

## Chapter 5

# Institutional Investors

Institutional investors' share<sup>1</sup> of the public's asset portfolio amounted to 36.7 percent at the end of 2003 compared to 35 percent last year. The balance of institutional investors' assets increased this year and, in December, amounted to approximately NIS 508 billion compared to NIS 433 billion last year. The main increase was evident in mutual funds and to a lesser extent in profit-sharing life-insurance schemes – an increase that was partially offset by the decline in the proportion of established pension funds and guaranteed-yield life-insurance schemes.

The trend for the withdrawal of money from provident funds<sup>2</sup> remained unchanged during the year despite the relatively high yield in the fixed income and equity markets with the public increasing its deposits mainly in mutual funds specializing in unindexed assets, especially in Treasury bills. The high positive accrual in these funds proved worthwhile, *inter alia*, as the revenue from investments in Treasury bills was tax-exempt in 2003.

During 2003, institutional investors directed their investments into unindexed assets and share holdings, a trend that characterized the public's financial asset portfolio in general. This change is attributed, among other things, to the adjustment of financial asset holdings to the expected decline in inflation, reduced interest in the markets and the increase in share prices.

Towards the end of the year a reform in the pensions sector was put into operation. Within the context of the reform, the government reduced the issue of earmarked bonds for the pension funds. The greater part of the money that was invested in these funds will be transferred to the equity market.

<sup>1</sup> On the basis of estimates of the Capital Market Division in the Ministry of Finance.

<sup>2</sup> Provident funds and severance pay funds.

## 1. MUTUAL FUNDS

## a. The development of assets

The balance of mutual funds' assets again increased in 2003 by approximately NIS 37 billion and amounted to approximately NIS 83 billion, after the positive trend of the previous years had been halted in 2002 with the balance reaching its highest level in ten years (Table 5.1). The increase in assets recorded a net positive accrual of 30.7 billion and a relatively high yield—15.6 percent of the mutual funds' total assets for the year under review. The significant accrual in these funds was due, mainly, to a massive accrual in NIS funds, which invest mainly in tax-exempt assets<sup>3</sup> and particularly

**Table 5.1**  
**Institutional Investors: Main Developments, 2000–2003**

	(NIS billion, current prices)							
	Mutual funds	Provident and severance pay funds	Advanced study funds	Pension funds		Life insurance schemes		Total
				Established	New	Guaranteed yield	Profit sharing	
<i>Balance (NIS billion, current prices)</i>								
2000	45.8	120.0	42.2	105.4	7.5	40.6	30.1	391.6
2001	63.0	123.8	48.0	109.4	10.6	41.5	37.4	433.8
2002	45.8	119.8	47.0	119.7	14.3	44.5	41.8	433.0
2003	83.2	134.7	54.7	120.6	18.5	43.8	52.4	508.2
<i>Percent of public's asset portfolio</i>								
2000	4.1	10.6	3.7	9.3	0.7	3.6	2.7	34.6
2001	5.2	10.2	4.0	9.0	0.9	3.4	3.1	35.8
2002	3.7	9.7	3.8	9.7	1.2	3.6	3.4	35.1
2003	6.0	9.7	3.9	8.7	1.3	3.2	3.8	36.7
<i>Net accrual (NIS billion, current prices)</i>								
2000	11.0	-1.0	3.3	-2.1	2.0			13.2
2001	15.4	-4.1	2.6	-2.9	2.6			13.6
2002	-14.9	-3.0	-0.7	-3.2	3.0			-18.8
2003	30.7	-2.7	0.9	-4.3	3.4			27.9
<i>Real yield (percent)<sup>a</sup></i>								
2000	4.4	3.4	3.6					
2001	3.7	6.4	6.9					
2002	-6.6	-6.9	-6.4					
2003	15.6	19.1	17.8					

<sup>a</sup> The real yield of the provident and severance pay funds does not include the yield of the central severance pay funds which were 2.8 percent in 2000, 6.7 percent in 2001, -7 percent in 2002, and 18.8 percent in 2003.

SOURCE: Bank of Israel.

in Treasury bills that were tax-exempt until the end of 2003. The accrual derived, *inter alia*, from expectations of a continued reduction in interest rates and, as a consequence, the expectations of capital gains. The increase of the total balance contributed also to

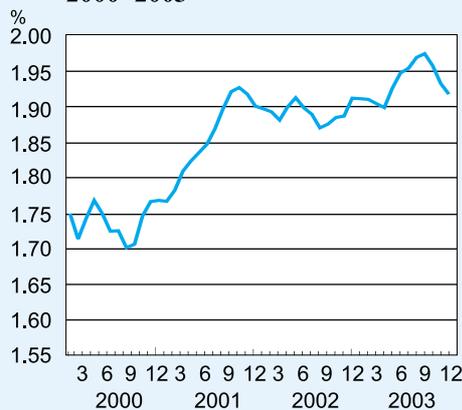
<sup>3</sup> The unindexed bonds that were issued before the determinant date for the tax reform, May 2002, and Treasury-bill series that were exempt from tax up until the end of 2003.

the increase in the assets of funds specializing in shares; this was a reflection, predominantly, of sharp increases in share prices on the Tel Aviv Stock Exchange as accrual in these funds was low in the year under review.

A trend of positive accrual in assets was evident during the year, gathering strength and reaching considerable amounts. After a slight accrual of only NIS 860 million in the first three months of the year, expansion of assets accelerated from April onwards due to a massive accrual in funds specializing in unindexed local-currency holdings.

With the increase in the volume of the assets, 64 new funds were formed this year, bringing the total number of funds to 648. This rise, continuing the trend of recent years, occurred mainly in funds specializing in local-currency assets (36 new funds) and funds specializing in assets abroad and in government bonds (13 and 7 funds respectively). The number of funds specializing in shares, still the largest group, rose by 7 to 155. Thus the proportion of the mutual funds in the total assets held by institutional investors also rose, from 11 percent in 2002 to 16 percent in 2003, and comprised 6 percent of the public's total assets.

**Figure 5.1**  
Normalized HHI Index of  
Concentration in Mutual Funds,  
2000–2003



SOURCE: Bank of Israel.

