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Issues in Private-Sector  
Finance in Israel

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## ABSTRACT/RÉSUMÉ

### Issues in private-sector finance in Israel

The 2008-09 global financial crisis did not result in the failure of any major financial institution in Israel, but it did reveal vulnerabilities in the non-banking sector – particularly in the corporate-bond market. Conservative regulation of the banking sector helped this segment avoid a financial meltdown, and low loan-to-value ratios in mortgage lending are undoubtedly helping limit the pace of house-price increases. Nevertheless, as elsewhere, capital requirements and stress tests for banks have been ramped up. Also the identification and monitoring of systemic risks and macro-prudential problems has intensified. In the Israeli context somewhat unusual issues arise from the control of most of Israel's major financial institutions by family-based business groups that have significant interests in non-financial sectors of the economy. This close link between the financial and non-financial sectors generates potential risks to financial stability, and it is a key issue in a wider debate about the relative merits of the business groups in terms of competition and control in the economy. This Working Paper relates to the *OECD 2011 Economic Survey of Israel* ([www.oecd.org/eco/surveys/Israel](http://www.oecd.org/eco/surveys/Israel)).

*JEL classification codes:* G01, G21, G22, G23, G28, G38

*Keywords:* Israel, banks, Israeli banking, finance, Israeli finance, corporate bonds, micro-prudential oversight, macro-prudential oversight, securitization, institutional funds, pensions, business groups, corporate governance.

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### Enjeux de la finance privée en Israël

La crise financière mondiale de 2008-09 n'a entraîné aucune banqueroute parmi les grands établissements financiers en Israël, mais elle a révélé les vulnérabilités du secteur non bancaire, en particulier sur le marché des obligations de sociétés. Une réglementation bancaire rigoureuse a notamment permis d'éviter l'effondrement du secteur financier, tandis que les quotités prudentes des prêts immobiliers contribuent indubitablement à limiter la hausse des prix résidentiels. Toutefois, les exigences de fonds de propres et les tests de résistance des banques ont été renforcés comme ailleurs. L'identification et le suivi des risques systémiques et des problèmes macroprudentiels ont aussi été intensifiés. Dans le contexte israélien, des questions quelque peu inhabituelles se posent du fait que la plupart des établissements financiers d'Israël sont contrôlés par des groupes familiaux qui détiennent des participations significatives dans les secteurs non financiers de l'économie. Le lien étroit entre les secteurs financier et non financier est susceptible d'engendrer des risques pour la stabilité financière et pourrait devenir un enjeu majeur dans le cadre du débat plus large sur les mérites relatifs des conglomérats du point de vue de la concurrence et du contrôle au sein de l'économie. Ce Document de travail se rapporte à l'*Étude économique de l'OCDE d'Israël 2011* ([www.oecd.org/eco/etudes/Israël](http://www.oecd.org/eco/etudes/Israël)).

*Classification JEL:* G01, G21, G22, G23, G28, G38

*Mots-clés:* Israël, banques, système bancaire israélien, finance, système financier israélien, obligations de sociétés, surveillance microprudentielle, surveillance macroprudentielle, titrisation, fonds institutionnels, retraite, groupes, gouvernement d'entreprise

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## Issues in private-sector finance in Israel

By Philip Hemmings<sup>1</sup>

Private-sector finance, *i.e.* the process of intermediating between savings and investment by households and businesses, is core to market-based economies. Policies influencing primary lending and borrowing and the structure, conduct and performance of financial intermediaries affect the welfare of households, the growth and profitability of the business sector, and overall macroeconomic performance and stability. Although Israel's financial sector survived the 2008-09 global crisis without the collapse or rescue of any financial institutions, the credit crunch was nevertheless severe. Vulnerabilities were exposed during this episode, and the renewal of unusually turbulent conditions in global financial markets has generated fresh concerns, although Israeli banks and financial institutions are not believed to have significant direct exposure to troubled European sovereign debt.

### Key developments

- As in many countries, the 2008-09 crisis has prompted reflection on the structure of financial supervision not only in terms of the oversight of particular institutions ('micro-prudential' oversight) but also whether scrutiny is sufficient from system-wide perspectives ('macro-prudential' oversight). Abstracting from the crisis, the task of supervising private-sector finance has anyway become more important and complex. Outstanding debt in the business sector is now larger than government debt (Figure 1, Panel A), and total debt held has shifted away from banks and non-residents towards that held directly by households and indirectly *via* institutional funds (Figure 1, Panel B).
- The rise in debt held directly by households and by institutional funds is largely in the form of corporate bonds, which have become increasingly important as a means of financing for the business sector since the early 2000s (Figure 1, Panel C). During the 2008-09 crisis the bond market dried up completely for a while, and a number of companies have restructured their debt. This has prompted tighter regulation of the market.
- In banking, prudential regulation has intensified in response to the 2008-09 crisis but also in reaction to the housing boom. By mid-2011, mortgage lending had reached NIS 220 billion, representing a 56% increase since 2007 and equivalent to 25% of GDP (Figure 1, Panel D).

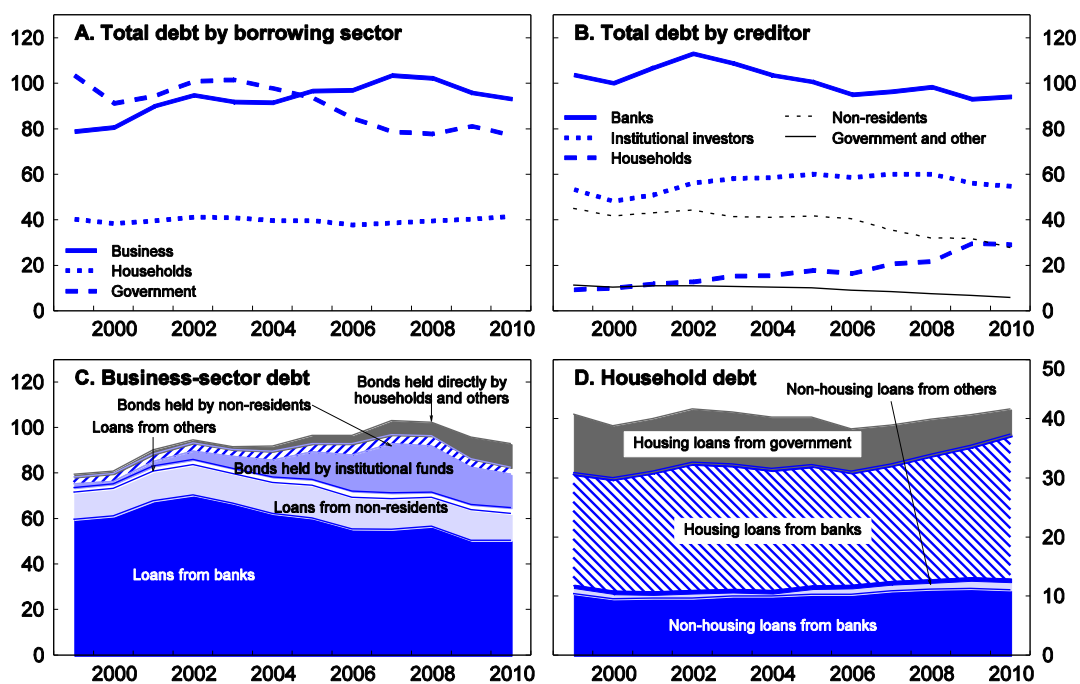
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1. Head of the Israel Desk in the OECD Economics Department. This paper was produced for the OECD *Economic Survey of Israel* (<http://www.oecd.org/eco/surveys/israel>) published in December 2011 under the authority of the Economic and Development Review Committee. The author is indebted to OECD staff members Andrew Dean, Bob Ford and Peter Jarrett (Economics Department); Grant Kirkpatrick, Hans Christiansen and Daniel Blume (Directorate for Financial and Enterprise Affairs); and, Edward Whitehouse and Andrew Reilly (Directorate for Employment, Labour Social Affairs) for their valuable comments and to Françoise Correia for research assistance and to Mee-Lan Frank for editorial support. The paper has also benefitted enormously from discussions with policymakers and experts in the Ministry of Finance, the Israeli Securities Authority and the Bank of Israel.

- Many households are relying heavily on saving in institutional funds to provide income for retirement. Minimum mandatory contributions were introduced in 2008, and the contribution rates are being steadily increased. In 2010 it was agreed that the contributions should eventually reach 17.5% (by 2014), instead of the previous target of 15% (by 2013). This mandatory component is in addition to tax breaks on a range of institutional saving products.
- There has been a longstanding debate about concentration and competition in the financial sector. Successive reforms have diminished the dominance of banks, notably legislation that forced them to divest their institutional saving funds. But disquiet about the degree of competition in retail banking remains. Furthermore, most major banks and insurance groups are controlled by large family-based company groups, which also have controlling interests in a wide range of non-financial activities. The presence of financial entities in the groups amplifies various concerns about the strategy and *modus operandi* of the groups.

Figure 1. Outstanding debt from various perspectives

As a percentage of GDP



Source: Bank of Israel.

## Background<sup>2</sup>

### *Liberalisation and privatisation in the 1980s and 1990s*

Until the mid-1980s there were far-reaching government interventions and controls over the financial sector, as there were for much of the economy. Most credit to the private sector was directed under government programmes, and foreign-capital controls were extensive. Banking groups held the vast

2. For a more detailed account of the evolution of the financial sector see OECD (2011a).

majority of financial assets and engaged in a broad range of related activities. Echoing a number of severe economic problems in the 1980s, a collapse in bank shares prompted the nationalisation of most banks in 1983.<sup>3</sup> In parallel with wider economic reforms, the financial sector was then gradually liberalised and privatised. Reforms promoting the development of capital markets were implemented in 1993, and in 1995 changes to the pension regime and a deregulation of provident-fund investments gave institutional investors more flexibility in their portfolio allocations.<sup>4</sup>

The pension reform was particularly significant. Previously, household saving had been channelled into occupational defined-benefit pension funds run by trade unions. Despite subsidy *via* preferential-rate (“designated”) government bonds, by the mid-1990s the funds had become financially unsustainable, and the 1995 reform froze membership and established defined-contribution funds (‘New’ pension funds) run by the financial sector. Various arrangements were made to put the ‘Old’ pension funds on a stable financial footing, and they are now also managed by the financial sector.

