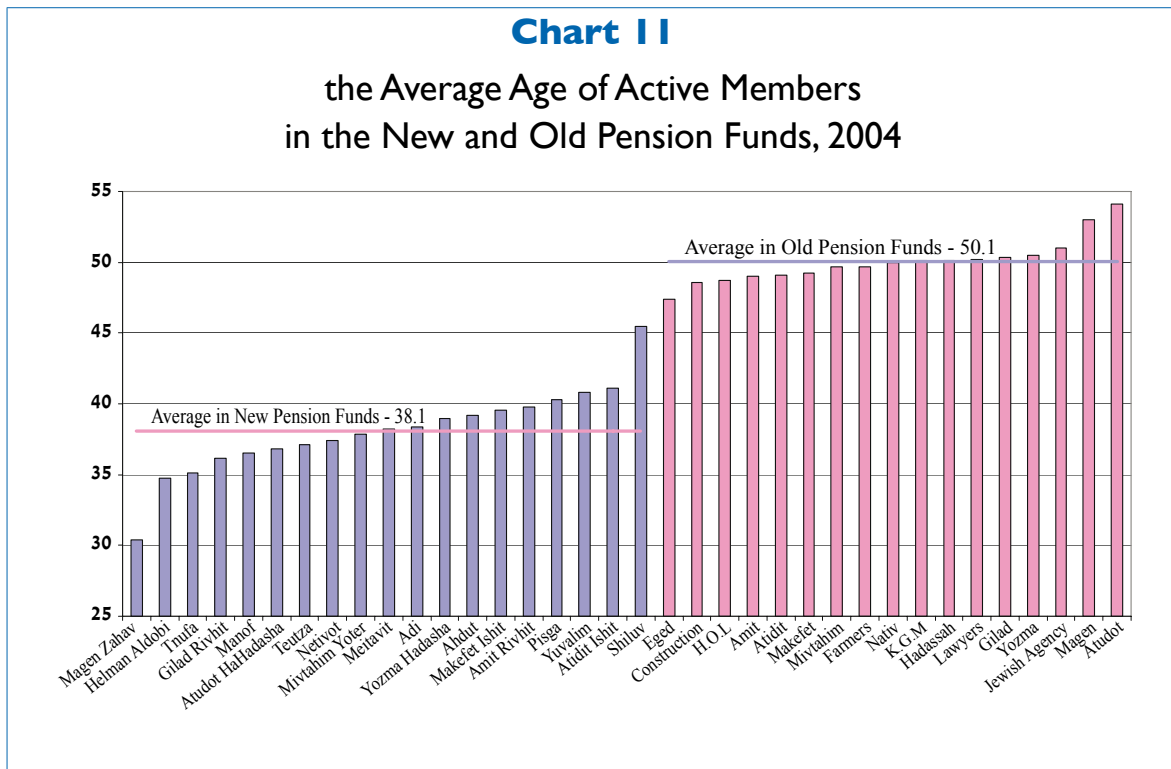
Within the scope of the changes in the pension funds market, the Capital Market Division took action last year to encourage the competition for the insureds' savings, and, at the same time, improved the possibilities for switching between the bodies. The increasing competition in the pension sector is characteristic of other developed countries, and reflects changes in the operating parameters of modern pension funds.

The modern pension funds see themselves as competitive firms, whose main objective is to achieve a high yield for insureds, more than as an administrative entity, who receive the allocations of the employees and employers. Increasing the competition in the pension fund market in Israel is likely to create new conditions in the pension market, which should help to reduce the high level of market concentration, which has always characterized the pension sector, and should improve the quality of the service and the professionalism being provided to insureds.

The Main Developments

The balance of the assets of the old and new pension funds grew in 2004 by about 5 percent and totalled about NIS 149 billion by year end, the majority of which is still not being invested in the capital market. Out of the said sum, the old pension funds are holding about NIS 125 billion – an increase of about 2 percent compared to the total in December 2003. Since 1995, new members are not permitted to join the old pension funds, and therefore, the number of members regularly injecting allocations into these funds is gradually diminishing, while the number of members receiving benefits is rising. During the last two years, about NIS 1.6 billion, net, were withdrawn from the old funds, and the pace of the withdrawals is expected to continue to increase gradually. However, since these funds benefited from an issue of “Meron” earmarked bonds – bonds bearing high effective, real interest of about 5.6 percent – at the scale of most of the accruals in the funds, the value of their assets continued to rise, and their share in the publicly held assets portfolio has remained high, about 8.2 percent, constituting about 27 percent of the total assets of the contractual savings institutions.

The balance of the assets that accrued in the new pension funds reached about NIS 24 billion by the end of 2004 – an increase of about 24 percent compared to the balance in December 2003. The fast growth rate of the new pension funds derives from the addition of new members to the funds, as well as from the low average age of the savers (about age 38, compared to about age 50 in the old funds), thanks to which, the funds are amassing monies, almost without having to pay any benefits (Chart 11). The new funds are also benefiting from the issue of earmarked bonds, which bear high effective real interest, which contributes to the appreciation of their assets: the new pension funds had been required, until not too long ago, to invest 70 percent of the net accrual each month in “Arad” type bonds, when the effective interest rate being paid on them is 5.05 percent. The massive issuance of earmarked bonds to the old and new pension funds makes it difficult to develop and deepen the capital market in Israel, since it is lacking the involvement of these funds, mainly as a source of long-term financing for the business sector, and since it is also competing for the sources of financing that the banking system is supplying.



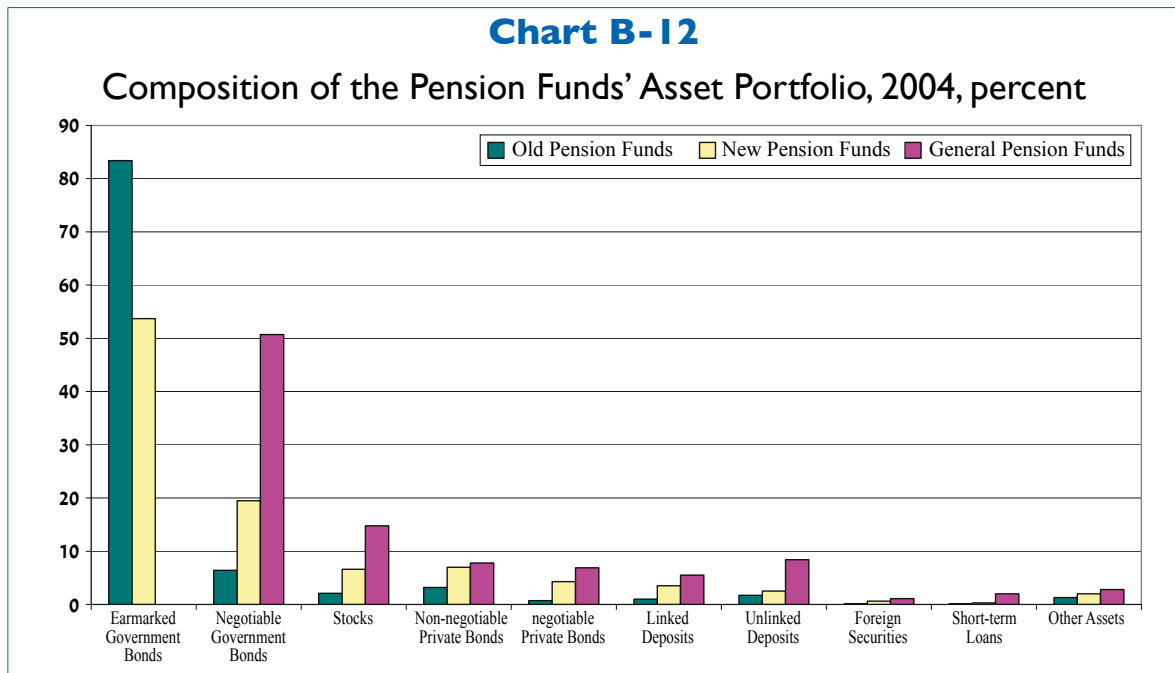
Source: Publicized Financial Statements.