The concentration index (the normalized HHI index)<sup>4</sup> of the mutual funds industry rose during 2003 but declined in the last quarter of the year, returning to the relatively high level that had prevailed over the previous two years (Figure 5.1). The distribution of the funds' assets on a management basis remained unchanged this year; the three large banking concerns that manage most of the funds' assets held approximately 79 percent of their total assets, and the share of the medium-sized and small banks in fund management was 11 percent on average. The remaining funds are managed by private, nonbank, management companies.

#### **b. The development of mutual funds' assets by declared specialization**

The significant increase in the mutual funds' assets in 2003 encompassed almost all specialization bases and reflected both the increase in the funds' activity and the increased yields (Figure 5.2). The balance of assets of the funds specializing in unindexed local-currency assets and in particular in Treasury bills (almost all of whose assets are

<sup>4</sup> The Herfindahl-Hirschman index that measures the degree of concentration, is calculated by adding the square of each group's participation rate in the mutual funds market, and is normalized relative to the concentration index that represents uniform distribution. A rise in the index implies a growth in concentration in the mutual funds industry.

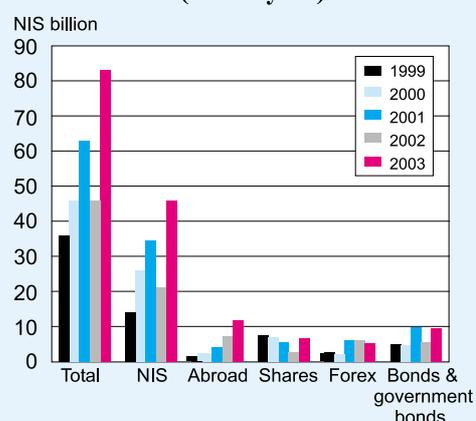
unindexed) more than doubled and reached approximately NIS 46 billion, the lion's share of the assets of all the funds. The balance of assets of mutual funds specializing in shares, which with 155 funds outnumber all the other funds, also more than doubled, reaching NIS 6.7 billion, some 8 percent of the assets of all the funds. The balance of assets of funds specializing in overseas investments recorded an increase of two-thirds this year, reaching NIS 12 billion—approximately 14 percent of the assets of all funds.

The total accrual of the funds for 2003 amounted to NIS 30.7 billion (Figure 5.2).

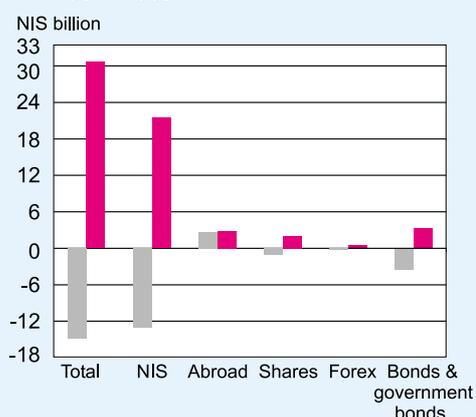
The largest positive accrual was in mutual funds specializing in unindexed assets—NIS 21.5 billion—after a drop of NIS 13 billion last year. As a result of increased inflation expectations in the first months of the year, these funds recorded redemptions of NIS 350 million. However, with the subsequent downward revision of these expectations along with the reduction in interest by the Bank of Israel, the accrual in these funds increased and peaked at the end of the year. On the other hand, funds specializing in shares recorded a relatively low accrual of NIS 2 billion, after the redemptions of 1.4 billion in the previous two years. The accrual this year in these funds—partly in the second quarter and principally in the last quarter—reflected price developments in the equity market. The low level of the annual accrual demonstrates that households that invested in the equity market through a mutual fund did so only towards the end of the year, after sharp price increases had already been recorded.

Funds specializing in overseas investments showed a larger accrual, NIS 2.9 billion, which occurred mainly in the second half of the year, continuing the trend of the last five years. This took place because *inter alia* the taxation on an investment made through exempt funds that invest most of their money in these assets is more favorable than a direct investment in those same assets (as will be described below) and because of the liberalization of the foreign currency market. The activity in funds specializing in bonds and government bonds, that was reflected by an accrual of

**Figure 5.2**  
**a. Balance of Assets in Mutual Funds, by Declared Specialization, 1999–2003 (end of year)**



**b. Accrual in Mutual Funds' Assets, by Declared Specialization, 2002–2003**

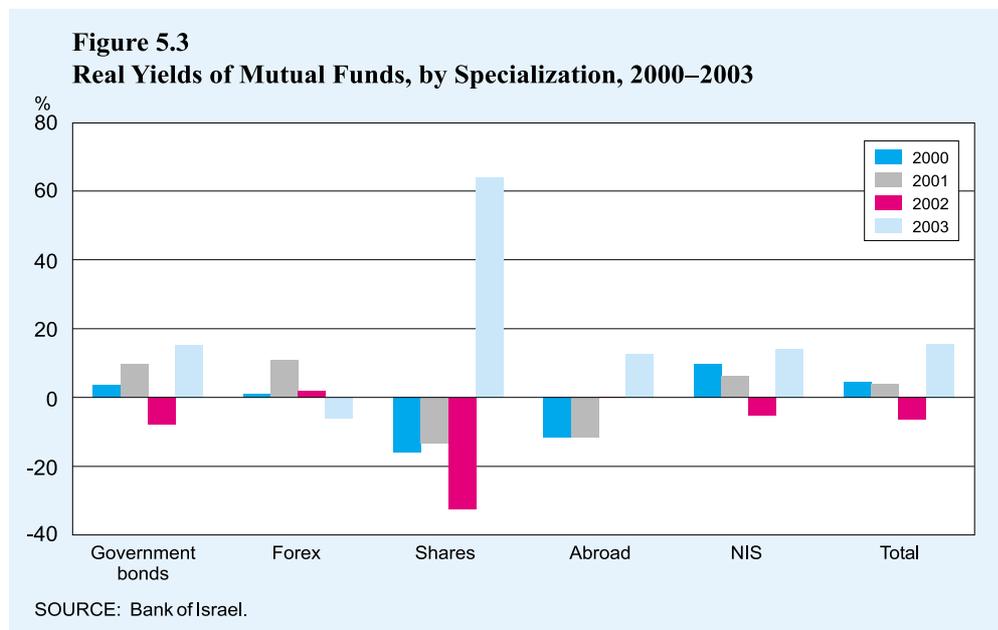


SOURCE: Bank of Israel.