Economy-wide privatisation during the 1990s prompted greater use of equity financing. In addition, with the lifting of restrictions on access to foreign capital many Israeli firms began to issue securities abroad. Most notably, the high-tech sector, which grew rapidly during the 1990s, began listing shares on foreign exchanges, especially the NASDAQ. As part of its wider privatisation policy, the government began divesting its bank shares, with controlling shareholdings largely ending up among Israel’s large company groups.

#### ***Efforts to reduced the scope of banks in the 1990s and 2000s***

Following recommendations of the Brodet Committee, regulations limiting the ownership concentration of banks’ capital were introduced in the mid-1990s. In the early 2000s another committee (the Bachar Committee) was established in light of concerns that banks were using their control over collective investment schemes (notably pension savings) to finance affiliated firms. As a result, in 2005 banks were forced to divest their interests in mutual and pension funds. Most of the funds were taken over by existing insurance groups. Therefore, although the Bachar reform successfully reduced the scope of banking-group operations, it did not significantly alter the line-up of principal players in financial markets. Also, it concentrated institutional savings because the insurance groups were already offering life-insurance packages with significant savings components. Other elements of the Bachar reform included rules preventing entities offering long-term savings products from also offering advisory services on what products to buy. The latter have remained the domain of the banking groups.

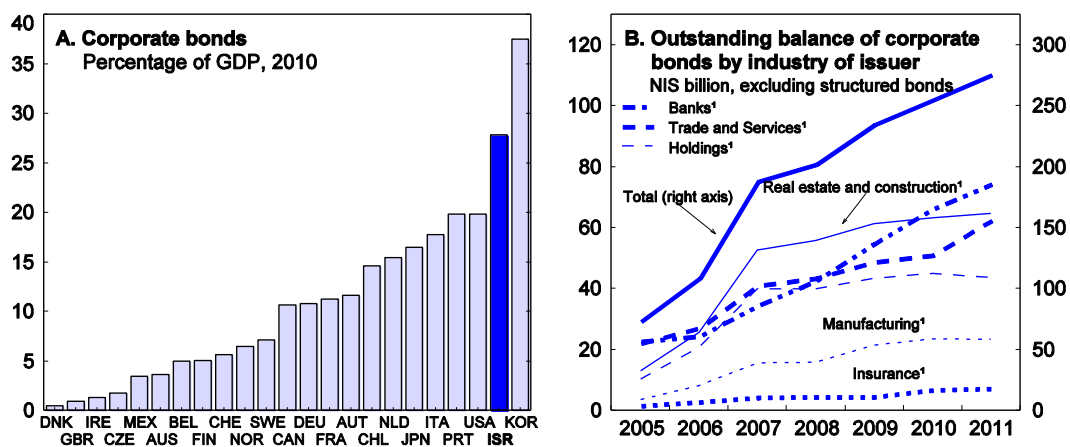
#### ***The shift towards non-bank credit since the early 2000s***

The shift towards non-bank credit, and in particular corporate bonds, was prompted by a number of factors. Reluctance by banks to offer credit following the “dot.com” boom and bust cycle is thought to have been one factor driving businesses towards financing *via* corporate bonds. Slowdown in new government bond issues and further liberalisation of portfolio regulations for institutional funds in the early 2000s helped move further in this direction. Evidence shows that corporate-bond financing is more extensive in Israel than in most OECD countries (Figure 2). The bonds are used in a wide range of sectors, most notably in the financing of the real estate and construction sectors.

- 
3. The collapse in bank shares in 1983 was partly the result of price manipulation by controlling shareholders. This prompted the “Bank Shares Arrangement” in which the government took control of four of the five largest banks (all except First International Bank). Shares of these banks were delisted from the stock exchange, with non-controlling shareholders receiving government bonds in exchange for their holdings.
  4. Provident funds in Israel are a “pure” savings instrument, notably excluding insurance components. The return is calculated according to the individual’s share in the fund’s assets (see Table 2).



Figure 2. The expansion of the corporate bond market



1. Left axis.

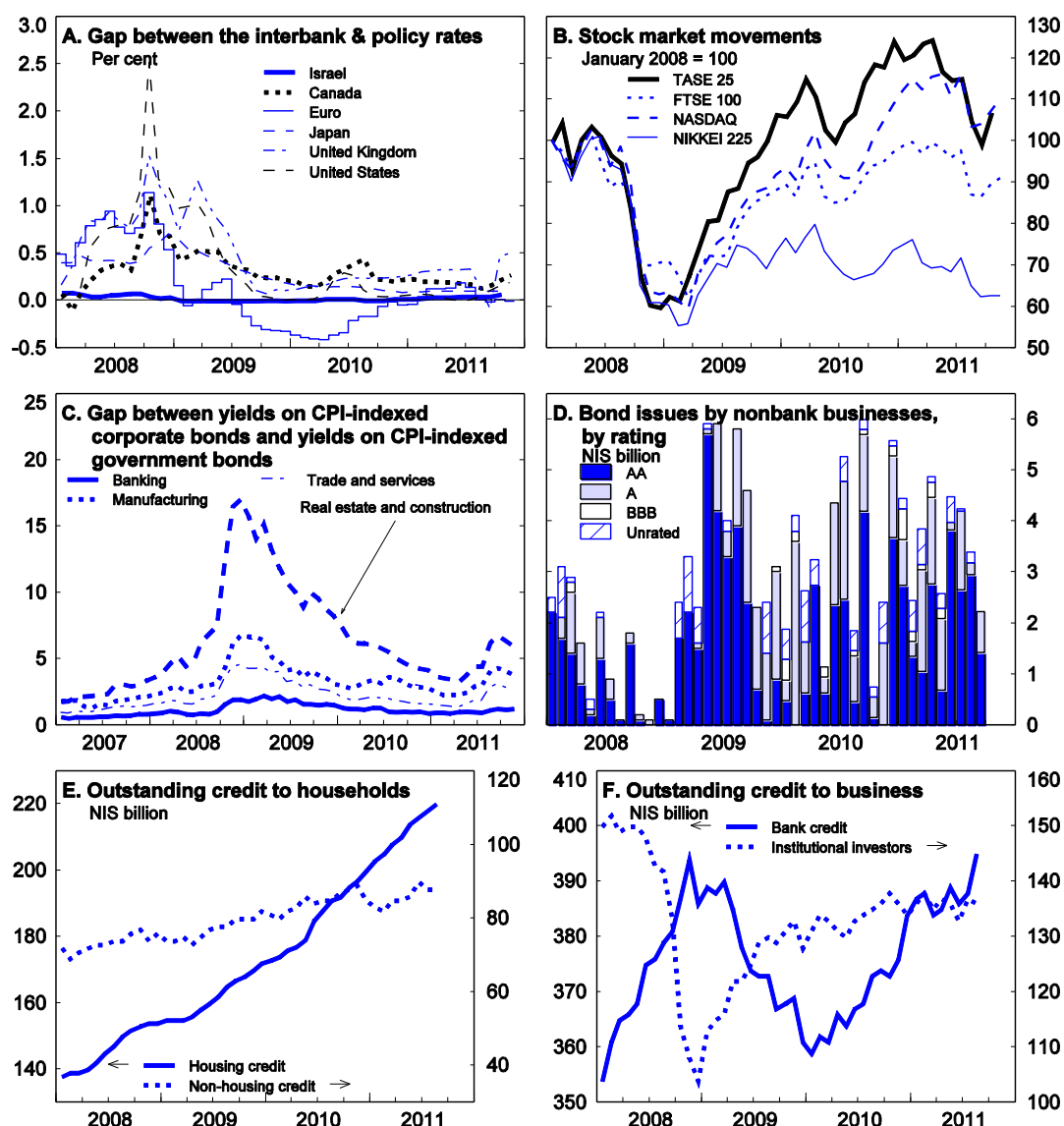
Source: Bank of Israel (2010), *Annual Report*.

### *Developments during and since the 2008-09 crisis*

Though less calamitous than in some other countries, the 2008-09 credit crunch was nevertheless significant. The banking sector did not experience a sharp rise in inter-bank rates (Figure 3, Panel A), but the stock market closely tracked the substantial fall in foreign indices (Panel B). Developments in the corporate-bond market prompted the greatest concern. Yields rose sharply in the secondary market (Panel C), especially for bonds issued by the real estate and construction sectors, and this contributed to a dramatic fall in new issues (Panel D). Indeed, between August 2008 and February 2009 new issues practically dried up completely. Furthermore, the number of firms entering debt-re-organisation procedures increased markedly in the wake of the crisis, although the value of the renegotiated debt was not a significant proportion of the total value of the corporate bond market.

As an immediate monetary-policy response to the crisis, the Bank of Israel reduced its policy rate following the events of September 2008. The rate was lowered in several steps from 4.25%, reached 0.50% in March 2009 and was held at this level for several months thereafter. These steps were backed with purchases of government bonds in the secondary market to increase liquidity and enhance the impact of monetary-policy changes on longer maturities. This intervention ran from March to August 2009. Moreover, technical adjustments to the Bank's monetary operations sought to shift the liquidity mix towards longer-term holdings. In addition, the Bank increased and extended a pre-announced programme of daily foreign-currency purchases that began in the spring of 2008. This also operated until August 2009, and since then the Bank has been intervening on a discretionary basis.

Figure 3. Developments in the financial sector since 2008



Source: Central Bureau of Statistics, Bank of Israel and OECD.

The government stepped in with measures to support the corporate-bond market and to ease credit conditions for businesses in general (Box 1). These included the establishment of investment funds; guarantees to banks (none of these were called upon) and a temporary guarantee on the returns to second-pillar pension savings for savers close to retirement. Several additional steps were taken to support the non-financial business sector and help the unemployed, though these do not add up to a large fiscal stimulus (see previous *Economic Survey*, OECD, 2010).