The reform in the pension sector was designed to resolve the actuarial deficit in the old pension funds, and within its scope, measures were taken with respect to the old non-deficit funds and with respect to the new funds. These measures included, *inter alia*, discontinuing the issuance of earmarked bonds to all pension funds (the old and comprehensive new funds), until their rates will drop below 30 percent of the portfolio, this, *inter alia*, in order to increase the funds' involvement in the free market. These changes did not affect the new general pension funds, which have been operating in Israel since 2000, since they are not entitled to an issuance of earmarked bonds.

The discontinued issuance of earmarked bonds and the assimilation of the new investment rules, which increase investment flexibility, should help to develop a deep and liquid market in Israel. Such a market increases the chances that advanced financial instruments will be developed, such as securitization, and reverse mortgages, as is customary in most developed countries. Furthermore, they are likely to reinforce the government's commitment to maintain budgetary discipline, since it has to compete with the private market when recruiting sources of financing.

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Subsequent to these changes, the weight of the earmarked bonds in the old pension funds' asset portfolio dropped from about 91 percent to about 83 percent. Parallel to this reduction, the old pension funds increased their holdings of private bonds and negotiable government bonds, and, to a lesser extent, their holdings of stocks and deposits in banks, even though the holdings of these assets are still a marginal portion of the funds' total assets (Chart 12).



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The yield in the old pension funds has only an indirect impact on the members' rights. In contrast to them, the pension to which insureds of the new and general pension funds will be entitled is directly dependent upon the yield that the pension fund achieves on its investments, and, it is for this reason that the asset portfolio in these funds and the yield achieved on their investments are so important. Similarly to the development in the old pension funds, the ratios of the new pension funds' assets, which are invested in earmarked bonds, dropped from about 68 percent to about 54 percent, and parallel to this, there was an evident rise in the rate of their holdings of negotiable assets (mainly government bonds and private bonds, Chart 12). These measures are expected to have a positive impact on the capital market in general and on the private bonds market in particular, because investors with perspective, such as the pension funds, know that long-term investments have a stabilizing impact on the market.

C. The Insurance Companies

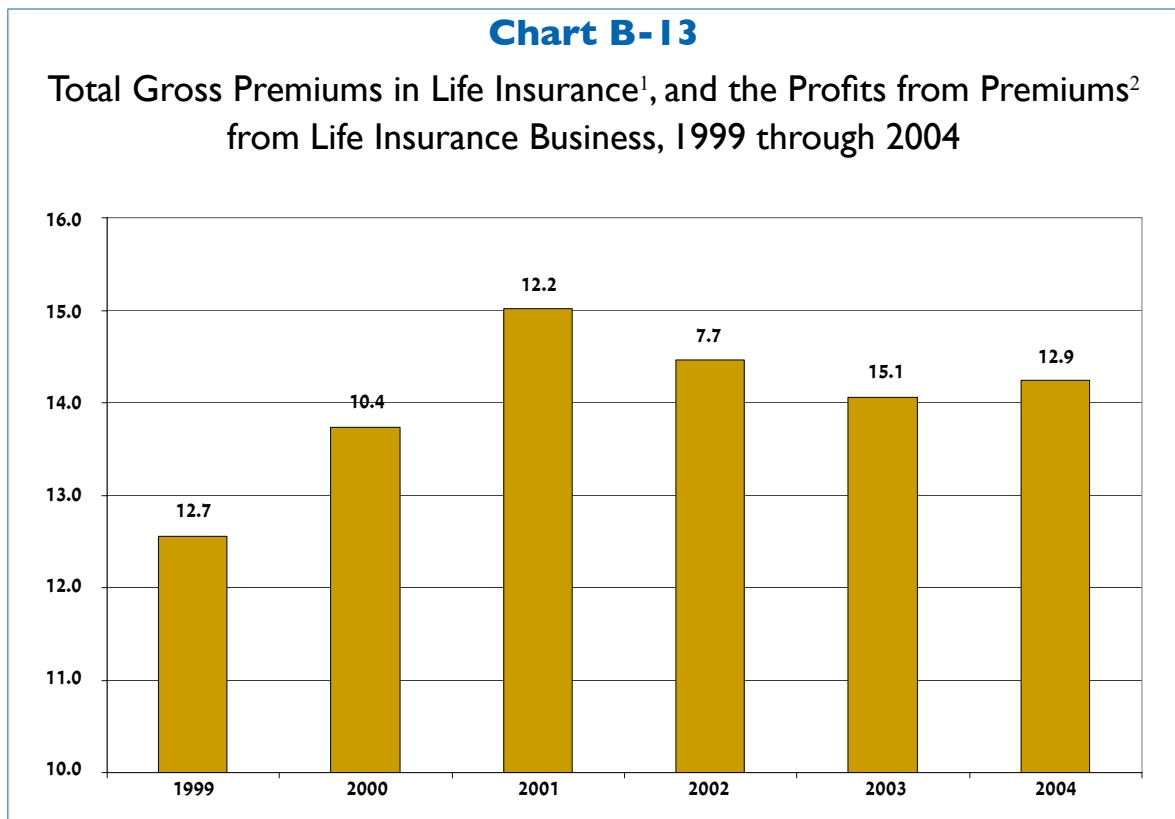
Restructuring

In 2004, material changes occurred in the life insurance sector – mainly in the structure and conditions of the insurance policies being marketed to the general public, which contain a savings component. Within the scope of these changes, the products were required to be configured with full structural separation between the three components of the policy – the savings, the insurance coverage (“the risk”) and the expenses; this, in contrast to the situation in the past, whereby the insured did not know what portion of the premium that he paid was allotted to purchasing savings, to covering “the risk” or to covering the insurance company’s commissions and expenses. Subsequent to this separation, the insurance plans should be transparent and clear, so that insureds will be able to compare the costs and insurance covers of the various companies, and to choose insurance according to their own personal needs.