NIS 3.3 billion apparently derived from expectations of further declines in yields in the bond market, which implied chances of capital gains; This followed a negative accrual of NIS 3.6 billion in 2002. The accrual in funds specializing in foreign currency this year was positive but low, NIS 0.5 billion, despite the trend of NIS appreciation. Only from September onwards did the redemptions in these funds exceed the issues.

### c. Yield developments

Mutual funds yielded a real return of 15.6 percent in 2003, compared with a negative real return of 6.6 percent in 2002. A yield of this magnitude was achieved by most of the funds, except for those specializing in shares, which showed a yield of more than four times this average, and those specializing in foreign currency, which had a negative yield of about 6 percent (Figure 5.3).



From a comparison of the profitability of investments in mutual funds by funds' specialization, according to the Sharpe Index<sup>5</sup> that takes account also of the risk level of the investment, it appears that funds specializing in investment in Israeli securities traded overseas yielded the highest excess return (i.e., in excess of the yield on a risk-free asset), 12.5 percent, consisting of its yield and a relatively high risk level; this applies also to funds that specialize in shares, in which the excess return was about 9 percent, with the yield itself lower and the risk higher. The excess return of funds specializing in bonds and in government bonds and of those specializing in unindexed

<sup>5</sup> The Sharpe Index represents the assets portfolio's yield in excess of the yield of a risk-free asset (a Treasury bill) in terms of a unit of risk.

local-currency assets were similar—approximately half the highest excess return. The mutual funds specializing in CPI-indexed assets did not attain a return higher than the risk-free market while mutual funds specializing in foreign currency recorded a negative excess return of 9 percent—that is, lower than the return on a risk-free asset.

On comparing the actual return of the funds with a flexible investment policy—those whose managers enjoy freedom in selecting the composition of their investments—with the yield in a theoretical portfolio that represents the return they would have yielded without any action on the part of the managers during the year,<sup>6</sup> it appears that the managers gave investors a higher yield, contrary to previous years. It should be pointed out that the transactions—deposits and withdrawals—were relatively small, thus enabling managers of these funds to act without influencing market prices. In the mutual funds specializing in bonds and in government bonds, the yield did not exceed that of their relevant theoretical portfolio, the implication being that their management did not contribute to their performance.

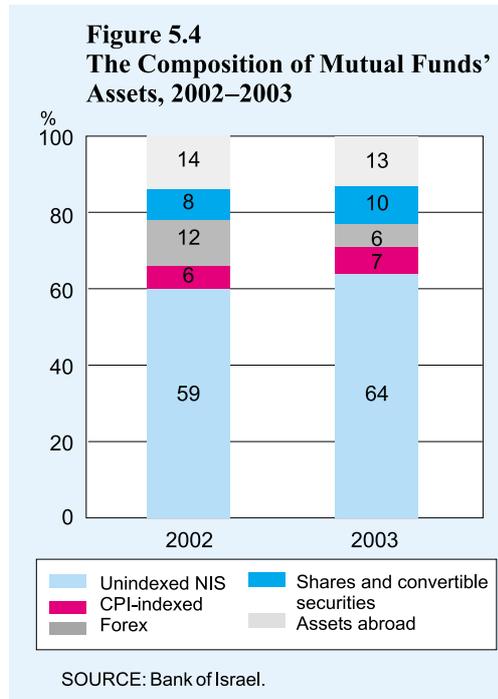
On analyzing the yield on mutual funds on the basis of the assets in which they specialize, it is also customary to compare their returns to the relevant market indices and to examine whether the investor derives any benefit from investing via these funds rather than investing directly in the market. If the real annual return on the funds with a particular specialization, after deducting fees for managing the portfolio, is higher than the yield of the relevant market index, an investment via the funds is preferable. In 2003, as in recent years, the yield on these funds was in general lower than the relevant market yields. Thus, for example, the yield on mutual funds specializing in unindexed assets was about 1.5 percentage points lower than the yield of the relevant market index. Funds specializing in shares were the exception in 2003, recording a yield approximately 2 percentage points higher than a direct investment in shares. It should be pointed out that this comparison should be treated with caution because 2003 was a transition year with regard to the tax reform, and there was still a lack of uniformity in the taxation of the various assets and the various methods of investing in them. Because of the difference in the tax status of the funds, some of them showed the yield after tax and some showed the yield before tax; part of the yield gap may thus derive from the difference in taxation. Most of the unindexed assets held by mutual funds are not taxed, however, so that the return for funds specializing in these assets in 2003 was unaffected by taxation. Moreover, most of the assets invested in shares belong to funds that do not pay tax (the tax is paid by the holders of units of participation).

#### **d. Distribution of the mutual funds' assets portfolio by indexation base**

The reduction of the Bank of Israel's interest rates, together with the continued decline in interest rates in the markets and the sharp rise in share prices provided the background to changes in the composition of the mutual funds' financial assets portfolio in 2003. Thus, the proportion of unindexed assets, the largest component in the funds' portfolio, rose continuously throughout the year, to approximately 64 percent. This increase,

<sup>6</sup> This portfolio maintains the composition that was specified for it at the beginning of the year.

however, did not offset the contraction of this component in 2002 (Figure 5.4). The preference for this investment channel, as in the case of the public's asset portfolio, derived principally from its relatively high expected yield and from the preferential tax on Treasury bills and some government bonds still in effect in 2003. The proportion of CPI-indexed assets in total assets rose more slowly—against the backdrop of the



downward trend in expected inflation—as did that of shares. These two components reached their highest point of the year in the middle of the year, subsequently falling slightly at the end of the year to 7 percent and 10 percent of the total portfolio respectively. The proportion of foreign-currency-indexed assets and foreign-currency-denominated assets rose by one percentage point at the beginning of the year, then fell before stabilizing at 6 percent. This represents half of its proportion in the total portfolio in 2002. The proportion of investors' assets overseas also rose by one percentage point at the beginning of the year to 15 percent and after declining during the year, rose again to 13 percent.