For a while the financial markets appeared to be on track for a full recovery from the 2008-09 downturn, but renewed weakness has emerged in recent months. The main stock market index has fallen substantially in 2011 (Figure 3, Panel B), which probably reflects contagion from other markets. Rather more worrying is that yield differentials on corporate bonds have been edging up (Panel C), possibly reflecting financial difficulties among some issuers (notably business groups). Also, outstanding

bank credit to businesses has levelled off (Panel F). This may partly reflect slowing exports but may also indicate dwindling confidence in the strength of domestic demand growth too. There is no sign as yet of a significant slowdown in the growth of total outstanding mortgage credit (Panel E), but given the signs of softening in the housing market in recent months, this is likely to emerge in the coming months' data.

#### Box 1. Temporary measures taken to support financial markets during the 2008-09 crisis

Several measures aimed at directly supporting the corporate-bond market:

- Establishment of private investment funds partially supported with government capital ("Manof" funds). The government earmarked a contribution up to NIS 1.1 billion, and total funding was potentially NIS 4.5 billion. Three funds were created but were not utilised during the crisis.
- Suspension of mark-to-market rules for institutional investors up to a maximum of 3% of their assets and conditional on commitment to holding the bonds to maturity. A temporary tax exemption was granted on interest from corporate bonds for foreign investors as well as a reduction in the tax rate on dividends from abroad.

Other measures included:

- State-backed guarantees to banks from the Ministry of Finance to the value of NIS 6 billion (these were never called upon).
- Special provisions allowing small- and medium-sized enterprises to pay taxes in instalments and reduced guarantee requirements for businesses supplying government (the one-time value of this was estimated at NIS 0.8 billion).
- A savings guarantee ensuring that provident funds deliver a minimum real yield to policyholders aged 57 years equal to the real yield in the policyholder's portfolio as of end-November 2008 (these were never called upon).

### The structure of financial supervision and provisions for macro-prudential oversight

Financial supervision is carried out by three bodies with responsibilities divided along a more or less institutional basis. The Bank of Israel's Supervisor of Banks regulates and supervises banking activities, while the Ministry of Finance's Capital Market, Insurance and Savings Division (CMISD) regulates insurance, pension funds and provident funds. The Israeli Securities Authority (ISA) is responsible for mutual funds, securities firms, brokerages and investment advisers. General supervision over market structure and competition operates *via* the Israel Antitrust Authority. Key legislation pertaining to the structure, conduct and performance of the financial sector is listed in Annex A1.

Although the 2008-09 crisis did not expose major deficiencies in supervision, it has prompted increased attention to micro- and macro-prudential oversight:

- Stress tests on banks are being improved with the introduction of additional scenarios and new techniques. For instance, a report by the supervisor (Bank of Israel, 2010) describes special tests on the stability of housing credit. Nevertheless, there is room for improvement. According to an IMF assessment, the tests need to draw on more detailed bank figures, make wider use of corporate and household balance-sheet data, involve closer collaboration with CMISD and be more strongly linked to macroeconomic forecasts (IMF, 2011).
- In broad terms macro-prudential regulation has been sound. The Bank of Israel hosted a conference in March 2011 devoted to discussing lessons from the crisis and prepared a detailed report on Israel's experience (Bank of Israel, 2011b). Furthermore, the policy responses to developments in the housing market (see OECD 2011b) demonstrate an ability to co-ordinate reactions to specific issues. Ongoing development of legislation on rating agencies is being undertaken by the ISA.

Continued close attention is required, particularly to macro-prudential issues in light of the widening downside risks in recent months. Past and present shocks provide useful lessons in what ought to be monitored more stringently. However, oversight cannot be only reactive because future risks may well emerge from entirely different sources than in the past. Thus, the authorities need to ensure that the financial sector is monitored from multiple perspectives. It is now widely accepted that monitoring needs to extend beyond the examination of individual institutions, for instance, by examining the overall stability of the financial system and the structure, conduct and performance of the business sector as a whole. In this regard steps should be taken to ensure closer co-ordination and co-operation between the supervisory bodies. Regular monthly meetings of the supervisors have recently been held, but this may not be enough. Also, there are plans to publish a financial stability report, which would be useful as such reports can assure coherence in monitoring and policy messages. Various specific measures geared towards better macro- and micro-prudential supervision have also been taken.

There has been longstanding debate on the relative merits of the CMSID operating within the Ministry of Finance. Proponents of the *status quo* underscore that the CSMID is largely independent from the Ministry because special legislation governs its activities, and that progress in legislative and regulatory reform and effectiveness during times of crisis have benefited from close co-operation between the CMSID and the rest of the Ministry. This said, internationally, there has been tendency to reinforce independence by shifting supervision from ministerial control (not only in finance but also in other sectors) to bodies that are more clearly separate from government. As such, the arrangement in Israel would appear out of line with best practice. The Minister of Finance has significant powers regarding the appointment of the Commissioner of Insurance, and a range of issues require the Minister's approval. While it may be true that independence has not been compromised, the risk nevertheless remains in principle, and a model that more fully separates CMSID's activities from the Ministry should be sought that at the same time retains incentives for close co-operation.

Though the Bank of Israel has frequently argued that it should take over CMISD's activities, this is only one option. Wide central-bank responsibilities in supervision are a feature of some, but by no means all OECD countries. International debate on the structure of financial supervision, including in the wake of the 2008-09 crisis, has not yielded any particular consensus on this topic, and a definitive ranking of institutional frameworks is unlikely to emerge because their relative merits depend heavily on country-specific aspects of financial systems and regulatory structures. It seems that the quality of supervision depends more on the strengths of the supervisors, rather than any specific institutional arrangement. In any event, whatever decision is made, continued close cooperation among supervisors will remain of key importance.

### **In banking, institutional and regulatory settings are well positioned to cope with challenges**

Conservative commercial banking, particularly in terms of lending to households and businesses, meant an absence of significant over-extension of domestic credit during the run up to the 2008-09 crisis. Partly for this reason, a housing-market bubble did not emerge in the 2000s as it did in some other OECD countries (rather, house prices have risen substantially since 2008; see OECD, 2011b). In addition, exposure to toxic foreign credit was limited. Nevertheless, the crisis has prompted some reform and raised the question of how to proceed with further financial liberalisation.

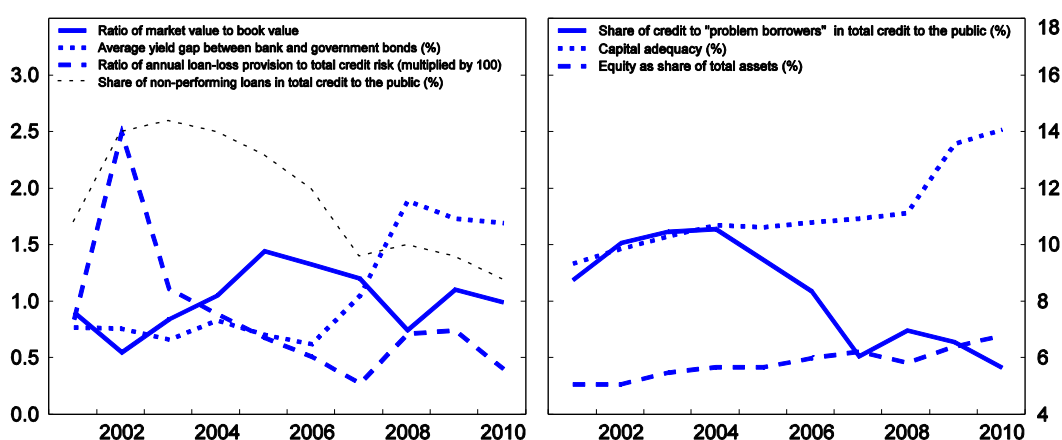
#### ***Capital provisions are in good shape***

Good progress has been made in capital provisioning, and, in general, indicators suggest that the banking sector is sound. The Basel II guidelines had been fully adopted by the end of 2009 (Bank of Israel, 2010). Satisfying the minimum capital requirements and other guidelines has involved action on a number of fronts, including upgrading of risk-management frameworks, auditing and corporate

governance. The Supervisor has set a 12% overall capital-adequacy ratio, and the minimum core capital ratio was raised to 7.5% in 2010. Furthermore, a timetable for increases in the latter has been set as part of the adoption of Basel III guidelines. Other measures underway include adoption of the International Financial Reporting Standards and the Financial Stability Board's principles of compensation practices.

According to the latest data the industry-wide average capital-adequacy ratio is 14%, well above the target, and other indicators point to favourable risk and capital-adequacy conditions (Figure 4). The Bank of Israel has investigated the merits of introducing a counter-cyclical minimum capital ratio (*i.e.* higher during booms and lower during recessions) as suggested in the Basel III regulatory standards. However, research by the Bank concludes that during downturns Israeli banks are more constrained by increased borrower risk than a shortage of capital, implying that counter-cyclical capital ratios may not be very effective (Bank of Israel, 2011a).

Figure 4. Indicators of risk and capital adequacy in the banking sector



Source: Bank of Israel.

### *Securitisation of mortgages should proceed with care*

Various longstanding features of Israeli's banking legislation and regulation helped to avoid failure of any systematically important financial institutions in the 2008-09 crisis. In particular, regulated loan-loss provisions for mortgage loans, which result in low loan-to-value ratios have proved to be an effective tool. These provisions almost certainly helped to prevent a housing bubble similar to that in some other OECD economies. And the requirements have undoubtedly tempered the more recent rapid increase in house prices. Indeed, the provisions have been used actively to cool down the market. However the authorities should act quickly in the event of evasive action by banks that circumvents and dilutes the impact of tighter regulation of mortgage lending. Given recent housing-market developments, macro-prudential measures in the opposite direction may be required to prevent a hard landing.