Another material change implemented within the scope of the reform in the life insurance sector, which is in line with increasing transparency and broadening the customer’s freedom of choice, is the revision of the rules and principles applicable to insurance agents and to insurance companies when selling life insurance policies. The agents and companies are required to present all information to the purchaser of a policy about his rights and the coverage being provided to him. If an insured desires to cancel an existing policy in order to purchase an alternative insurance policy, from the same insurance company or from another company, the insurance agent must obtain his signature on a document containing parameters that clarify the advantages and disadvantages in the existing policy versus the new policy.

The many changes implemented in the field of life insurance are likely to enhance the competition in each of the components of the premium: in the savings component – over the quality of investment management; in the insurance coverage – over the price and scope of the coverage; and in the expense component – over the height of the expenses. These changes are also expected to have an impact on the insurance companies’ profitability in their activities in the life insurance line: on the one hand, the anticipated increase in the savings component of the insurance policies, and a decrease in the revenues, due to a reduction in the management fees being collected from customers, are likely to reduce the revenues from the premiums – a critical component of the insurance companies’ profits (thus, for example, in 2004, the gross premiums in the life insurance plans totalled NIS 14.2 billion, and the profit rate from the life insurance businesses out of the gross premiums stood at

12.9 percent, Chart 13); on the other hand, the agents' commissions should shrink as well – an outcome of a change in the method of remunerating agents – and be dispersed over the lifetime of the product¹⁶. This development is likely to reduce the high cancellation rates that were previously prevalent, and thus help to sustain the portfolio, which should increase the insurance companies' profitability.



1. NIS billions, December 2004 prices
2. percent

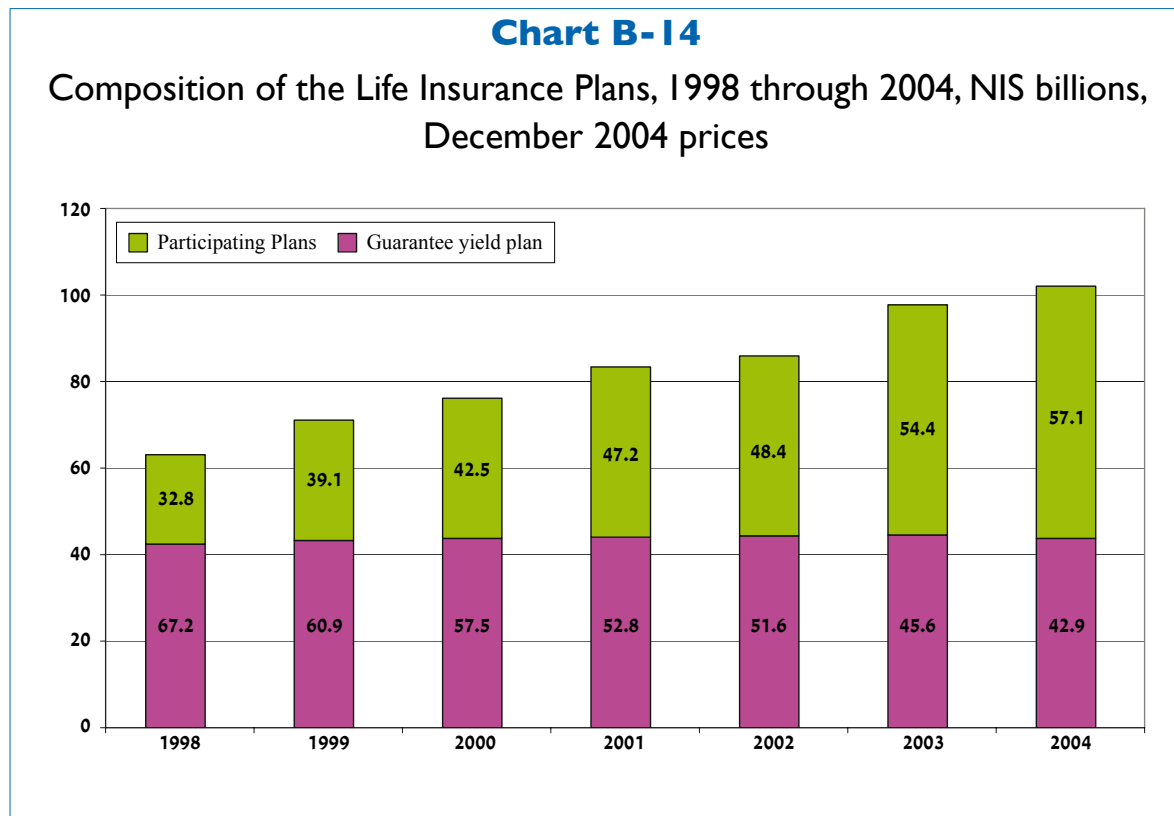
Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division.

Main Developments

At the end of 2004, the balance of the life insurance plans' assets totalled some NIS 102 billion, an increase of 4.4 percent compared to the corresponding period last year. This growth derives from the participating insurance plans, whose share in the life insurance plans' total

16. This, in order to prevent the situation that had occurred in the past: the insurance companies customarily paid agents high purchase commissions when the policies were issued, and lower commissions in the subsequent years. This payment method encourages the practice of "twisting" or exchanging, of policies.

assets rose substantially during recent years. While in 1998, participating insurance plans constituted only about 33 percent of all insurance plans, this year their share reached more than 57 percent (Chart 14). The reason for this is that, since the closure of the guarantee yield plan to new investors in 1992, investors have only been able to join participating plans, which invest the majority of the reserves accruing therein in the capital market, and which are not entitled to an issuance of earmarked bonds.



Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division and for the Bank of Israel's Monetary Department data.

The efforts being exerted in the marketing of the participating insurance plans, which receive expression in the development of new insurance products tailored to customers' needs, as well as the yield on their investments, have increased their assets; in 2004 alone, their value rose by about 10 percent and by year end reached about NIS 58 billion. The share of the participating insurance plans in the publicly held asset portfolio is gradually rising, and by the end of 2004 reached 3.8 percent – 13 percent of the total assets held by the contractual savings institutions. However, this past year, there have been signs of a change in tastes in the market in favor of savings in pension funds and in provident funds, at the expense of savings in insurance plans.