A substantial transition to investment in Treasury bills due to the temporary preferential taxation is evident from an analysis of mutual funds' local-currency assets. The proportion of Treasury bills rose from December 2002, reaching its peak for the year, 45 percent of all local-currency assets, in October 2003, declining again to 40 percent at the end of the year, compared with 36 percent in November 2002. The increase in 2003 was at the expense of assets invested in *Shahar*-type bonds that fell from 36 percent in November 2002 to approximately 27 percent at the end of 2003. The proportion of the monies invested in deposits and cash rose to an annual peak in December—13.5 percent of all local-currency assets.

#### e. Distribution of the mutual funds' assets portfolio on the basis of the taxation track

Within the context of the Amendment to the Income Tax Ordinance as recommended by the Rabinowitz Committee, mutual funds were divided in 2003 into three types of fund, distinguished from each other by taxation conditions: tax-exempt funds, liable funds and mixed funds (for details see the 2002 Annual Review of the Bank of Israel Monetary Department).

In 2003, many mutual fund managers chose to operate on the liable funds track due to the tax exemption on capital gains from unindexed assets for the year, and the one-

time option afforded to these fund managers to change the funds' tax status before 2004 on condition that they met specific criteria regarding their holding in tax-exempt assets. Consequently, approximately 80 percent of the total balance of mutual funds' assets at the end of 2003 were held by funds classified as liable funds, of which approximately two-thirds were funds specializing in unindexed assets. Most investors in liable funds are households who prefer to avoid contact with the tax authorities, or customers who do not invest in other securities and therefore do not need to offset losses against future profits or losses and profits from different forms of investment.

In 2003, the balance of exempt funds' assets was relatively small—approximately 3 percent of all the funds' assets. Almost all these funds specialize in overseas investments, as the rate of tax on capital gains on selling holdings in such funds, 25 percent, is lower than the 35 percent tax on a direct investment in foreign securities. Investment in other assets (not foreign securities) via exempt funds is not worthwhile as the tax rate is lower on a direct investment or on an investment in a fund with another tax status.<sup>7</sup> As all forms of income are tax exempt in a fund of this sort, the principal investors in funds of this type will be companies and institutions that prefer to obtain an exemption from deduction of tax at source and to benefit from the option to offset losses against capital gains. The option to offset losses against profits from interest and from a dividend by means of mutual funds provides a tax advantage to those investing in them.

The balance of assets of funds classified as mixed funds in 2003 was approximately 17 percent of all mutual funds' assets. The funds that selected this track vary from the aspect of the assets in which they invest. This tax track suits them for two reasons: the rate of tax is not as high as that of exempt funds but is identical to the rate of tax that would have been applicable in the case of a direct investment: in addition, in 2003, an investor could benefit from offsetting losses on all the securities he held. Approximately a third of the funds' asset balance in 2003 was in share-oriented funds—in which the advantage of offsetting losses was particularly marked this year due to the drop in prices in 2002—and 20 percent was held in funds specializing in unindexed assets.

In 2003 more than 80 percent of the accrual was in liable funds; the remainder was accrued in those classified as mixed, and activity via these funds increased during the year.

## 2. PROVIDENT AND SEVERANCE PAY FUNDS AND ADVANCED STUDY FUNDS

### a. Asset developments

The balance of provident funds' assets at the end of 2003 totaled NIS 135 billion compared with NIS 120 billion at the end of 2002 (Table 5.1). This increase is explained

<sup>7</sup> Tax on interest and capital gains is 15 percent of the interest and real capital gains, or 10 percent of the interest and nominal capital gains: tax on a dividend from an Israeli company is 25 percent.

by the positive real yields of the funds, approximately 19 percent, as net withdrawals from the funds continued during the year, and totaled NIS 2.7 billion, similar to those in 2002. Despite this trend of withdrawals, provident funds still hold very considerable assets and they are dominant as financial intermediaries for savings. The balance of assets in provident funds in 2003 comprised 9.7 percent of the public's financial assets, and 27 percent of institutional investors' assets.

Negative net accumulation (deposits *minus* withdrawals) in the provident funds continued along its downward path in 2003, and reached NIS 2.7 billion, similar to its level in 2002. The principal reason for the negative accruals in provident funds was their relatively low average yields over the years, and their increased volatility which give an investment in them the characteristics of short-term savings. The annual net negative accrual also derived from the recession in real activity in the economy, the influence of which was evidenced in increased withdrawals from the funds by employers to pay compensation on dismissals. Nevertheless, from the second half of the year, withdrawals fell, from an average of NIS 1.3 billion a month in the first half of the year to an average of approximately NIS 1 billion in the second due to the funds' high yields, and consequently the negative net savings accrual also declined. A further reason for the moderation of the withdrawals trend is the total exemption from tax on profits on deposits until 2003 at both the investment and the withdrawal stages as opposed to taxation to be imposed on deposits in funds from 2004, within the context of the tax reform. The high accrual of approximately NIS 1.3 billion in December 2003 compared with those in December 2002 and 2001 is attributed to lower withdrawals by members<sup>8</sup>—possibly in view of the full tax exemption on monies that were deposited until the end of 2003.

The provident funds' increased yields in 2003 derived from the composition of the investment of their assets: the largest part, 42 percent, was invested in the government bond market in which prices rose considerably, and in the equity market, that was characterized by an even sharper price increase, and in which the funds increased their investments to 15 percent of their portfolio. Provident fund yields were highly volatile over the last few years, in line with market yields. This volatility increased further in 2003—a year of high yields following the negative yields of 2002. This was against the backdrop of an increase in the proportion of tradable assets in the portfolio. Volatility increases the level of risk inherent in a provident fund and accords this savings instrument with a short-term characteristic, while some of those making deposits in a provident fund consider them long-term savings. This phenomenon is an indication of the problematic structure of provident funds that creates a contradiction for the fund manager in determining the fund's investment policy: savers whose funds are already liquid are willing to take a relatively high risk in return for the chance of obtaining high yields in the short term, while savers whose date of maturity on their savings is still in the comparatively distant future are interested in a solid, long-term investment

<sup>8</sup> Self-employed members' deposits in December 2003, intended to take advantage of tax benefits before the end of the year, were similar to those of previous years.