In light of the positive dimensions of conservative mortgage lending and international experience, facilitating the transfer of credit risk through securitisation should proceed with caution. To date, while securitisation is not barred in Israel, the legal framework and tax treatment means it is costly and cumbersome, and therefore has not been widespread. However there are plans for this to change. Proposals are being developed for securitisation under certain conditions, including "true sale" (*i.e.* investors will have a legal right over the receivables) plus requirements for the originator to retain a minimum share of the securitised product (possibly 10%). In addition, procedures would be simplified and biases in tax law removed.

*Other issues*

The 2008-09 crisis revealed some weaknesses in mechanisms dealing with banks in difficulty, and these should be confronted. The current legislation dates back to 1969 and is insufficiently clear on some points and out of date on others. Specifically, the Bank of Israel (2011b) recommends strengthening the powers of the Governor and the Supervisor of Banks for early intervention when a bank's stability comes under threat. In addition, it recommends provisions to override legal public disclosure requirements when banks are in difficulty, so as to facilitate discrete rescues, thereby lowering the risk of panic among markets and the public at large. The report also recommends clearer rules regarding the collateral that the Bank of Israel could accept in order to secure credit.

As elsewhere, the 2008-09 crisis prompted concerns that compensation structures for personnel in the financial sector were amplifying principal-agent problems. In the banking sector, new rules were introduced in April 2009 requiring compensation to be based, *inter alia*, on long-term profitability.

**Vulnerabilities in the corporate-bond market and related issues for institutional funds***The sources of trouble in the corporate-bond market*

The 2008-09 crisis underscored various weaknesses in the corporate-bond market, *inter alia*:

- Thin trading volumes. Despite growth of the market, liquidity and trading volume for any given bond is typically thin. Hence, market prices can be volatile and an inaccurate guide for traders and investors. During the downturn this added to difficulties in launching new issues.
- Deficient information flows in the process of bond issuance and in criteria that help classify the riskiness of bonds. In particular, an absence of instruments that safeguard the credit status of bonds contributed to a loss of confidence in the market during the crisis. In Israel the bond contract (the "indenture") rarely includes clauses to protect the bondholder through the sort of covenants and financial criteria that are common in more mature corporate-bond markets.<sup>5</sup>
- Lack of orderly debt-arrangement processes. Where doubt about debt repayment does arise, the procedures bondholders (notably institutional investors) should follow in order to secure their rights lack clarity.<sup>6</sup>

Little can be done by policymakers to combat problems generated by thin liquidity and trading volumes. As regards the other difficulties, the crisis has probably prompted greater awareness of risk among bond purchasers. Indeed, according to the latest *Annual Report* of the Bank of Israel (Bank of Israel, 2011a), with the exception of mutual funds, institutional funds' holdings of corporate bonds have

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5. Covenants and financial criteria aim to enhance the credit worthiness of bond issues and typically increase in number and strength with investment risk. Examples of commonly used covenants are: merger restrictions; negative pledges (commitments not to pledge assets to other parties); restrictions on the scope of the borrower's business activities; and cross-default covenants (automatic default of the bond if another bond of the issuer defaults). Borrowers may also commit to a cap on overall leverage in company financing.

6. From the final quarter of 2008 to the end of 2009, 50 companies with bonds totaling NIS 17.3 billion at face value entered a debt arrangement and a further 11 companies did so in 2010 (with bonds totaling NIS 2.1 billion). By the end of 2010 there were 52 companies still in an arrangement, but the face value was only NIS 6.8 billion due to the resolution of arrangements involving some large companies.

been scaled back. However, as the 2008-09 global financial crisis showed, “self-regulation” should not be counted on too heavily. Accordingly, the authorities have introduced various regulatory reforms.

### *Steps taken so far*

The corporate-bond market is governed by the Securities Law (see Annex A1). As such, the legislation and related guidelines cover tradable bond issues (*i.e.* bonds that are offered to the public under a prospectus and that are traded on the stock exchange) and non-tradable bond issues (*i.e.* bonds offered only to selected entities, typically institutional investors) offered by public companies listed on the stock exchange. Therefore, non-tradable bonds issued by private companies (referred to in Israeli documentation as “bonds issued by a non-reporting corporation”) are not covered by the Securities Law and until recently were not subject to any guidelines or regulation.

The authorities have tightened regulations on institutional investors acquiring corporate bonds, in part to gain policy leverage on bond issues by non-reporting corporations. In the immediate aftermath of the 2008-09 crisis the CMISD tightened various rules and added new provisions; for instance, these institutions have now been required to appoint a risk manager. Further steps were taken following the recommendations of the Hodek Committee (2009). These comprise guidelines on best practices and a number of mandatory measures pertaining to institutional investors:

- preparatory analysis when purchasing in the primary market;
- approval by the institution’s investment committee in the case of bond purchases above a certain threshold;
- registration of non-tradable bonds in a newly established registration bureau;
- receipt of specific documentation from the issuer prior to primary investment;
- requirement that purchases from non-reporting corporations furnish an “offering memorandum” (equivalent to a prospectus) and a commitment from the issuer to provide purchasers with information during the lifespan of the bond;
- minimum (and recommended) contractual covenants and financial criteria and the use of contractual templates; and
- classification of corporate-bond investments and the setting of explicit criteria by the institution’s investment committee on the size and composition of investment in corporate bonds.

Steps have also been taken to improve the conduct of companies issuing bonds. Measures taken by the ISA include new reporting requirements. In addition, legislation is in the pipeline to increase the responsibility of bond trustees and improve the corporate governance of companies issuing bonds to the public. Furthermore, new legislation that will increase transparency and formalise the activities of the rating agencies is in train. Efforts to improve debt-arrangement (*i.e.* restructuring) processes were also made. The ISA proposed a blueprint for procedures to restructure corporate bonds, and a legal framework was created to allow the appointment of credit officers to assist in restructuring tradable debt.

Given the difficulties in anticipating the effectiveness of tighter regulation, these steps should be closely monitored. A more hands-on approach using more direct regulation should be used if weaknesses in the bond market persist. Experience following implementation may reveal, for instance, that some provisions provide little useful information to the market and merely add to back-office paperwork. Others may prove particularly effective and could be usefully beefed up. In the case of the Hodek recommendations, recognition that fine-tuning will probably be required was to some extent recognised; for instance, it recommended that the rules requiring the receipt of specific documentation be reviewed

after 12 months. However, no commitment for a comprehensive monitoring and follow-up of the measures has been made.

In addition, regulations on bond purchasers should apply more uniformly, as the application of new rules only to institutional funds for long-term savings has caused some concern. The Hodek measures have already had some impact. Samples of bond issues reveal that in 2010 about 40% included contractual covenants or requirements to meet financial criteria, compared with 28% in 2009 (Bank of Israel, 2011a). However, the new regulations risk splitting the market, one segment comprising relatively 'safe' bonds that comply with the Hodek reforms and held largely by institutional funds, and the other non-compliant bonds held by short-term investors (mutual funds in particular). Such a division could lead to problems if trading becomes thinner and the holders of any particular issue less diversified.

Specific concerns relating to the use of uncollateralised corporate-bond financing in the real-estate sector may remain. In principle, this practice may diminish in some segments of the real-estate sector with the planned introduction of facilities for mortgage securitisation. However, other segments, such as those investing in foreign real estate (activity by Israeli companies in Eastern Europe has become prominent), may continue to rely on uncollateralised bond issues.

#### ***Other issues for the non-banking sector***

The measures described above deal with only the one leg of the connection between primary borrower and lender: the relationship between the issuers and the institutional fund managers. The relationship between the fund managers and policy holders (*i.e.* the public) may be dysfunctional due to asymmetries in information and differences in priorities. For instance, even if the corporate-bond market works well, the scale and composition of such bonds in institutional portfolios may anyway be inappropriate. In an effort to combat such concerns, and similar to the banking sector, CMISD has introduced regulations requiring institutional funds to adopt compensation packages for their staff based on long-term performance. In addition, default investment tracks for long-term saving are planned (see the following section), which may also alleviate some principal-agent problems.

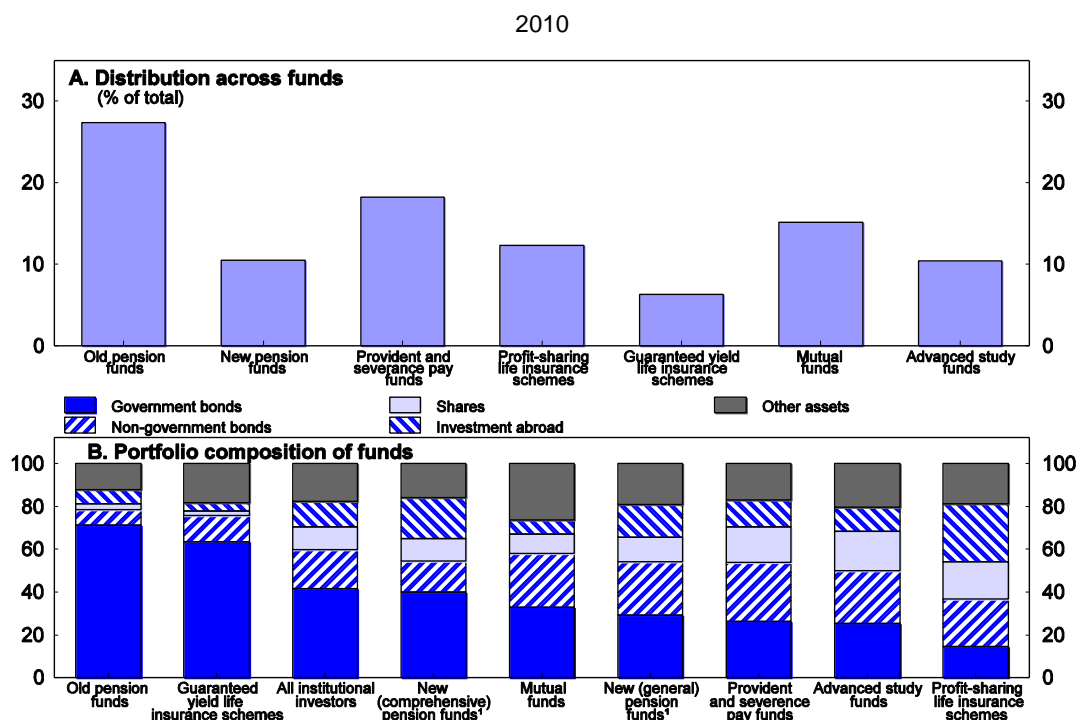
Capital adequacy and risk management in insurance groups is being improved through the introduction of regulations echoing those of the EU's Solvency II directive by January 2013. According to Bank of Israel (2011a), the capital ratios of the five largest insurance companies were already in line with these regulations by the end of 2010. However, the Bank has expressed concern that its facilities for providing liquidity to the non-bank sector in the event of a crisis are not fully developed. Although the new Bank of Israel Law provides a legal framework for such intervention, details for an operable system need to be fleshed out.