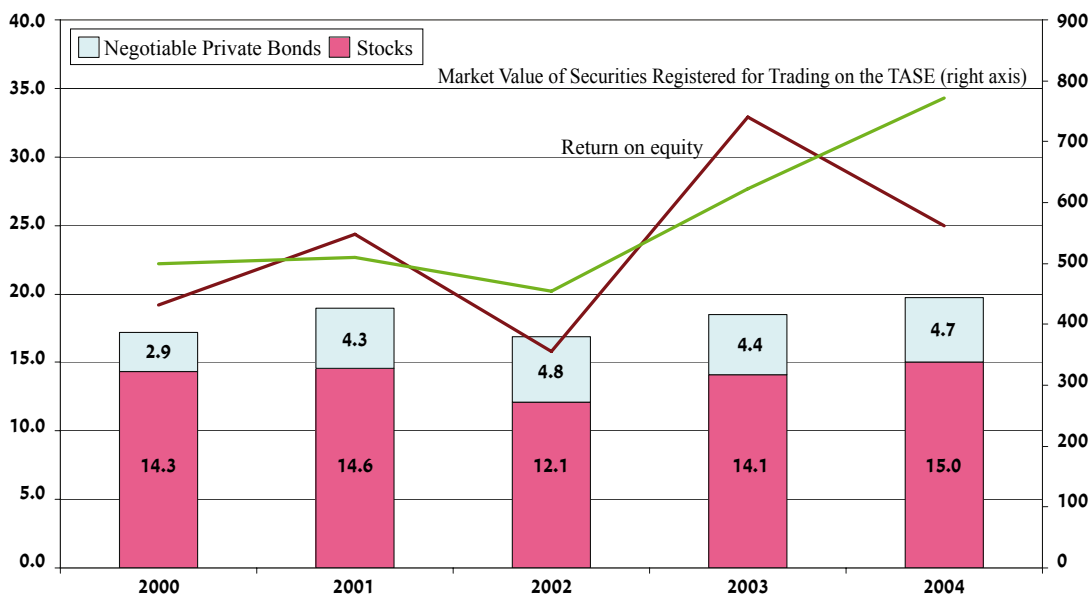
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This phenomenon is liable to stunt the sector's growth in the future.

The growth that characterized the assets of the participating plans in recent years, and with it, the fact that the majority of these plans' assets are being invested in the capital market, have gradually turned the insurance companies into dominant investors in the market. Thus, for example, in December 2004, the insurance companies held about 8 percent of the negotiable government bond market, and about 6 percent of the private bond market, compared to only negligible percentages in the past. The share of stocks in the insurance companies' portfolios, in respect of participating plans, rose during 2004 and, by year end, reached about 15 percent of the portfolio (Chart 15). However, their share in the total value of the negotiable stocks remained relatively low, only about 2 percent. The relatively high holding of stocks and private bonds, whose rates skyrocketed during the past two years, have produced handsome capital gains for the insurance companies and a relatively high yield on the capital.

Chart B-15

Weight of the Negotiable Assets in the Asset Portfolio of Participating Life Insurance Plans¹, the Yield on the Insurance Companies' Capital¹ and the Market Value of the Securities Registered for Trading on the Tel-Aviv Stock Exchange², 2000 through 2004



1. percent

2. NIS billions, December 2004 prices

Source: Data processed by the Information and Development Department for reporting to the Capital Market, Insurance and Savings Division, for the Bank of Israel's Monetary Department data, publicized financial statements and the TASE.

The balance of the assured-yield insurance plans reached about NIS 44 billion by the end of 2004, and their share in the asset portfolio dropped from 3.2 percent in December 2003 to 2.9 percent at the end of 2004. Guarantee yield plan are entitled to an issuance of earmarked bonds at the rate of about 85 percent of the reserves accruing therein, and therefore, the majority of their assets, about 67 percent of the balance at the end of 2004, is invested in earmarked bonds issued by the State of Israel. The yield on these bonds has been dropping over the years, from 6.2 percent to 4 percent. During recent years, the insurance companies have been redeeming some of the earmarked bonds and converting them to assets generating a preferred yield, within the scope of early redemption tenders that the Ministry of Finance held. Last year, these tenders were not held, since the yield that the alternative investments in the market produced was insufficient to justify redeeming the earmarked bonds and diverting to invest in other channels.

4. A Global Perspective on the Long-term Savings System

The development that characterized the contractual savings institutions in many countries around the world was affected in recent years mainly by the changes in the field of pension insurance. This issue took center stage in political and economic forums, mainly in the developed countries, in light of the aging of their populations and the increase in the insurance costs, which gave rise to debates about the financing capabilities of the pension savings arrangements in the future. Following this, many countries instituted reforms in their pension systems, within which scope the members' rights were reduced, for example, by raising the retirement age and equating the retirement ages of men and women. Private pension funds were also established (and companies engaging in life insurance developed) which, in effect, assumed the responsibility for the welfare of the citizens upon reaching retirement age, in place of the government. Consequently, the government's functions diminished to ensuring a minimal income in the first pillar, and supervising the bodies operating in the long-term savings market.

The following trends are at the foundation of the new policy: diversion from pension plans with defined benefits (DB), which are financed on a pay-as-you-go (PAYG) basis, and managed by the government¹⁷, to defined-contribution (DC) pension plans, which are financed on a fully-funded basis¹⁸, and managed mainly by private bodies, with the insureds themselves bearing the responsibility for managing the savings accruing in them, in a wide variety of tracks available to them¹⁹.

The relative importance of the contractual savings institutions (pension funds and life insurance companies) to a country's economic activity is reflected in the ratio of their assets to the gross domestic product (GDP). In member countries of the Organization for Economic Cooperation and Development (OECD), this ratio ranges between a few percentage points

17. A DB pension plan undertakes to pay a pension to the insured upon retirement. The insureds' contributions during a defined period finance the retirees of that fund.