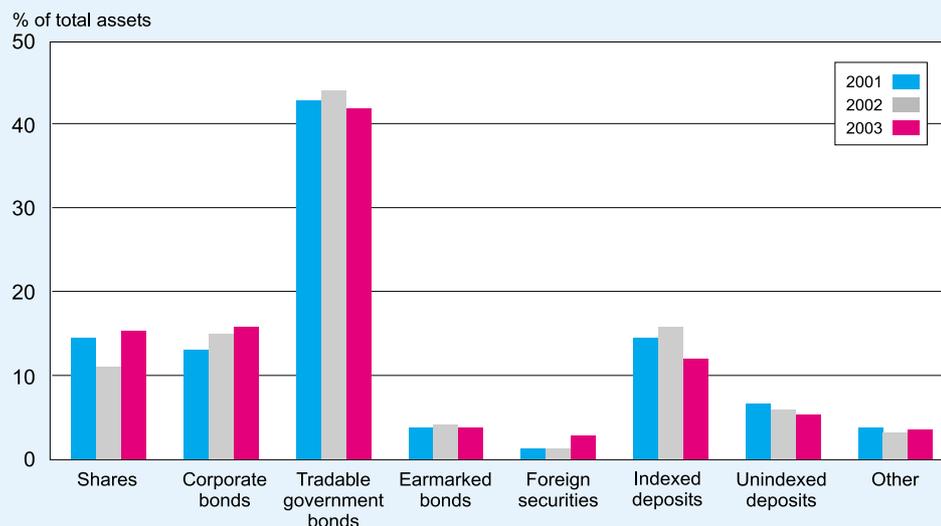
without a high risk. An additional structural problem in the provident funds sector is the problem of the centrality of control: 85 percent of their total assets are still held by the banks.

The assets of advanced study funds amounted to NIS 54.7 billion at the end of 2003, compared to NIS 47 billion in 2002. This increase derived principally from the rise in prices, and over the year as a whole there was a positive net accrual of NIS 937 million. The advanced study funds also recorded a high positive real yield of approximately 18 percent in 2003. At the start of the year, the trend of net negative accruals that had started in 2002 was maintained, while from June deposits exceeded withdrawals and the accrual became positive, if low. The net negative accrual in the advanced study funds in 2002 and the first five months of 2003 is *inter alia* the result of the first opportunity for self-employed members to withdraw monies deposited in them from 1996.

#### b. Distribution of the asset portfolio of the provident funds and advanced study funds

In 2003 provident funds' managers chose to reduce the proportion of their investment in CPI-indexed and foreign-currency-indexed investments, principally in favor of their investments in shares and convertible securities and their overseas investments to 15 percent and 3 percent respectively, and to a lesser degree, also in corporate bonds (Figures 5.5). The proportion of tradable securities has therefore increased to 66 percent of the portfolio, as holdings in deposits declined. It may be that these changes testify to

**Figure 5.5**  
**Distribution of the Provident Funds' Asset Portfolio, 2001–2003**



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

a trend on the part of fund managers to disperse their investments and to transfer monies to holdings with a higher risk in an attempt to increase the yield on their assets. Nevertheless, and despite the fact that the new investment regulations came into effect in October 2002, no significant change in the investment patterns of the funds is yet evident. CPI-indexed assets, despite a 5 percentage-point reduction in their share in the total, constituted the main part, 42 percent, of these funds' investments. The greatest part (53 percent) of local-currency assets, whose proportion in the total portfolio, 21.8 percent, has remained almost unchanged, were invested in *Shahar*-type bonds, while withdrawals from deposits and cash components continued.

A similar picture emerges with regard to the advanced study funds: managers chose to increase the proportion of the investment in shares, convertibles and overseas investments, and also to increase the proportion of tradable assets, mainly at the expense of their investments in CPI-indexed and foreign-currency-indexed investments but also at the expense of local-currency assets. As to the distribution of the local-currency investments, a transfer from deposits and cash is evident, principally to *Shahar* bonds.

### 3. THE PENSION FUNDS

#### a. The pension funds for veteran members

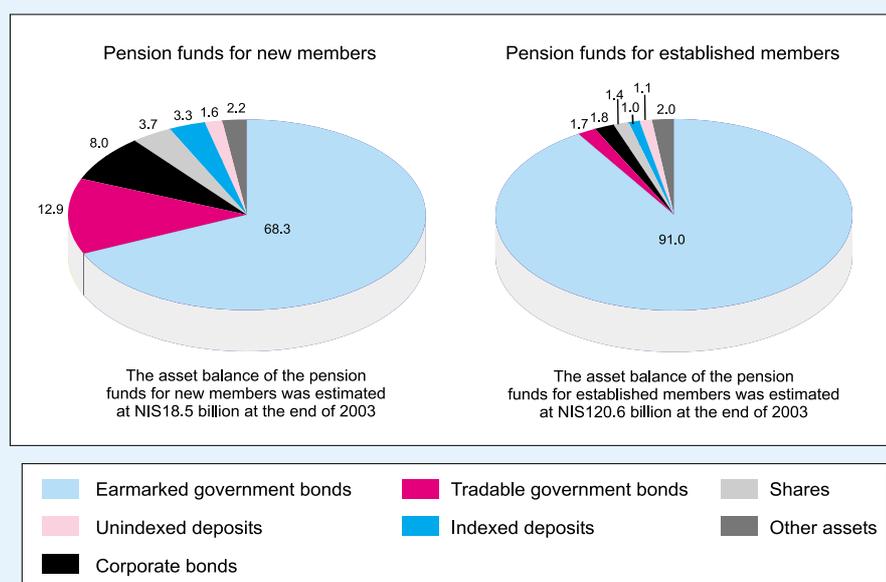
The asset balance of the pension funds for veteran members at the end of 2003 totaled NIS 120.6 billion compared with NIS 119.7 billion at the end of 2002. The increase resulted from the guaranteed yield on earmarked bonds. Since 1995, new members have been permitted to join only the new pension funds and not established pension funds. As a result, the number of members contributing to these funds is gradually decreasing as payments to veteran members increase. Closure of the established funds to new members has led to withdrawals from these funds in recent years and, during 2003, NIS 4.3 billion was withdrawn compared with NIS 3.2 billion in 2002. The greater net negative accrual this year is a reflection of the reduced deposits by members concurrent with increased redemptions. The asset balance of the established pension funds in 2003 represented 8.7 percent of the public's total financial assets portfolio, or 24 percent of the total assets held by the institutional investors.

