



Report of the State Comptroller of Israel |
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Capital Market, Insurance, and
Savings Authority

Aspects of Cumulative Pensions and the Pension Distribution Market – Follow-up Audit



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Background


Savings for retirement age consists of three layers: the first layer is the old-age pension; the second layer, usually the primary source of income after retirement from work, is the pension savings accumulated by the employee throughout his years of work; and the third layer is the private savings of households. The new pension funds are included in the second layer of pension savings – as Defined Contribution (DC) pension plans. In the DC method, the benefit is determined according to the accumulation of the employee's and the employer's provisions to the fund, plus the return earned by the fund, net of the management fees, and based on assumptions regarding life expectancy. In this method, the return risks are entirely borne by the employee.



Key Figures

NIS 464.7 billion	NIS 44.9 billion	1.95%	0.19%
the balance of assets of the new pension funds by December 31, 2020 – an increase of about 15% compared to 2019	deposits to the new pension funds in 2020 – a 5% increase compared to 2019	management fees average rate from the deposits of all members in the new and comprehensive pension funds in 2020, compared to 2.85% in 2016	management fees average rate from the assets of all members in the new and comprehensive pension funds in 2020, compared to 0.26% in 2016
56%	93%	41.5%— 43.2%	479
the rate of inactive savers who paid the maximum management fees in 2021, compared to 90% in 2015	the rate of pensioners who are recipients of an allowance who paid the maximum management fees in the five largest new pension funds in 2021, compared to 100% in 2015	the cumulative return of the default funds, compared to an average return of 35.56% for all new pension funds in 2019–2021	the number of pension consultation license holders in 2020 – compared to 922 in 2015 – a decrease of about 48%

Audit Actions

 In 2016, the State Comptroller's Office published a special audit report regarding the pension arrangements in the country¹ (Previous Audit Report). From January to March 2022, the State Comptroller's Office examined the Capital Market, Insurance, and Savings Authority (Capital Market Authority) actions to rectify the deficiencies noted in the Previous Audit Report in the cumulative pension and the pension distribution market. The follow-up audit was conducted at the Capital Market Authority. Completion examinations were carried out in the following government ministries and companies: the Ministry of Economy and Industry, the Ministry of Energy, the Ministry of Education,

¹ The State Comptroller, Special Audit Report on the **Pension Arrangements in the Country** (2016).



the Ministry of Justice, the Ministry of Public Security, the Ministry of Interior, the Ministry of Communications, the Civil Service Commission, Haifa Port Company Ltd. (Haifa Port), Israel Electric Company Ltd. (the Electric Company), Ashdod Port Company Ltd. (Ashdod Port), Israel Railways Company Ltd. (Israel Railways) and Netivei Israel – National Transport Infrastructure Company Ltd. (Netivei Israel).

Key Findings



The Rate of Management Fees of Inactive Savers – the Previous Audit raised that about 90% of inactive savers in the five largest new pension funds paid the maximum management fees. The follow-up audit raised that the deficiency was partially rectified. In 2021, about 67% of inactive savers in the five largest new pension funds paid the maximum management fees, but the rate of inactive savers who paid the maximum management fees in the market as a whole in 2021 was about 56%.



The Ownership Structure in the Pension Distribution Market – by the Previous Audit, the Capital Market Authority did not examine the ownership structure of the insurance and arrangement agencies² and did not set provisions limiting the distribution of the parent company's products through agencies owned by institutional entities. By the follow-up audit, the deficiency was rectified to a small extent – the Capital Market Authority did examine the ownership structure of the insurance and arrangement agencies but did not set provisions limiting the distribution of the parent company's products through agencies owned by institutional entities.



The Agents' Compensation Model – by the Previous Audit, the Capital Market Authority did not set clear rules to provide economic incentives in the insurance agents' compensation method to minimize the influence of extraneous considerations regarding the distribution of the client pension savings. The follow-up audit raised that the deficiency was not rectified and that the rules above had not been set.



The Reasoning Document – section 14 of the Control of Financial Services (Pension Consulting, Marketing, and Clearing System) Law, 2005 (Pension Consulting and Marketing Law), requires the license holder to provide the client when recommending savings, a written document detailing the recommendation reasons regarding the profitability of the client's or their relative's savings using a pension product (the Reasoning Document). In the Previous Audit, the State Comptroller's Office found that

2 Large agencies that specialize in managing complex pension arrangements for enterprises, including consulting for the employers and enterprise employees, accompanying the clients throughout their insurance life, collecting the funds each month and distributing the funds between the various companies and products.



the use of the Reasoning Document as a main working tool by the license holder created the appearance of concern for the client's best interests but, in practice, did not guarantee that the selected pension product was indeed the most appropriate product for the client, and therefore does not solve the inherent conflict of interest of the insurance agent. The follow-up audit found that the deficiency was slightly rectified – the Capital Market Authority changed the Reasoning Document and expanded the due diligence regarding the considerations that guided the license holder in the recommendation, but this does not solve the inherent conflict of interest of the insurance agent.