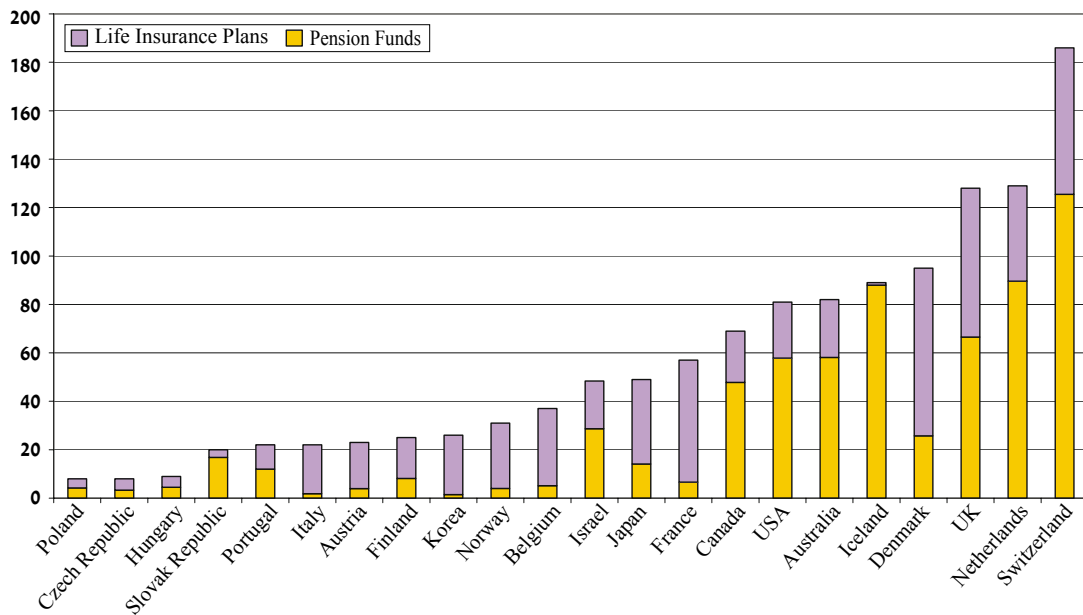
18. In a DC pension plan, the size of the pension being financed from the insured's own pocket is determined according to the allocations accruing in a pension savings plan (plus accrued profits).

19. Thus, for example, in the United States, within the scope of the dramatic changes in savings for retirement, there has been a switch from DB pension plans, which employers provided, to personal retirement accounts (mainly individual retirement accounts – IRAs).

for countries that joined the OECD in recent years – Poland, Hungary and the Czech Republic – to a ratio that exceeds 100 percent in other countries – Switzerland, the UK and the Netherlands (Chart 16). Another difference between the countries is expressed in the distribution of pension assets between life insurance and pension funds. Thus, for example, in Portugal, Italy and Austria, the ratio of the pension savings institutions’ assets to the GDP is similar, while their composition is different: in Portugal, the assets are nearly equally distributed between life insurance plans and pension funds, while in Italy and Austria, the share of the life insurance plans in the total assets outweigh the pension funds. These differences between the countries are influenced mainly by the existence of a tradition that is sufficient for the activities of the private pension funds, and, to a certain extent, by the difference in the parameters of the activities and in the rules of investment, which facilitated the development of these bodies.

Chart B-16

Ratio of the Assets of the Private Pension Funds and the Life Insurance Plans to the GDP in OECD Member Countries and in Israel, 2003, percent



Source: Data processed by the Information and Development Department for OECD member countries’ data, which were taken from the organization’s website, and for Israel’s data, which were taken from the Central Bureau of Statistics, from reports to the Capital Market, Insurance and Savings Division, and from Monetary Department data at the Bank of Israel.

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The investment policy of institutional investors managing long-term savings derives from finding a fair compromise between two considerations: one is the need for a safe and stable investment in order to ensure the payment of the savings to the insureds; while the second is the need to achieve the highest possible yield, which will provide insureds with a reasonable standard of living when they retire. In order to protect the insureds and to protect their money from excessive exposure to risks, most countries deemed it warranted to intervene and institute regulations that restrict the institutional bodies' investment possibilities. Some of these countries used restrictions in order to realize socio-economic policy. The restrictions on institutional bodies in developed countries are imposed in three principal areas: on investment channels, on the investment in each channel, and on the investment's risk level. Examples of this are the limit on the extent of the assets being invested in one company or group of affiliated companies; a restriction on investing abroad; and setting a minimum bracket for investing in government bonds. The restrictions leave contractual savings institutions a wide range of investment possibilities in a variety of assets, and this is expressed by the diversity in the distributions of the countries' asset portfolios.

In most countries, bonds are the largest component of the asset portfolio of the life insurance plans: their ratio reaches on average about 50% of the total assets. In Australia, the UK, Sweden and Greece, the stock component of the asset portfolio is the dominant component, while in Germany and Iceland, loans are the core component of the portfolio. On the other hand, in all countries, cash and deposits make up a relatively limited portion of the asset portfolio (Table 6.A.). Similar findings are shown also in terms of the composition of the pension funds' asset portfolios: in most countries, the pension funds customarily diversify their assets mainly between stocks and government and private bonds. On the other hand, their investments in cash and in deposits, in loans and in real estate are relatively limited (Table 6.B.).

Table B-6.a.

Composition of the Life Insurance Plans' Asset Portfolios in
OECD Member Countries and in Israel, 2001, percent

Country	Cash and Deposits	Private and Government Bonds	Loans	Stocks	Other Assets
Australia	6.0	27.5	4.0	58.7	3.8
Hungary	1.8	67.2	1.0	1.2	28.7
Iceland ¹	6.4	15.5	33.9	19.6	24.5
Italy	2.2	69.3	0.4	10.4	17.7
Japan	3.9	57.2	28.5	8.4	2.0
Korea	5.6	47.3	25.5	4.2	17.3
Mexico ¹	0.8	82.2	1.5	7.0	8.5
Netherlands	4.8	31.1	29.0	29.5	5.6
Norway	3.6	57.3	6.7	26.9	5.5
Poland	3.3	84.6	2.1	7.7	2.3
Portugal	8.4	73.5	0.2	8.6	9.3
Spain ¹	13.0	45.6	4.1	31.0	6.3
Sweden	2.0	41.2	4.3	52.5	0.1
Switzerland	5.7	42.0	21.2	31.1	0.0
UK	7.2	16.0	1.1	63.5	12.2
USA	6.9	53.6	10.8	27.9	0.9
Czech Republic ¹	11.7	58.0	0.3	10.4	19.5
Denmark	1.1	59.8	0.8	33.5	4.9
Finland	1.0	51.8	2.2	44.9	0.0
Austria	4.1	36.0	17.2	6.5	36.2
Belgium	3.1	51.1	9.0	34.0	2.8
Canada	0.9	46.6	18.0	21.9	12.7
Germany	1.7	33.7	60.7	3.3	0.5
France	1.6	48.7	4.8	42.5	2.5
Slovak Republic	25.9	36.1	0.1	1.4	36.5
Greece	2.7	36.7	2.4	45.0	13.2
Turkey	13.5	75.3	1.2	0.3	9.7
Luxembourg	7.0	44.9	0.0	0.0	48.1
Average	5.6	49.6	10.4	22.6	11.8
Israel-2001²	16.7	43.5 (38.7)³	3.1	14.6	65.6
Israel-2004²	15.2	52.8 (40.1)³	3.5	15.0	66.3

1. Data of all insurance companies (including companies operating in the non-life insurance lines).
2. Data of the participating plans only.
3. Figures in parentheses are the ratio of negotiable bonds in the asset portfolios of participating plans.

Source: OECD member countries' data – the organization's website; Israel's data – reports to the Capital Market, Insurance and Savings Division, and from Monetary Department data at the Bank of Israel.