From June to August 2003, before the government reduced the issue of earmarked bonds within the context of reform of pensions, managers of established funds exploited the last opportunity to increase the inventory of these bonds. The relatively high profitability of the guaranteed yields in this arrangement during 2003 in conjunction with the continued decline in the yield on the long-term CPI-indexed tradable government bonds therefore also contributed to the low level of effective interest paid on earmarked bonds. Consequently, purchases of *Meron*-type bonds by the funds rose sharply, from an average of NIS 500 million a month in January–May to an average of NIS 1.4 billion a month in June–August.

Earmarked bonds made up 91 percent of the pension funds' total assets at the end of 2003, compared with 93 percent at the end of 2002; the proportion reached its highest point of the year, 94 percent, in August, before the end of the issue of these bonds (Figure 5.6), and then declined. A certain coincidental increase was evident in the rate of these funds' holdings in private bonds, government bonds and, to a lesser extent, in CPI-indexed deposits. The low proportion of private bonds in the established pension funds' portfolio increased threefold to 1.8 percent. Nevertheless, the pension funds invest principally in nontradable assets in the capital market and only minimally in tradable assets.

The pensions sector is still relatively highly centralized. Eighty-four percent of pension funds' assets are held by two large funds and, until the reform, 95 percent of the industry's assets were held by institutions of the Histadrut that also appointed their boards of directors. Within the context of the reform, the Ministry of Finance appointed special managers to administer the funds whose assets in December made up 88 percent of the total assets of the pension funds.

**Figure 5.6**  
**Distribution of Pension Funds' Assets, 2003 (percent)**



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

### b. The pension funds for new members

The pension funds for new members that began to operate in January 1995, focus on attracting new members, mainly young people who have just started to save for a pension. This is leading to a gradual increase in the funds' income from management fees while their expenditure on pension payments is still low. The asset balance of the

pension funds for new member totaled NIS 18.5 billion at the end of 2003 compared to NIS 14.3 billion at the end of 2002. In 2003 comparatively large net positive accrual continued, rising to NIS 3.4 billion from NIS 3 billion in 2002. The new funds exhausted almost their entire permitted investment potential—68 percent—in *Arad* earmarked bonds, as they did in 2002. The proportion of assets invested in tradable government bonds and deposits declined to 13 percent and 5 percent respectively (Figure 5.6). This was mainly to the advantage of the proportion of the private tradable and nontradable bond component and the share component, even before the ending of the issue of earmarked bonds for the new funds in January 2004. In future, the implementation of the new investment regulations will lead to the increase of the proportion of tradable assets, as managers gradually become accustomed to investing in new and more varied holdings; this is due to the reform that was intended, *inter alia*, to allow funds to vary their investments in channeling most of their assets to the market (see Box 1). In regard to the indexed component in the pension funds for new members – the proportion of the CPI-indexed assets declined slightly to approximately 81 percent and the proportion of unindexed local-currency assets fell to 5 percent.

### **c. The general new pension funds**

The establishment of the general new pension funds was approved in 1999. These funds are not entitled to earmarked bonds and are intended for those wishing to pay into a pension fund in excess of the permitted ceiling for new pension funds (up to twice the average salary in the economy). One-time provisions can also be made to such a fund, a facility that is not available in the case of pension funds that are entitled to earmarked bonds. The asset balance of these funds totaled NIS 157 million at the end of 2003 compared to NIS 103 million in 2002. Approximately 42 percent of this sum was invested in government bonds, 12 percent in the corporate bonds market and 10 percent in the equity market. The proportion of CPI-indexed deposits declined this year by 15 percentage points while the proportion of local currency deposits increased by approximately 5 percentage points.

### **d. The reform in the pensions sector**

In May 2003 the Knesset approved an extensive reform of the pensions sector, and in August the new investment regulations for the pension funds were approved. This reform is intended to deal with management of the funds against the background of the actuarial deficits of the established funds. Within the context of the reform, a uniform regulation was applied to members' rights, intended to bring the funds into actuarial balance, similar to the mechanism governing the new funds. It was specified that the earmarked bonds (nontradable earmarked government bonds) in pension funds would decrease gradually, to only 30 percent of the estimated value of the funds' assets, compared with over 93 percent and 70 percent of the balance of the established and new funds respectively before the reform. Only when the total value of the earmarked

bonds in the established or new fund was below 30 percent would its manager be able to purchase earmarked bonds provided that the purchase did not bring their total value to more than 30 percent of the fund's assets. Moreover, their guaranteed yield component will be lower than before the reform.

The issue of earmarked bonds to established pension funds stopped in September 2003, and their issue to the new funds in January 2004. The issue of earmarked bonds to new funds is expected to be renewed only in 2008 and to established funds in 2012. Additional regulations that apply to the established funds within the context of the reform obligates them to invest in Israeli government bonds (including Treasury bills) so that the total investment in earmarked and government bonds will be 80 percent. In addition, they must invest at least 13 percent of their assets in Israeli government bonds and loans (including tradable bonds) and in deposits rated A and above. The remainder of the assets must be invested in Israel in accordance with the provident funds' investment regulations, and the fund will be obligated to comply with a specific index for the spread of the risk.

#### **Box 5.1**

#### **The Expected Long-Term Implications of the Pensions Reform on the Capital Market**

The principal aim of the reform of the pensions sector is to improve management of pension funds while maintaining an actuarial balance. The reform is based on the principle of reducing the hidden guarantees which the government gave hitherto to the pension funds by means of extensive issues of earmarked bonds. Within the context of the reform, investment regulations were also eased to enable funds to diversify the composition of their portfolios. The reform came into effect in September 2003 with the termination of issue of earmarked bonds to the established pension funds.

Savings for retirement age through pension funds constitutes more than a quarter of all institutional savings. This channel represents a considerable and stable demand for investment assets with time horizons that match the forecast requirement for pension payments; they do not offer immediate profits with high risk, but guarantee a minimum return over a long period. The government's obligation to issue fixed-interest CPI-indexed earmarked bonds to pension funds, like the issue of government bonds in general, leads to the exclusion of many capital resources from the private sector and reduces competition between the funds that would improve the potential yield to members. The diversion of pension savings into the capital market within the context of the reform is likely to create the infrastructure essential for the development and improvement of the market, at the same time deepening its tradability and introducing stabilizing institutions that are not speculatively

motivated. Nevertheless, the government is still obligated to supervise fund managers and to prevent any significant detriment to the savings that are more exposed to market fluctuations than they were in the past.