#### **Room for improving households' incentives and choices for saving in institutional funds**

Households' institutional savings comprise six types of product, four of which are for long-term savings. As mentioned earlier, pension reform in 1995 resulted in two types of pension fund: "Old" (defined-benefit) and "New" (defined-contribution). In addition, tax breaks are provided for two other types of long-term savings: "provident funds" and life-insurance products. Finally, there are two short-term savings vehicles: mutual funds and "advanced training funds" (Kranot Hishalmut). Old pension funds account for the largest share of institutional savings (Figure 5) but are being run down; the role of the New pension funds, which currently account for less than 10% of institutional savings, will steadily grow (see below). Insurance products in total account for just under 20% of institutional savings, and a similar share goes to provident and severance-pay funds. For further detail on the private pension system see OECD (2011c).



Figure 5. Distribution and portfolio composition of institutional funds



1. "New (comprehensive) pension funds" include an insurance component while "New (general) pension funds" do not.

Source: Bank of Israel (2011), *Annual Report 2010*.

Examination of portfolio composition underscores the significant shift in the type of bond holdings in institutional saving. Government bonds are a significant share of the portfolios of Old pension-fund portfolios (73% in 2009) and of guaranteed-yield life insurance, in both cases reflecting a need for low-risk returns. However, government bonds are used far less in the other types of institutional funds, and these funds are gaining market share. For example, in 2009 only 35% of new (general) pension funds were invested in government bonds (30% of these funds have to be invested in designated government bonds), while 26% were invested in corporate bonds. Furthermore, government bonds accounted for only 16% of profit-sharing life insurance in 2009, with corporate bonds at 26%.

Regarding short-term savings, mutual funds do not benefit from any special tax breaks, but the advanced training funds (Kranot Hishalmut) do. Savings in these funds benefit from tax credits and, despite the name, can be spent on a wide range of goods and services. Tax breaks on short-term savings are hard to justify on economic grounds, as they bias the consumption/saving decision, distorting the allocation of resources. Hence, the tax breaks on savings in these funds should be phased out.

The four types of long-term savings form the 'second pillar' of the pension system. Provisions from first-pillar pensions are modest, and so many households rely heavily on the proceeds from long-term savings for retirement income. All four types of savings benefit from a common set of tax breaks in contributions, fund returns and pension (or annuity) payouts (Table 1). In 2008 an agreement between employer representatives and trade unions introduced mandatory minimum contributions for defined-contribution schemes for all employees. Initially, the contribution rate was set at 2.5%, and in the original agreement it was scheduled to reach 15% by 2013 (5% as the employees' contribution and 10% from employers). It is estimated that between 2008 and 2010 the agreement prompted about 730 000 workers, the vast majority on low wages, to join pension funds. In addition, contributions from

many of those with policies set up prior to 2008 will have been increasing as a result of the agreement. The agreement is somewhat unusual in that it did not include exemptions for older workers. Typically, in introducing, or increasing, mandatory contributions, those close to retirement age are exempted because of concerns about risk on market returns from a short contribution period and disproportionate overheads in management fees. This aspect of the system should be monitored.

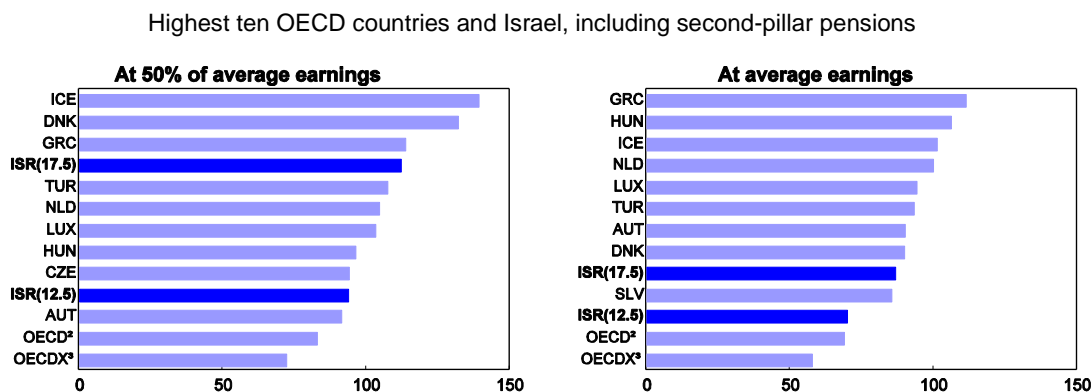
Table 1. **Contribution regulations and tax treatment of second-pillar pension savings**

Contributions	<ul style="list-style-type: none"> <li>Mandatory minimum contributions to the new pension funds were introduced in 2008 and apply to employees' earnings up to the average gross wage. Initially the total contribution rate was 2.5% but is undergoing stepped increases and will reach 17.5% (7.5% from employees and 10% from employers) by 2014. Five percentage points of the employers' contribution also serves as severance insurance. The legal maximum contribution rate is 22.8%: 7% for employees, 15.83% for employers (7.5% pension and 8.33% severance insurance).</li> </ul>
Tax treatment	<ul style="list-style-type: none"> <li>Favourable tax treatment for pensions, provident funds and life-insurance products not only applies to "regular" pension products but also to saving <i>via</i> life-insurance and provident fund products. The tax treatment was equalised across savings products in 2008.</li> <li>Employer contributions are not counted in employees' taxable income (with a ceiling).</li> <li>Employee contributions are subject to a 35% (wastable) tax deduction (with a ceiling).</li> <li>Returns on pension saving are not taxed.</li> <li>Payouts (annuities) are taxed according to regular income-tax rules except there is: <i>a</i>) a tax credit of 35% on the annuity (with a ceiling equal to about 30% of the average wage); and, <i>b</i>) an additional "credit point" (worth NIS 197 per month in 2009 against tax due) if one's spouse does not work and has no pension.</li> </ul>
Other dimensions	<ul style="list-style-type: none"> <li>Tax incentives generally guide policyholders' decisions on when to retire. For example, following a 2008 reform tax exemptions on provident-fund savings apply only if the fund is held until age 60 or above (previously they applied after the fund was held for 15 years).</li> <li>Pensioners must redeem their pension on a monthly annuitized basis (and not, for example, make capital withdrawals), unless the person has separate monthly income of at least NIS 4 000 (<i>i.e.</i> about 60% of the average wage).</li> <li>Portability provisions for switches between pension plans were introduced in 2008 (in the past unions or employers often chose the savings vehicle).</li> </ul>

In 2010 unions and employers agreed to raise the mandatory pension contribution rate to 17.5% by 2014. OECD simulations show a contribution of this magnitude implies a relatively high net pension replacement rate at low earnings levels compared with similar calculations for other countries (Figure 6). Indeed, the net replacement rate is 112% at half of average earnings, which implies that perhaps too much saving is being mandated. However, there are some caveats. First, five percentage points of the contribution can be used as severance pay in the event of redundancy, which, if fully utilised, implies a pension contribution of 12.5% and a replacement rate of 94%. In addition, low earning households are likely to accumulate fewer contribution years than were assumed in the replacement rate calculations (which assumed full-time careers starting at age 20). Furthermore, existing laws and regulations do not precisely define which components of salary should be included in the calculation of the pension contribution. In particular, this means there is considerable variation, depending on the specific working agreement, whether overtime and allowances are included in the base. Nevertheless, the replacement rate would seem to be ample, and therefore no further increases in the minimum contribution rates are warranted. It should also be noted that research indicates that the introduction of mandatory pension saving

is imposing a net fiscal cost. This is because revenue losses from tax credits on the additional contributions outweigh the savings in income-support payouts to pensioners.<sup>7</sup>

Figure 6. International comparison of simulated net pension replacement rates by earnings levels<sup>1</sup>, men



1. The simulation assumes individuals starting full-time careers at age 20.
2. Unweighted average.
3. OECD average excluding highest 10.

Source: OECD, from OECD pension models.

Reforms in the tax treatment of pensions are planned; this is welcome in principle, though details have yet to be made public. The mandatory contributions were introduced without any alteration to the tax benefits, and thus employees continue to receive tax breaks on the mandatory component, which is somewhat wasteful from a policy perspective. In any case, the incentives are regressive, at least for low- to middle-income earners. Indeed, the breaks on contributions are of practically no value for low-income households because other credits cut their tax bills to zero or close to it. A similar argument applies to the tax concessions on pension payouts. The 2010 *Survey* also recommended making the tax credits non-wasteful so as to boost lifetime returns to defined-contribution pensions for those on low incomes, and removing special tax credits on pension payouts, once again on the grounds that these largely benefit only middle- and upper-income earners.