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Thanks to the advances in the reforms in recent years, the composition of the asset portfolio of the contractual savings institutions in Israel is approaching the level customary in developed countries, and the proportion of negotiable assets, such as stocks and bonds, in the portfolio has been growing. However, the government is still the main factor controlling the sources of financing reaching the contractual savings institutions, and this control is impairing the perfecting of the financial system in Israel. Furthermore, comparison between the distribution of the asset portfolio in Israel (of life insurance plans and of pensions funds) and that of OECD countries shows that, in Israel, the proportion of assets being invested through the banking system (cash and deposits) is one of the highest in the sampling – about 15 percent in life insurance plans and about 13 percent in pension funds. These data reflect the dominance of the banks in the financial sector's activities.

Table B-6.b.

**Composition of the Pensions Funds' Asset Portfolio in
OECD Member Countries and in Israel, 2003, percent**

Country	Cash and Deposits	Government Bonds	Private Bonds	Loans	Stocks	Real Estate	Mutual Funds	Other Assets
Austria	2.3	73.6	0.0	0.7	16.5	0.7		6.2
Belgium	4.4	13.6	3.2	0.3	14.6	1.1	55.8	7.0
Canada	4.9	18.7	5.4		23.6	3.5	36.7	7.2
Czech Republic	7.9	60.1	24.8	0.0	4.9	0.4	0.0	1.9
Denmark	0.3	25.6	39.9	0.5	21.1	2.7	7.8	2.1
Finland	0.0	0.0	33.3	0.2	27.0	15.4	0.0	24.1
Germany	2.6	36.3	0.0	27.0	12.7	6.2	7.8	7.4
Hungary	4.4	68.1	5.2	0.0	8.7	0.0	5.8	7.8
Iceland	2.5	35.4	14.9	12.8	30.4	0.2		3.8
Italy	9.1	33.0	0.5	0.0	5.8	11.0	4.3	36.3
Korea	4.4	34.6	30.6	13.3	2.3	1.8	4.0	9.0
Mexico	0.2	85.4	14.4	0.0	0.0	0.0	0.0	0.0
Netherlands	2.2	25.5	13.8	5.3	44.6	5.0		3.6
Norway	4.6	28.8	33.8	3.9	19.2	5.8		3.9
Poland	4.8	61.0	1.7	0.0	32.1		0.0	0.4
Portugal	9.0	21.4	21.6	0.0	19.3	8.8	16.5	3.4
Spain	4.2	20.0	35.0	0.0	15.9	0.3	6.7	17.9
Switzerland	7.1	26.8		4.9	26.5	10.5	15.2	9.0
UK	2.6	14.5	4.7	0.5	53.8	4.3	11.4	8.2
USA	7.1	4.9	4.8	0.2	29.3	0.8	21.3	31.6
Average	4.2	34.4	15.1	3.7	20.4	4.1	12.1	9.5
Israel 2003¹	15.5	40.7	25.2 (13.9)²	3.0	11.7		0.6	3.3
Israel 2004¹	13.0	42.1	24.4 (9.3)²	2.2	14.3	0.0	0.3	3.7

1. Composition of the unrestricted investment portfolios of the new pension funds.
2. Data in parentheses – ratio of negotiable bonds in the new pension funds' unrestricted investment portfolio.

Source: OECD member countries' data – the organization's website; Israel's data – reports to the Capital Market, Insurance and Savings Division, and Monetary Department data at the Bank of Israel.

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All countries give tax benefits for long-term savings²⁰, despite the apparent global trend towards expansion of the tax base, and towards taxing income from capital and capital gains (including interest received on individuals' savings). Benefits are given to members depositing money in a contractual savings institution and to institutional investors managing pension savings funds, at three points in time: for members – at the time of deposit and at the time of withdrawal of the money; for institutional investors – when investment profits are taxed. In most countries, the employers' and employees' allocations to pension funds and the profits from the funds' assets are tax- exempt, up to the maximum prescribed by law, while pensions are taxable (Table 7).

20. In most countries, there is a distinction between long-term savings (or investment) and short-term savings. Consequently, assets being held for a long period usually are not charged capital gains tax at the full rate or they are completely tax exempt, this, in order to encourage long-term savings.

Table B-7**Tax Benefits to Private Pension Funds¹ in OECD Member Countries**

Country	Deposits ²	Accrual		Pension Payments	
		Principal	Yield	Pensions	Capital
Australia ³					
Employee	Taxable	Exempt	7.1% ⁴	Taxable ⁵	16.5% ⁶
Employer ⁷	15%	Exempt	7.1% ⁴	Taxable ⁵	16.5% ⁶
Austria ³					
Employee	Partial charge	Exempt	Exempt	Partial charge	Partial charge
Employer	Exempt	Exempt	Exempt	Taxable	Taxable
Belgium ³					
Employee	Taxable ⁵	0.17%	Exempt	Taxable ⁵	10%
Employer	Exempt	0.17%	Exempt	Taxable ⁵	16.5%
Czech Republic ³					
Employee	Partial charge ⁸	Exempt	Exempt	15% ⁶	15% ⁶
Employer	Exempt ⁸	Exempt	Exempt	15% ⁶	15% ⁶
Denmark	Exempt	Exempt	15%	Taxable	40%
Finland	Exempt	Exempt	Exempt	Taxable	Taxable
France	Exempt	Exempt	Exempt	Partial charge	Partial charge
Germany	Exempt	Exempt	Exempt	Partial charge	Taxable
Greece	Exempt	Exempt	Exempt	Taxable	Taxable
Hungary ³					
Employee	Taxable ⁷	Exempt	Exempt	Exempt	Exempt
Employer	Exempt	Exempt	Exempt	Exempt	Exempt
Iceland	Exempt	Exempt	Exempt	Taxable	Taxable
Ireland	Exempt	Exempt	12.5%	Partial charge	Partial charge
Italy	Exempt	Exempt	Exempt	Partial charge	Partial charge
Japan	Exempt	Exempt	Exempt	Partial charge	Partial charge
Korea	Exempt	Exempt	Exempt	Partial charge	Partial charge
Luxembourg ³					
Employee	Exempt	Exempt	Exempt	Taxable	Partial charge
Employer	20%	Exempt	Exempt	Exempt	Exempt