In the initial stages of implementing the reform, it is to be expected that most of the sums obtained from redemption of the earmarked bonds and accrual in the funds will be channeled to the government bond market in which the funds are obliged to invest the major part of their assets. The amounts that are likely to be introduced to the market in the coming years are estimated at between NIS 12 billion and NIS 14 billion a year.<sup>1</sup> As the government will issue only tradable bonds during this period (also as a replacement of the earmarked bonds, that will be issued again only after their balance in the funds' portfolio is down to 30 percent), the supply of government bonds will increase in line with the demand for them so that no price shocks are expected. These steps may be expected to have a positive impact on the bond market and on the capital market in general, as investors with a long-term investment perspective such as the pension funds usually have a stabilizing effect on the market—purchasing securities when prices are low and selling them when prices rise. Market volatility is therefore expected to decline as fund managers become more active.

The pensions sector reform will also start the process of making government debt tradable, and will make fund-raising more flexible, which was not possible before the reform because of the government's obligation to supply pension funds with earmarked bonds on an extensive scale. Within the context of the new rules, the composition of the pension funds' portfolio may be expected to change – as fund managers will have greater flexibility in diversifying their investments over the different holdings and for different terms than that imposed by an investment in earmarked bonds. Competition in the market may therefore be expected to increase and so create an additional source of financing for investment in the infrastructure, for increasing the tradability of the markets and contributing to their improvement with the development of new financial instruments.

<sup>1</sup> According to the estimates of the Capital Market Division of the Ministry of Finance.

#### 4. LIFE-INSURANCE SCHEMES

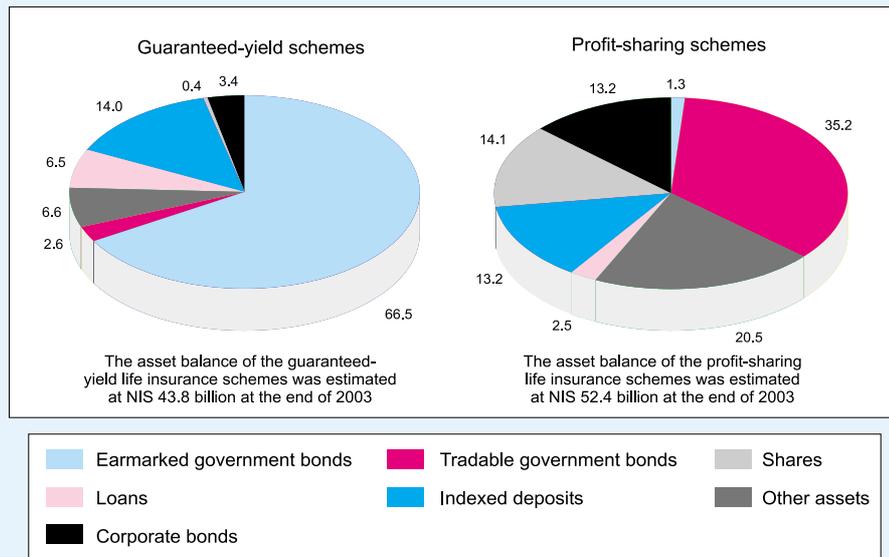
##### a. The guaranteed-yield life insurance schemes

The asset balance of the guaranteed-yield life-insurance schemes was estimated at NIS 44 billion at the end of 2003 – a decline of 1.7 percent since the end of 2002. Schemes of this type are entitled to issues of earmarked bonds that bear a CPI-indexed rate of

interest of between 4 percent and 6.2 percent on 86 percent of the money accrued in them. Accordingly, the lion’s share of their assets, 67 percent, is invested in earmarked bonds and only the remainder is invested in other forms of investment, including 14 percent in bank deposits and cash and 6.5 percent in loans (see Figure 5.7). The assets balance of schemes of this sort constituted 3 percent of the public’s financial assets portfolio in 2003, or 9 percent of institutional investors’ total assets.

In 2003, insurance companies redeemed NIS 70 million of earmarked bonds within the framework of the government’s early redemption tenders, compared with NIS 170 million redeemed last year. Insurance companies participate in the early redemption program for earmarked bonds when market conditions are favorable, and so continue to reduce holdings of nontradable bonds in their portfolios, while increasing their holdings in tradable securities—a transition that contributes to the greater efficiency of the domestic financial market.

**Figure 5.7**  
**Distribution of the Assets of Life Insurance Schemes, 2003 (percent)**



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

**b. The profit-sharing life-insurance schemes**

The proportion of profit-sharing life-insurance schemes (in existence since 1991) continues to increase gradually as a percentage of the public’s asset portfolio. In 2003, for the first time, their share of the portfolio, 3.8 percent, or 10 percent of the total assets held by institutional investors, exceeded that of the guaranteed-yield schemes. Also for the first time, insurance schemes of this type also comprised the majority of life-insurance schemes.

The profit-sharing life-insurance schemes' assets balance was estimated at NIS 52 billion at the end of 2003, an increase of 26 percent since 2002. As these life-insurance schemes are not entitled to invest in earmarked bonds, most of their accruals are invested in the tradable capital market. An analysis of the distribution of assets portfolio on the basis of type of investment indicates that the proportion of tradable government bonds amounted to 35 percent, similar to their proportion in 2002, and the proportion of nontradable private bonds increased to approximately 9 percent, principally at the expense of bank deposits and cash (see Figure 5.7). Insurance companies took advantage of new investment regulations (effective from April 2001) under which most of their investment quotas in specific assets were cancelled, and they purchased private, mainly nontradable bonds. The backdrop to this was the difficulty in raising bank credit that motivated businesses to satisfy their funding needs through increased issuance of private bonds. As of 2001, insurance companies have been allowed to invest abroad, and this year they increased their investments there by over 70 percent.

### **Box 5.2**

#### **Contractual and Non-Contractual Institutional Savings (Mutual Funds) in Israel and the World**

Contractual savings—an accepted concept in many countries—are savings managed by pension funds and insurance companies. It refers to financial savings that accrue within the framework of various arrangements that oblige their members to save at fixed intervals and over long periods of time, generally in the framework of deductions from monthly salaries.