Plans for 'life-cycle' portfolio adjustment are welcome. Similar to developments in some other OECD countries, proposals are being developed that define a limited number of pension portfolios with different risk characteristics. Institutional funds will be obliged to offer (at least some) products according to these templates, and workers will be encouraged to choose among these options and to shift from high- to low-risk variants as they get older (a default sequence will also be proposed). These provisions will potentially not only protect households but also reduce the risk of moral hazard by institutional funds taking excessive risk on the assumption that the state is likely to support those most affected in the event of poor returns (*i.e.* those close to retirement). In the process of introducing life-cycle adjustment, consideration should be given to removing regulations giving old and new (comprehensive) pensions access to preferential-rate government bonds (indeed these funds must invest a minimum of 30% in such bonds), so as to reduce distortions in portfolio choice and put long-term savings products on a more equal footing.

7. Bank of Israel (2011a, p. 258) estimates the annual revenue cost of the mandatory pension scheme to be NIS 1 200 million per year at 2010 prices (*i.e.* about 0.15% of GDP), while total income supplements for pensioners range between NIS 350 and 400 million. Therefore, even if improbably the mandatory pension savings removed the need for all income supplements, then there would nevertheless be a net fiscal cost.

The life-cycle plans will help simplify pension products, but additional streamlining would be helpful. The Israeli pension system offers scope for wide product differentiation, so that many households are probably not making well informed choices. Efforts to improve financial education will help somewhat but should be coupled with clarification and simplification of the pension products themselves. At present, even choosing between the basic product types involves fairly sophisticated assessment (although there is a default pension plan, which, as long as it reasonably approximates the preferences of those who do not want to make an active decision, helps in this regard). Table 2 illustrates how insurance criteria, rules on one-time deposits, contribution caps and rules on designated government bonds vary across the different categories of long-term saving products. In addition, wide variations are possible within each category (for instance, regarding the details of insurance components).

Table 2.2. **Selected characteristics of long-term savings products**

Common characteristics	<ul style="list-style-type: none"> <li>Choice is possible between lump-sum and annuity withdrawal with the provision that the policyholder has arranged a minimum monthly income in retirement (as per Table 1).</li> </ul>
New “comprehensive” pension funds	<ul style="list-style-type: none"> <li>Must include insurance for disability and death.</li> <li>One-time deposits precluded.</li> <li>Insured salary is capped at twice the gross average wage.</li> <li>Portfolio must contain at least 30% ‘designated’ government bonds.</li> </ul>
New “general” pension funds	<ul style="list-style-type: none"> <li>Not required to include insurance for disability or death.</li> <li>One-time deposits allowed.</li> <li>No cap on the insured salary.</li> <li>Portfolio cannot contain ‘designated’ government bonds.</li> </ul>
Provident fund	<ul style="list-style-type: none"> <li>No insurance component is allowed (as part of a recent proposal for pension reforms the Ministry of Finance is recommending this be lifted).</li> <li>Tax benefits apply only after 15 years and if the policy holder is at least 60 years old.</li> <li>One-time deposits allowed.</li> <li>Portfolio cannot contain ‘designated’ government bonds.</li> </ul>
Life insurance policies (with savings component)	<ul style="list-style-type: none"> <li>Usually include life insurance and may also include other insurance.</li> <li>One-time deposits allowed.</li> <li>Portfolio cannot contain “designated” government bonds.</li> </ul>

## Competition and corporate-governance issues

Despite various measures, notably the Bachar reform (see above), disquiet about the degree of competition in the financial sector remains. There are essentially two dimensions to these concerns. The first is fairly straightforward: that financial intermediaries may be colluding in the design and parameter settings of retail financial products. The second concern relates to the fact that most financial institutions are controlled by Israeli business groups with significant interests in non-financial sectors (see Tables 3 and 4). In broad terms this may be contributing significantly to excessive power and influence of these groups, and of the individuals that control them.

### *Competition in retail products*

Good progress has been made regarding retail bank fees, which have long been a target of complaint by the public. Indeed, private members’ bills proposing direct regulation of the level of bank fees have periodically surfaced in the Knesset, though none have made it onto the statute books, which is welcome. The authorities have instead aimed to increase transparency, and a number of steps in this direction were taken by the Supervisor of Banks in 2008. These included a reduction in the number of fees, harmonisation

Table 3. Five largest banking groups

Banking group	Key shareholders (as of October 2011)	Share of total banking assets (September 2010) (%)
Bank Leumi Group	Controlled by the State with a minority stake (6.03%) Other key shareholders: businessman Shlomo Eliyahu with holdings of 9.59%.	29.7
Bank Hapoalim Group	Controlled by Arison Holdings with a minority stake (20.22%). Arison Holdings is an Israeli company group owned by the businesswoman Shari Arison. Other key shareholders: Delek group (6.14%).	27.1
Israel Discount Bank	Controlled by Treetops Acquisition Group Ltd. (26.16%), which is controlled by businessman Matthew Bronfman who, for instance, also controls a large Israeli supermarket chain (Supersol).	16.8
Mizrahi Tefahot Bank Group	Controlled by the Ofer and Wertheim company groups, with a majority stake (42.01%). The Ofer family controls one of Israel's largest business groups (Israel Corporation). Wertheim is also a business group. Other key shareholders: Leen Holdings (5.72%).	11.3
First International Bank Group	Controlled by FIBI holdings (53.53%) which majority is owned by Israeli businessman Zadik Bino. Other key shareholders: Israel Discount Bank (26.49%).	8.7
<b>Total</b>		<b>93.6</b>

Source: TASE, Shares in total assets from Bank of Israel (2010), information on key shareholders from various sources.

Table 4. Six largest insurance groups

Insurance Group	Key shareholders (as of October 2011)	Share of total long-term savings assets (%) (December 2009)
Migdal	Controlled by the Italian insurance company, Assicurazioni Generali S.p.A. with a majority shareholding (69.13%). Other key shareholders: Bank Leumi (9.79%).	16.80
Clal	Controlled by the IDB Holding Corporation (54.97%), an Israeli company group headed by businessman Nochi Dankner. Other key shareholders: Bank Hapoalim (9.51%).	14.76
Menora-Mivtachim	Controlled by Palmas Establish (30.93%) and Naiden Establish (30.93%). Other key shareholders: Kalman Aharon (2.72%).	10.66
Psagot	Controlled by Apex Partners, a London-based private equity company.	9.68
Harel	Controlled by an Israeli family (the Hambergers) through G.Y.N. Financial Consulting and Management Ltd. (49.35%).	8.99
Phoenix and Excellence	Controlled by the Delek group, an Israeli company group headed by Isaac Tshuva (56.98%). Other key shareholders: Mayer's Cars & Trucks Co. Ltd. (1.93%).	8.44
<b>Total</b>		<b>69.3</b>

Source: TASE, Share of long-term savings assets from Annual Report of the CMISD.

of their definition and the introduction of more stringent disclosure requirements. The latest assessment of fees since the rule changes (Bank of Israel, 2011a) suggests progress has been made: for instance, the

report found that fees on current-account services have fallen by 13% on average in real terms and fees on credit cards by more than 20%. In addition, it concluded that promotional campaigns have become more common, which also indicates banks are competing more vigorously. Moreover, the 2008 reform has been followed up by further steps: in December 2010 regulatory amendments were made to facilitate switching from one credit-card issuer to another, and legislation endeavouring to further promote competition in the credit-card market was passed in 2011.<sup>8</sup>

Reforms to fees charged by institutional saving funds have also been proposed. In 2010 a report was submitted to the Knesset that found significant increases in the annual management fees of provident and pension funds since these were transferred from banks to insurance companies. In response, the CMISD has proposed various changes. Notably, annual management fees on provident funds and unit-linked products would be capped at 1.2% of accumulated assets and 5% on contributions, while those on New pension funds will remain at 2% of assets and 6% of contributions. Management companies will be allowed to change their fees only once every two years.

### ***The role of financial institutions in the debate about “business groups”***

Debate about the merits of Israel’s business groups has intensified in recent years. In part this has been prompted by empirical results underscoring what many had suspected: that controlling interests in the economy are unusually concentrated. In 2007 a paper published by a researcher at the Bank of Israel (Kosenko, 2007) used data for 650 firms listed on the Israeli stock exchange to investigate the concentration of ownership. This revealed that the 20 largest families (in terms of shareholdings) held about 30% of the total market value. International comparison with similar calculations for 22 other countries (of which 17 were OECD Member states) indicated this figure to be reasonably high (Figure 7). In October 2010 a committee was established to examine concentration. The social protests of 2011 have given further impetus to the debate, with some (at least partially) blaming the groups for high prices of retail goods and services.

Israeli company groups have pyramidal control structures, and discrepancies between ownership and control rights can be large. In an extreme case, one group reportedly exerts full control at the bottom of the pyramid with only 3% of cash-flow rights (OECD, 2011d). The prevalence of pyramidal structures is in part due to limited use of voting-rights differentiation across share classes. Options for the latter were narrowed significantly by an amendment to the Securities Law in 1989, which largely stopped control-enhancing mechanisms, such as priority shares and voting-rights ceilings.<sup>9</sup> Preferred shares and shareholder agreements are permitted in principle but are not very widespread. Israel’s company-group structures are similar to those of many countries in Europe and Asia, with parallels drawn in particular to Korean *chaebols* (OECD, 2011d).