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Country	Deposits ²	Accrual		Pension Payments	
		Principal	Yield	Pensions	Capital
Mexico	Exempt ⁸	Exempt	Exempt	Partial charge	Partial charge
Netherlands	Exempt	Exempt	Exempt	Taxable	Taxable
New Zealand ³					
Employee	Taxable	Exempt	33%	Exempt	Exempt
Employer	21%	Exempt	33%	Exempt	Exempt
Norway	Exempt	Exempt	Exempt	Taxable	Not applicable
Poland	Exempt	Exempt	Exempt	Taxable	Taxable
Portugal ³					
Employee	Taxable ⁵	Exempt	Exempt	20% ⁶	Partial charge
Employer	Exempt	Exempt	Exempt	20% ⁶	Partial charge
Slovak Republic	Exempt	Exempt	Exempt	15%	15%
Spain	Exempt	Exempt	Exempt	Taxable	Partial charge
Sweden	Exempt	Exempt	15%	Taxable	Taxable
Switzerland	Exempt	Exempt	Exempt	Taxable	Taxable
Turkey	Exempt	Exempt	Exempt	Exempt	5% ⁶
Canada	Exempt	Exempt	Exempt	Taxable	Taxable
UK	Exempt	Exempt	Exempt	Taxable	Partial charge
USA	Exempt	Exempt	Exempt	Taxable	Taxable

1. The private pension plans include privately managed funds as well as compulsory or discretionary deposits of individuals.
2. Most countries impose maximums on the tax benefits granted at the deposit stage.
3. Countries in which various tax benefits are given to employees and employers.
4. The tax rate for a portfolio comprised of interest-generating assets (60 percent of the portfolio) and securities (40 percent of the portfolio).
5. A partial tax credit might also be given.
6. A partial exemption might also be given or a deduction from the taxable amount.
7. Compulsory deposits are taxable, while a tax credit is given on discretionary deposits.
8. The deposits benefit from a government subsidy, which enlarges individuals' savings.

Source: the OECD website.

005. The Long-term Savings Market – Opportunities for the Future

Long-term savings is one of the most notable and important issues being placed on the agenda of developed countries, and Israel is among them. There are those who view it as the most important economic (and social) issue that countries will have to contend with in the future, since the monies accruing in contractual savings institutions are in effect the long-term savings of salaried employees and of the self-employed – savings intended to ensure financing of the pensions that people will receive when they retire, for reasons of age or loss of earnings. These monies constitute a significant portion of the national savings, and, in all developed countries, these monies are channeled to the capital market and to investments in the economy and are financing economic growth. However, in Israel, the majority of the long-term savings are not yet in this market, which impairs the development and deepening of the Israeli capital market. The impairment of the development of an efficient and competitive capital market in Israel is explained also by the dominance of the banking system in all areas of financial intermediation, and by the high market concentration that characterizes the banking system itself, alongside built-in conflicts of interest in the variety of activities in which the banking corporations engage.

Against this backdrop, the Ministry of Finance has been encouraging in recent years that concerted efforts be taken in order to advance structural reforms – in the economy in general, and in the capital market in particular. Such reforms are required in the money market – *inter alia*, in order to develop non-banking financial intermediation, and by doing so, also the competition against the banking system – and in the bonds and institutional contractual savings market. While doing so, the privatization process has been accelerated – and this receives expression, for example, in the privatization of Israel Discount Bank, and in the sale of part of the government's holdings of Bank Leumi Le-Israel to foreign investors – measures that will also affect the developments in the capital market. The reforms at issue are interrelated: the advancement of one of them has an impact on the advancement of the others, and is influenced by them. This is because the common objective of all of them is the development of the capital market in Israel – an essential condition for increasing the growth in the economy and for its successful integration with the global economy.

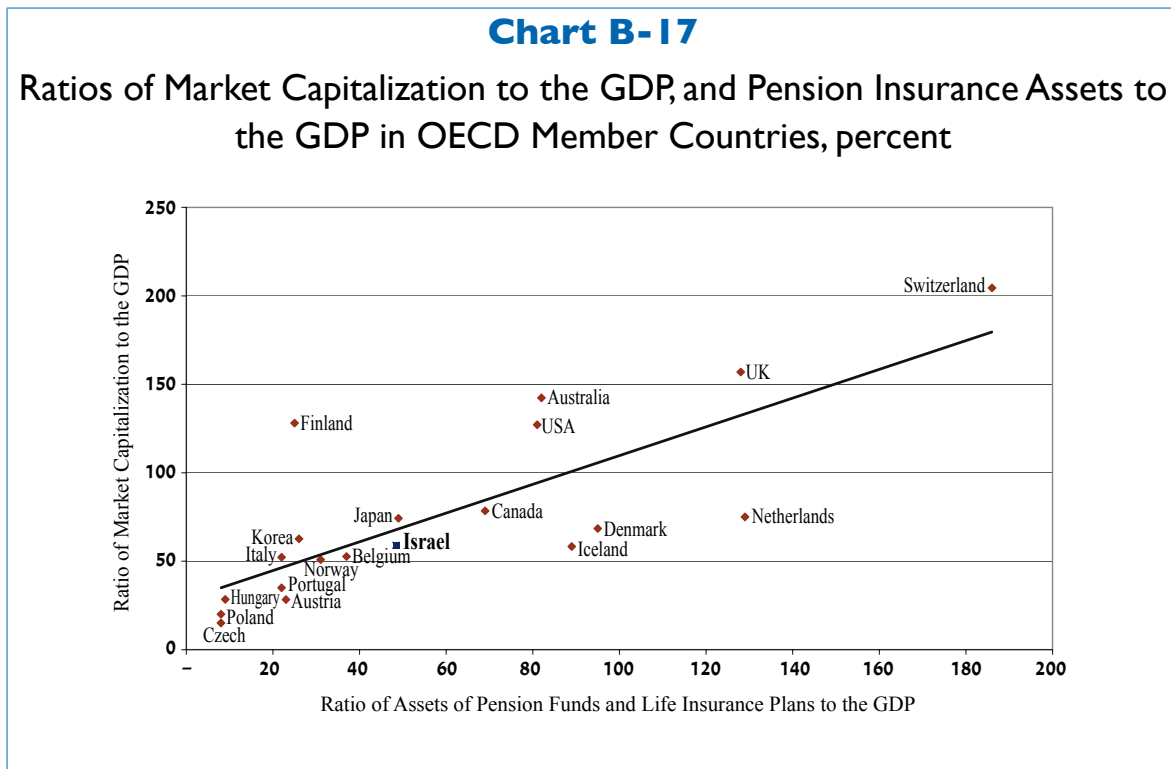
Long-term savings is one of the changes that are essential for perfecting the financial markets. Not only pension funds are engaging in this type of savings, but also provident funds and

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life insurance plans. A savings portfolio is being managed in these three frameworks – pension, provident funds, and life insurance – whose volume reached about NIS 460 billion in December 2004. The government is competing against the private sector for these savings, and it is evident that, for the most part, it is being used to finance the government's current expenses, instead of financing investments and credit required for the private sector's activities. Non-banking financial intermediation, which is based on the capital market, is a characteristic of a developed economy, and is impossible without it, if the objective is to maintain open and competitive financial markets.