The principle characteristic of contractual institutional savings is therefore long-term investment: investors are interested in accumulating money during their working life and withdrawing that money only after many years. Managers of contractual institutional savings diversify their investments among relatively secure financial assets (backed by collateral) with the aim of attaining high yields while taking a relatively low risk. In order to reduce the risk, they match the duration of their liabilities to those of their assets.

Elsewhere in the world, the better the financial markets function and the more flexible the regulations regarding investments, the more contractual institutional savings increase and long-term financial resources expand and continue to improve the functioning of the markets. This improvement serves to motivate contractual savings managers to extend their activities. The improvement takes the form of a transfer of contractual savings money to assets with a higher degree of tradability, for example stocks and corporate bonds. This is in contrast to the situation of undeveloped markets in which contractual savings managers tend to invest money in the government bond market. In the US, for example, over 40 percent of contractual savings are

invested in corporate bonds, approximately 20 percent in shares, and only 3 percent in government bonds.

Contrary to contractual institutional savings, investments channeled through mutual funds—that are not defined as part of contractual savings—are short-term investments, and the assets held by them are characterized by a relatively high degree of liquidity. Mutual fund managers offer professional management, and in contrast to contractual savings, they specialize in specific investment channels (shares, for example). In contrast to contractual savings, they are not dependent on various reforms in the areas of insurance and pensions, and therefore those funds grow quickly, while promoting the interests of the small investor. In countries where financial markets are in initial stages of development, mutual funds serve as a means of promoting new investment instruments.

Savings characteristics in Israel are similar to those described above. Non-contractual savings include mutual funds, while contractual savings include pension funds, insurance companies, and provident funds. The provident funds combine the characteristics of these two types of savings: they manage both long-term and short-term savings, and with regard to the latter they resemble short-term savings instruments, such as mutual funds. Most savers in provident funds are members who deposit money in them freely, taking advantage of the tax benefits accorded by that investment, and only 30 percent of such accounts are those of members who make deposits on the basis of work agreements in which the employer also makes contributions.

Institutional investors, as a whole, both in Israel and abroad, should serve as financial brokers in competition with the commercial banks, and as such to cause a reduction in margins and costs and an increase in the efficiency of the markets. The distinction between contractual institutional savings and non-contractual institutional savings, as described above, does indeed exist in Israel but the practice still exists of relating to all institutional savings, both contractual and non-contractual, as a single unit.

## *EVENTS IN THE CAPITAL MARKET<sup>1</sup> DURING 2003*

### **January**

#### *Bank of Israel interest rate*

- The interest rate was cut by 0.2 of a percentage point to 8.9 percent.

#### *The tax reform*

- The reform imposing tax on capital, savings and capital gains was implemented. The tax applies to deposits, savings schemes and bonds.

#### *NIS/\$ exchange-rate options*

- The Bank of Israel added a new series of half-year put options to those sold via auction, i.e., half-year call options, and three-month put and call options.

#### *Government bonds*

- A new series of bonds, *New Gilon*, with a 4-year maturity, was issued.

### **February**

#### *Treasury bills*

- The system of auctioning Treasury bills was changed: the Bank of Israel no longer publishes the maximum yields set before each auction.

### **April**

#### *Bank of Israel interest rate*

- The interest rate was cut by 0.2 of a percentage point to 8.7 percent.

#### *Government bonds*

- The Bank of Israel stopped publishing the minimum price set before each auction.
- As part of the sale to the public of state loans by auction, the Bank of Israel started selling, on behalf of the government, an additional quantity of state loans at the closing price of the auction. This occurs when there is excess demand at the closing price and a differential between the closing price and the average price in the auction. The Bank publishes the additional quantity and the maximum differential between the closing price and the average price in the auction in a circular issued prior to each auction.

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

## **May**

### *Bank of Israel interest rate*

- The interest rate was cut by 0.3 of a percentage point to 8.4 percent.

### *The secondary reserve requirement on foreign-currency deposits*

- The process that started in August 2002 of monthly reductions of one percentage point in the secondary reserve requirement, was completed, and the secondary reserve requirement on foreign-currency deposits is zero percent.

### *Pension funds*

- The Knesset passed legislation covering the arrangement for the veteran pension funds. The arrangement is intended to resolve the problem of actuarial deficits in the funds and to include in their rules a mechanism for ensuring actuarial balance, similar to the mechanism in the new pension funds.

## **June**

### *Bank of Israel interest rate*

- The interest rate was cut by 0.4 of a percentage point to 8.0 percent.

### *Government bonds*

- From June 15 the Bank of Israel trades in bonds in the Tel Aviv Stock Exchange on the first trading day following the auction (and not the second trading day, as hitherto). Also, the day of allocation and financial debit will be the day of the auction (and not the first trading day following the auction as hitherto).

## **July**

### *Bank of Israel interest rate*

- The interest rate was cut by 0.5 of a percentage point to 7.5 percent.

## **August**

### *Bank of Israel interest rate*

- The interest rate was cut by 0.5 of a percentage point to 7.0 percent.

### *Government bonds*

- The auction for the purchase of CPI-indexed government bonds was abolished.

*Pension funds*

- The rules governing investments of the veteran and new pension funds were changed. The main change was a reduction in the share of the funds' assets that they are required to invest in earmarked bonds to 30 percent (from 93 percent for veteran funds and 70 percent for new funds prior to the change).

**September**

*Bank of Israel interest rate*

- The interest rate was cut by 0.5 of a percentage point to 6.5 percent.

*Pension funds*

- As part of the reform of the pension funds, the issue of *Miron*-type earmarked bonds ended.

**October**

*Bank of Israel interest rate*

- The interest rate was cut by 0.4 of a percentage point to 6.1 percent.

**November**

*Bank of Israel interest rate*

- The interest rate was cut by 0.5 of a percentage point to 5.6 percent.

*The Stock Exchange*

- The Knesset Finance Committee approved the rules governing the activity of market makers in the Tel Aviv Stock Exchange

**December**

*Bank of Israel interest rate*

- The interest rate was cut by 0.4 of a percentage point to 5.2 percent

*Pension funds*

- *Arad* earmarked bonds will henceforth be issued for the new and veteran pension funds provided they do not account for more than 30 percent of the assets of each fund.