Company groups raise two issues in relation to the financial sector. First, when these include financial institutions, the advantages and disadvantages of groups (Box 2) are potentially amplified. A financial institution inside the group probably facilitates positive financial intermediation but potentially provides more opportunities for appropriation and distortion in the allocation of resources. For instance, a study

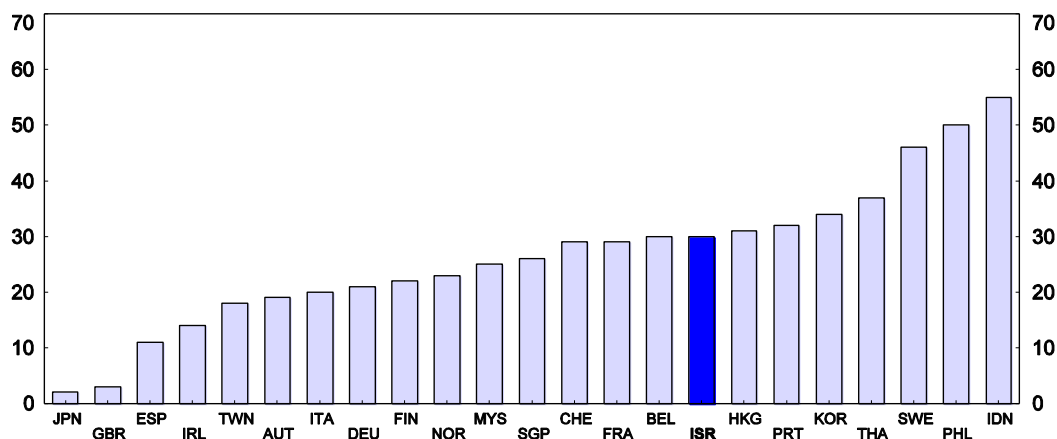
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8. The Bill for Promoting Competition in the Credit Card Market, for instance, includes a regulation with regard to contracts with businesses (such as shops) that forces major cards (issuers of more than 10% of credit cards) to allow other major cards to be cleared under the same contract.

9. Vote differentiation established prior to the 1989 amendment was, in principle, allowed to continue. However, the legal changes also stipulated that new share issues could take place only in the highest voting class, which prompted almost all companies to unify share classes. Currently only eight listed companies still feature vote differentiation.

using Mexican data finds evidence that loans from a bank to other members of the group are less likely to be repaid and more likely to be granted at favourable interest rates (La Porta *et al.*, 2003).

Figure 7. **The stock market share of the ten largest family/business groups**



Source: K. Kosenko (2007), "Evolution of business groups in Israel: their impact at the level of the firm and the economy", *Israel Economic Review*, Vol. 5, No. 2.

#### Box 2. Pros and cons of company groups

The defining characteristic of company groups is common control, often by an individual or family, over public companies where their ownership is partial (*i.e.* there are non-controlling shareholders). Such groups are widespread in the world and notably distinct in character from the diversified shareholding model of the United States and United Kingdom (where company structures may also be complex and linked to a different set of corporate governance issues).

Affiliation of companies with business groups can offer various advantages over independent control and operation, principally because better information flows, reduced transactions costs and common identity allow interactions between companies that would otherwise not exist. Opportunities for financial intermediation may be expanded; for instance, groups can facilitate the establishment of small companies with high growth potential but difficulty in gaining access to capital. But the advantages may not be limited to financing and risk management. For example, groups can usefully deepen markets for specialised workers and managers.

Criticism of business groups draws attention to various agency problems. Controlling individuals or groups can exploit informational and other advantages to their own ends, to the detriment of other shareholders or to the general well-being of the affiliated companies and by extension the economy as a whole. As part of this process, critics underscore that business-group leaders are often able to entrench their positions through powerful business and political lobbying and that their (often complex) structure affords ample opportunities for appropriation.

Pyramidal structures attract specific attention because such nested ownership means the controlling interest's corporate reach can extend far beyond their financial stake. For instance, suppose a family owns a stake (say 51%) in the company at the top of the pyramid which itself holds similar stakes in a second tier of companies, and these hold stakes in a third tier, and so on. The family controls all the firms in the pyramid but has successively smaller financial commitments at each level. Commitment at the second level is 26% (0.51 squared, expressed as a percentage), 13% in the third level (0.51 cubed as a percentage), and so on.

Viewed positively, pyramids provide a means for entrepreneurs to expand their business without ceding control and for allowing others to participate in the returns. Minority shareholders may, for instance, hold the entrepreneur in high regard and see positive benefits to the business group along the lines described above. Conversely, pyramids may also serve as a powerful vehicle for unscrupulous controlling interests to expropriate rents from minority shareholders. For instance, because the controlling interest's financial stake increases higher up the pyramid, there are incentives to divert resources from companies at the bottom of the pyramid, possibly through transfer-pricing strategies. There is evidence that markets factor in such adverse behaviour; the price of a minority share is often much lower than a share in the controlling block (a 'control premium').

Closely held and private companies are often included in company pyramids, providing additional means to transfer resources and obscure business dealings. This is regarded as a significant issue for Israeli business groups. Controlling interests in the group have greater leeway in appointing directors and management in such companies and can take advantage of lighter regulation in other respects, for example regarding the disclosure of information.



Second, company groups raise issues of prudence and systemic risk. The stability of financial entities may depend on the overall stability of the groups themselves. Furthermore, the group as a whole may pose a systemic financial risk, even if there is no bank or similar institution within the group. Indeed, during the disappearance of the bond market in 2008-09, concerns surfaced that one of the business groups might fail. In addition, for those groups controlling a bank, implicit deposit insurance may have acted as an insurance for the group as a whole, in much the same way that deposit insurance has, in effect, covered investment banking in countries where this can be conducted within the same institution as commercial banking. The financial turmoil generated by Iceland's banking sector (in which local investor groups gained control of the three main banks following privatisation) has provided a salutary lesson on the risks of ownership links between banking and non-financial sectors (OECD, 2009).

#### *Existing checks against self-serving behaviour*

Similar to most policy efforts elsewhere, attempts to limit the downsides of company groups use standard tools of corporate governance, *i.e.* there are no specific legal or regulatory measures defining and limiting the groups themselves. Several provisions in the 1999 Company Law aim, *inter alia*, to combat abuse of position by controlling shareholders (see Table 5). These include: disclosure of information rules for private companies that are part of publicly listed groups; special fiduciary duties; mechanisms giving minority shareholders special rights, for instance, in transactions with related parties and takeovers; and rules aiming to reduce the influence of controlling shareholders in determining the composition of company boards.

Several other measures to tighten corporate governance have been taken in light of recommendations made by a government-appointed committee (Goshen Committee, 2006). These broadly aim to give stronger powers to minority shareholders and independent directors, notably:

- Requirements that independent (and external) directors form a majority of the company audit committee and that an external director is the chairman of the committee. There are also new rules on the duties and procedures of the audit committee. Specifically, it has to now make recommendations following analysis of the company's financial statements, and the board of directors is obligated to discuss these recommendations.
- Establishment of a specialised economic court (or more precisely a special chapter of the existing Tel Aviv District Court) whose core objective is to provide minority shareholders with better access to legal procedures (the court began operating in late 2010).
- Changes to voting rules on related-party transactions: a majority of shareholders who are not interested parties to the transaction is now required, previously a vote of only one third was required (the Goshen Committee recommended to relax this to a simple majority once the economic court was established, but this has not been enacted).

In addition, bank credit and institutional funds' investments are subject to various limitations. Caps are imposed on the amount of a bank's capital that can be extended to any single borrower, group of borrowers and related-party borrowers (Table 6). The rules (some are slated to change) aim primarily to protect bank stability and therefore focus on limiting the concentration of the bank's credit supply. This of course does not mean that intra-group banking credit is insignificant. For instance, a bank's credit may account for a substantial share of the total credit extended to a group, while still remaining within these limits on concentration of credit in its portfolio. In the case of institutional investment, there are limits on investment in a given tradable bond series and restrictions on investment in non-tradable bonds. Nevertheless, substantial intra-group bond holdings are possible (*e.g. via* investment in multiple bond



series). Funds' shareholdings are quite restricted in relation to companies within the same group, though there are plans to ease these rules somewhat (Table 6).

Table 5. **Notable corporate-governance provisions in company and banking legislation**

Issue	Provisions (summary)
<b>Provisions in the Company Law (1999)</b>	
General fiduciary duties	All shareholders are required to act "in good faith and in a customary manner". However, in addition there are additional requirements for some classes of shareholder, notably controlling shareholders. Such shareholders are expected, in addition to "act fairly" towards the company. Also, in decisions on transactions with interested parties, these classes of shareholders are under an obligation to disclose personal interest.
Decisions on dividend distributions, transactions with interested parties, inspection of company documents and voting procedures.	Procedures to facilitate absentee voting and special powers for minority shareholders regarding agenda items and extraordinary general meetings.
Decisions on "extraordinary related-party transactions" (a transaction not in the company's ordinary course of business, not undertaken in market conditions, nor one that is likely to substantially influence the profitability of a company, its assets or liabilities)	Approval of a transaction requires a majority vote of not interested parties or failing this a non-majority vote as long as the "no" vote among non-controlling shareholders does not exceed 2% of total voting rights.
Takeovers	A specific procedure (a "special tender offer") has to be followed if a purchase will bring a shareholding above 25% of voting rights (if there is no other such shareholder) or 45% (if no other shareholder has more than 50%). A separate procedure applies ("complete tender offer") applies when a purchase will bring a shareholding to more than 90% of the shares in a company.
Provisions for legal action against management, the board of directors or other shareholders	Breach of the Company Law leads only to civil suits, while breach of the Securities Law can lead to criminal actions.  Provisions for class actions were widened in the Class Action Law (2006), which permits courts to consider claims relating to any action stemming from ownership, holding or purchase of a security or trust.
Independent directors	There must be a total of at least two independent directors, of which at least one must be an "external" director. Among the eligibility criteria, these directors, notably, must have no economic or family relationship to corporate management or to major shareholders. In addition, external directors must have financial or accounting expertise (or a similar area if another external director has such qualifications). At least one half of shareholders, excluding controlling interest, must vote in favour of each independent director (or the total number of votes opposing the appointment from among the non-controlling shareholders is less than 2% of the total voting rights in the company). These directors are appointed for three years, and remuneration is regulated by the Ministry of Justice.  Mandatory separation of the roles of Chairman of the Board and the Chief Executive Officer (temporary unification up to three years is allowed subject to approval of least two-thirds of voting shareholders).
<b>Provisions in the Bank (Licensing) Law (1981)</b>	
"Fit and proper" regulations	Shareholdings exceeding 2.5% require special reporting requirements; added shareholdings of more than 5% require a permit for which further conditions and approval by the Bank of Israel are required. One shareholding is identified as the "controlling shareholder" and has to fulfil further conditions. Legislation is being prepared to alter the system such that supervision can operate without a controlling shareholder.