A global comparison between OECD member countries shows that in those countries characterized by the existence of a market-oriented financial system, such as the Netherlands, Australia, the US and the UK, there is a high ratio of pension insurance assets (pension funds and life insurance plans) to the GDP, as well as a high ratio of market capitalization to the GDP. On the other hand, in countries whose banks fulfill a significant role in a banking-oriented financial system)²¹ – for example, Italy, Austria, Portugal, as well as Israel (who is still not counted amongst OECD countries), the ratios are lower. This high correlation shows that a developed contractual savings market is dependent, largely, on a developed capital market. However, it also shows that the fact that the pension savings institutions prefer to hold stocks in their asset portfolios is contributing to the development of the financial markets in various countries (Chart 17).

21. On the distinction between market-based financial systems and banking-based financial systems, see for example: Demirgüç-Kunt, A. and Levine R., The World Bank, Policy Research Working Papers, 2143, 1999.



Source: OECD member countries' data – the organization's website; Israel's data – reports to the Capital Market, Insurance and Savings Division, and data from the Monetary Department at the Bank of Israel and from the Central Bureau of Statistics.

The reforms instituted in recent years in the field of contractual savings should be seen as part of the process of reforms in the financial markets. The main reform is the reform in the capital market (Bechar Committee report). The objective of this reform is to establish the structure of the competition in the capital market in Israel and to improve its efficiency and modes of operation. The ways to achieve this target are: to reduce the market concentration and to minimize the conflicts of interest built into the bodies operating in the capital market – particularly in the banking system – and to expand the supervision and control over them and on those governing and holding them. The reform was implemented after previous attempts to change the institutional structure of the system failed, and it is expected to create a fundamental change in the ownership structure and businesses of financial intermediaries. This change is likely to create conditions for developing real competition in the capital market and for ensuring its proper functioning.

During July 2005, the *Knesset* approved the recommendations contained in the Bechar report, some of which address material changes in the contractual savings institutions market

in Israel: (a) the provident funds and mutual funds will be severed from the banks – both in terms of ownership and management – and thus, non-banking bodies, including insurance companies, will be able to acquire provident funds and mutual funds; (b) the marketing of insurance and financial products will be separated for the first time from counseling services for these products. All bodies operating in the capital market will have to choose between marketing of products or consultancy; while no body will be able to perform both operations; (c) banks will be able to engage in the counseling and selling of life insurance policies and pension products only after they sell their holdings in the provident and mutual funds; (d) the banks' activities in the sale of insurance products and pension products, as stated above, are conditional upon them not being interested parties in insurance companies.

The reform in the capital market is linked to a set of reforms instituted during the last two years, which address the operations of contractual savings institutions. Notable in the material changes is the implementation of the recovery plan for the old deficit pension funds and the insurance companies' penetration of the pension market – in order to ensure that apolitical professional bodies manage the investments, which are also supervised and controlled by the market powers – as well as the building of comparable new insurance products. Furthermore, many legislative amendments were enacted in the field of taxation, including reduction of the maximum income entitled to tax benefits from NIS 9,900 to NIS 7,100, increasing of employees' allocations to benefits to 7 percent of their wages, and increasing the employers' allocations to 7.5 percent of employees' wages – for all pension savings instruments²². This central change in the tax benefits is designed to encourage the creation of a more uniform savings system, in order to enhance the competition between the various instruments and to increase long-term savings.

The reform that the Capital Market Division initiated in the pension insurance market changes the rules of the game and the traditional power ratios between the players – the pension funds, the insurance companies and the provident funds. Subsequent to the transformation of the pension funds to yield funds²³, it is expected that the main competition in the market

22. Previously, the employers' allocations to benefits were up to 5 percent in life insurance and 6 percent in pensions; this in addition to the employers' permitted expenditure for work disability insurance other than within the scope of benefits. Employees' allocations to benefits had previously been up to 5 percent in life insurance and up to 5.5 percent to pensions.

23. In these funds, the height of the pension is dependent upon the amount that the member accrued in his personal account and upon the funds' yields on their investments.

will focus on the height of the management fees and on the yields that the institutional bodies achieve. Within this scope, management of the investments becomes a significant component in future competition. Subsequent to elimination of the tax discrimination between Israeli and foreign securities, the capital markets in Israel and abroad opened to pension funds and insurance companies, almost without restriction, and therefore, it is essential that sophisticated investment systems be built.

The growing competition for insureds' money intensified even more with the assistance of the Capital Market Division in other areas as well; thus, for example, data were published about the success of the private provident funds, and a series of new regulations were instituted, such as facilitating the shifts between the controlled bodies and choosing between instruments and tracks. The opening of the "Gemel-Net" website for comparing the provident funds, and the development of the calculator for comparing compulsory vehicle insurance tariffs, are also expected to help perfect the market. Moreover, it appears that the public debate about the conclusions of the Bechar Committee, whereby the provident funds and mutual funds must be severed from the banks, and the stress that the Capital Market Division has placed on expanding the requirements for transparency, proper disclosure and for improving the availability of information to members and insureds, has also contributed to enhancing public awareness and improving market discipline. These developments should contribute to increasing the returns to investors or private savers, to reduce the manipulation by the financial intermediation sector and intensify the competition between the banks and other financial institutions.

The recent deregulation and liberalization measures should create a financial system having new parameters, in which a few major financial intermediaries (banking and nonbanking) will be active, competing against each other for the supply of products and full services to consumers. Expansion of the financial institutions' variety of activities is a crucial matter, because it contributes to risk diversification and to increasing income stability over time, since there are many synergies between the various types of financial services. The latter developments intensified the contestability in the financial system, and they are expected to expose contractual savings institutions to competition with sources outside the system, mainly the local capital market and the banks. Furthermore, these developments can influence the positioning of the contractual savings institutions in the money and capital markets and influence the structure of their activities and income.

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However, it is important to emphasize that the process of reducing the restrictions imposed on the contractual savings institutions' activity in the money and capital markets, and their relative freedom to determine the conditions of financial intermediation and the services they will provide to the public within that framework, expose the institutions to greater risks than in the past. Under circumstances of heightened competition, there is a concern that these institutions will tend to assume excessive risks (including risks they are less familiar with) in order to get ahead of their competitors in various fields. For the sake of ensuring their stability in this new reality, the institutions must manage their risks in an educated and controlled manner. The Capital Market Division has been working diligently in recent years to regulate the risks in the controlled bodies. *Inter alia*, the controlled bodies were required this past year to implement procedures, and limitations to their credit risk exposure, and to manage the special risk reserves under insurance, as well as to begin establishing control systems for the spectrum of risks inherent in their activities.

In light of the anticipated changes in the money and capital markets, the main challenge today in the supervision of financial bodies is to strengthen the cooperation between the supervisory bodies and to jointly ensure the uniformity required, by regulating and controlling all bodies operating in the financial markets, in order to advance the Israeli capital market, to perfect the allotment of capital in the economy and thus contribute to its growth.