Source: OECD (2011d).

Table 2.6. **Summary of loan and investment limits for banks and institutional funds**

<b>Rules on indebtedness to banks</b>	
General limits on borrowers' indebtedness	A single borrowing entity's indebtedness cannot exceed more than 15% of any bank's capital. For groups of borrowers this limit is either 25 or 30%, depending on circumstance (there are plans for a single limit of 35%). In addition, the total indebtedness of the six largest borrowers (including groups of borrowers) cannot exceed 135% of a bank's capital (there are plans to reduce this to 120%).
Special limits in the case of related parties (which generally includes entities within the same company group as the bank)	Aggregate indebtedness to the bank of all related parties cannot exceed 10% of the bank's capital. When the indebtedness of a component in the company group is mainly to the same banking corporation, the indebtedness of that component cannot exceed 10% multiplied by its relative share in the core holding. For example, for a company controlled by a 40% stake in the same group as the bank, then its indebtedness cannot exceed 4% of the bank's capital.
<b>Limits on institutional funds (apply to all types except mutual funds)</b>	
Limits on investment in a single tradable bond series	Limits vary according to the bond's credit rating. The maximum limit is 15% for a single fund and 25% for the institutional body as a whole. There are plans to remove the limit for individual funds, cancel the link to the bond's credit rating and apply the limits to insurance companies' nostro accounts too.
Limits on investment in non-tradable bonds	Pension and provident funds face no limit in the share of investment in non-tradable bonds as long as the bonds are rated BBB- or above. Otherwise there is a limit of 7.5% of assets. Insurance companies face no limit as long as the bonds are at least BBB rated. There are plans to impose the same rule across all institutions.
Limits on security holdings in "related parties"	Pension and provident funds cannot invest in securities issued by companies belonging to the same business group. Insurance companies cannot invest in companies which control them (but can invest in "sister" companies). There plans for a common rule that allows investment up to a certain limit in related parties but not if these are closely held companies and/or "mother" companies in the group.
Tax disincentive	If holdings exceed 20% of the stock of a listed company, then the tax-free status (with respect to both income and capital-gains tax) no longer applies to the entire holding.

Source: Bank of Israel.

### *Assessing the options for further reform*

In September 2011 the committee established to look into company groups (known as the Concentration Committee) issued its preliminary recommendations. These do not aim for a wholesale break-up of groups, which makes a good deal of sense. The current 'controlling shareholder' model is well established and is not unusual in international comparison. In any case, diversified share ownership with management control has proven to have significant agency problems of its own. Nevertheless, the Committee is proposing deep regulatory reforms (State of Israel, 2011), most notably:

- As regards the relationship between real and financial sectors, the Committee recommends prohibiting a significant "real" entity from controlling a significant financial entity. This separation of large real and financial entities would be a welcome move. However, its ultimate success would depend heavily on which individuals or entities end up controlling the financial firms. Also, judging by the Korean experience (Box 3), ownership caps on banks (and possibly other financial entities) help prevent undesirable relations between financial and non-financial entities, but are not a panacea. Furthermore, there is a risk that in reaction to caps on ownership the business groups might engage in alternative forms of intra-group financing that may themselves be less than desirable.

- Other steps are being recommended that also relate to financial entities: restrictions on directors holding concurrent directorships in financial and non-financial entities; additional restrictions on the control of one significant financial entity by another financial entity to those introduced in the Bachar Reform; and, tighter rules on the exposure of financial entities to any single entity or group of borrowers.
- The Committee is also recommending several regulatory changes in corporate governance to strengthen the protection of minority shareholders. In particular, it proposes legally defining “wedge companies” (*i.e.* ones in which there is a gap between control and equity holdings) and applying additional governance regulations to them. For instance, a minimum of one-third of wedge company board members will have to be elected by minority shareholders (as opposed to two members otherwise). However, there may be concerns that, despite the implementation of these measures, the controlling company may be able to exert undue influence. For instance, if regulations on the fiduciary duty of company directors to all shareholders and the company are in practice not very effective (for example because of difficulties in proving fiduciary negligence), then the controlling shareholder may nevertheless manage to steer board decisions in favour of the group, rather than the company itself. In such circumstances then legislation defining a company group may be warranted as a means of attaching fiduciary duty to the parent thereby bringing transparency to the operations of the group.

#### Box 3. Korea's ownership limits on financial entities

Given the similarities drawn between Israel's business groups and the *chaebols*, Korea's experience in limiting relations between financial and non-financial entities is instructive. Non-financial (and financial) entities have long had restrictions placed on bank ownership. At present, no entity can own more than 10% of the shares in a given bank (15% in the case of local banks, see OECD, 2008). However, it is worth noting that these limits were seemingly not sufficient to prevent the problems in corporate governance that emerged during the 1997 Asian Crisis (OECD, 1998). In particular, intra-group loan guarantees had become a significant source of vulnerability. Thus, while the authorities have maintained the caps on ownership, they also engaged in a wide range of other steps to improve corporate governance and strengthen competition by removing barriers to imports and inward foreign direct investment in the wake of that Crisis. Arguably one of the most significant moves was to actually let one of the largest groups fail, which significantly altered the *chaebols'* perception of implicit government guarantees.

In spite of such reforms, the company groups are likely to remain a source of concern. Hence, the establishment of a permanent unit (within an existing supervisory body) or working group charged with monitoring the company groups should be considered. The unit (or working group) could not only monitor the impact of measures aiming to improve corporate governance but also check the financial stability of the groups and thus usefully augment macro-prudential oversight.

In addition, some concerns and problems relating to business groups may not relate to their structure *per se*, and thus policy actions outside the sphere of corporate governance could be warranted:

- Business-groups (and controlling shareholders) may partly be in an advantageous position because of monopoly profits in certain sectors and not because of any strong powers derived, for instance, from “excessive” control. Clearly, this implies a need to ensure policies regarding traditional sectoral competition issues are in good shape. Legislation on this front was strengthened in 2011 with measures providing the competition authority with enhanced enforcement powers when a small number of companies have more than a 50% share of any particular market.

- Popular complaints about business groups may partly reflect straightforward disquiet about the presence of high-earning and wealthy individuals in society. Agency problems in the business groups (or sectoral competition issues) may in fact not be large, but some may anyway believe the rewards to owners and managers are nevertheless unwarranted. Any policy response to this would be better addressed more directly through income, wealth or estate taxes.

Finally, the authorities should continue to promote greater foreign presence in the financial sector and in company groups in general as this would bring a healthy diversification of ownership and control. In meetings held with the Supervisor of Banks in preparation for this Survey, the authorities pointed out that they make strenuous efforts to attract foreign shareholders to the banking sector, whenever opportunity arises. There has been some positive news on this front: in July 2011, UBS announced it would launch financial services for affluent customers, corporations and institutions, and in August the Bank of Israel granted Barclays Bank a foreign bank licence and a permit to open a branch.

#### Box 4. Recommendations for private-sector finance

##### Structure of supervision and macro-prudential oversight

- Remove the supervisory duties currently carried out by CMISD from the Ministry of Finance as part of a broader assessment of financial-market supervision.
- Strengthen further communication and co-ordination among the supervisory bodies, particularly as regards supervision from a functional rather than an institutional perspective.
- Implement plans to publish a financial stability report.
- Focus in particular on regulatory reform and supervision of the non-banking financial sector.

##### Banking sector

- Build in strong safeguards in the plans to permit wider securitisation.
- Strengthen mechanisms for dealing with banks in difficulty, for instance by augmenting the powers of the Bank of Israel for early intervention.
- Counter evasive actions by banks that circumvent and dilute the impact of tighter regulation of mortgage lending.

##### Non-banking sector (corporate bond market)

- Adopt more rigorous regulation if weaknesses in the bond market persist in spite of the Hodek reform. In addition, pay attention to the risk that the reform divides the market; more uniform application of regulations may be required.
- Continue to closely monitor bond-market developments, in particular (uncollateralised) corporate-bond financing in the real-estate sector.

##### Household savings

- Pursue plans to reform the tax treatment of pensions and for life-cycle portfolio adjustment. As part of the latter reform, consider removing regulations that give some forms of long-term savings access to preferential-rate government bonds.
- Simplify the characteristics and range of pension products.
- Refrain from further increases in mandatory pension savings.
- Phase out tax breaks on savings in the advanced training funds.

##### Corporate governance and competition

- Implement the proposals of the Concentration Committee, notably the separation of financial and non-financial entities.
- Establish a permanent body, or forum, to monitor the company groups.
- Ensure sector-level competition legislation and oversight are in good shape.
- Promote greater foreign presence in the financial sector, and in company groups in general, as a means of diversifying ownership.

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*Annex A1***Key legislation relating to the financial sector**

<b>Related supervisory body</b>	<b>Legislation</b>
Supervisor of Banks	<p>Banking (Licensing) Law (1981). Describes the Bank of Israel's powers in awarding licences for the operation of banks and defines limits to banks' holdings and activities.</p> <p>Banking (Service to Consumer) Law (1981). Prescribes consumer protection by instituting fair practices between banks and retail customers and related information-disclosure requirements.</p>
Capital Market, Insurance and Savings Division, Ministry of Finance	<p>Control of Financial Services (Insurance) Law (1961).</p> <p>Control of Financial Services Regulations (Insurance, the Board of Directors and its Committees Law (2007).</p> <p>Control of Financial Services (Provident Funds) Law (2005).</p> <p>Control of Financial Services Regulations (Provident Funds, Distribution Commission) Law (2006).</p>
Israeli Securities Authority (ISA)	<p>Securities Law (1968). The core operational legislation for the ISA. It describes supervisory capacities and relates primarily to the offer of shares and bonds to the public. It also laid the legal framework for the creation of the ISA.</p> <p>Joint Investment Trust Law (1994). The main law governing mutual funds.</p> <p>Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law (1995).</p>
General	<p>Company Law (1999). General law applying to all companies with differentiation between private and public entities. Contains many key mechanisms of corporate governance.</p>

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