The Pension Consulting Market – by the Previous Audit, the pension consultation licensees rate among all consultation and brokerage licensees services related to insurance products and pension savings³ was only about 9% in 2014. Concerning most of the population, there is a lack of objective pension consulting to consider the insured needs. The follow-up audit raised that the deficiency was not rectified: the number of pension consultation licensees decreased from 922 in 2015 to 479 in 2020 (a decrease of about 48%). Furthermore, there has been a decrease in the rate of pension consultation licensees out of all individual license holders in the pension distribution market – from 8.2% in 2015 to 4% in 2020.



The Effectiveness of Enforcement – by the Previous Audit, no strategic examination work on the effectiveness of the enforcement of the provisions of the Pension Consulting and Marketing Law was conducted by the Capital Market Authority. By the follow-up audit, the deficiency was not rectified – the Authority did not carry out any strategic work to examine the effectiveness of the enforcement it performs, except for examinations of a few appeals it received from the public.



Frequency of Pension Consulting or Marketing During an Employee's Life – in all the audited entities in the follow-up audit (except for Israel Railways), including government ministries, the Electric Company, Haifa Port, Ashdod Port, and Netivei Israel, the employees do not receive pension consultation during their employment period, when there may be changes in their personal or marital status. In some organizations, employees are referred to a pension insurance agent or a pension marketer, which may cause a possible bias in the insurance products that employees receive.



The Management Fee Rate for Pensioners – the Previous Audit raised that in 2015 all pensioners in the five largest new pension funds paid the maximum management fee rate set by law. The follow-up audit raised that regarding retirees who retired as of February 2022, the deficiency was fully rectified, but no solution was found regarding members who retired before that date. In January 2022, the Knesset Finance Committee

3 Including pension insurance agents, pension marketers and pension consultants.



approved the amendment⁴ to the Control of Financial Services Regulations (Provident Funds) (Management Fees), 2012. In the said amendment, which was initiated by the Capital Market, Insurance and Savings Authority Commissioner in cooperation with the Minister of Finance, a lower cap for management fees was set for pensioners at 0.3% (instead of 0.5% in a new comprehensive pension fund and 0.6% in a new general pension fund) compared to the cap set in the Regulations. The follow-up audit further raised that in 2021, before the said amendment, about 93% of the pensioners receiving the allowance in the five large new pension funds still paid the maximum management fees, and that the percentage of those paying the maximum management fees among retirees has decreased in recent years from 100% in 2017 to 68% in 2021. The excess payment of pensioners receiving allowances who paid the maximum management fees in 2021, compared to the average rate of management fees paid by all members that year, was about NIS 59–87 million.

Choice of Selected Funds by the Capital Market Authority – in the Previous Report, the State Comptroller's Office recommended that the Capital Market Authority reconsider, as part of the arrangement's impact on the pension market, the need for additional criteria for selecting the default funds⁵, other than the rate of management fees, such as product quality and the adjusted yield. The follow-up audit raised that the deficiency was fully rectified and that in the framework of the second and third procedures for determining selected funds, published in August 2018 and August 2021, respectively, the Capital Market Authority considered adding criteria for choosing a selected fund, apart from the proposed management fee rate, and decided it was best to leave the management fee criteria as the only criteria in the selection process. This is because the management fee criterion is the only objective criterion on which this procedure can be based.

Selection of a Default Fund by an Employer or an Employee Organization – the Previous Audit raised, regarding the competitive procedure to select a default fund by an employer or an employee organization, that the Capital Market Authority did not adjust the yield criteria to the risk level of the investment portfolio, which may result in an inadequate comparison between the funds in the competitive process. The follow-up audit raised that the deficiency was rectified to a large extent, and that as part of the third procedure, the Capital Market Authority decided that in a competitive procedure that includes a criterion of the provident fund's yield, it would be possible to add the criterion of the "Sharpe risk-free interest rate index"⁶, which expresses the risk of the investment portfolio, however the Authority did not mandate the addition of this criteria.

4 The Control of Financial Services Regulations (Provident Funds) (Management Fees) (Amendment), 2021. The regulations were approved in January 2022 and entered into force with respect to retirees who began to receive an old-age pension from February 1, 2022 onwards.






5 The term "default funds" was used in the Previous Report to describe funds selected in a tender process conducted by the Capital Market Authority to provide discounted management fees to new entrants. Over the years, the Authority changed the term to "selected funds", as detailed in the report.

6 An index estimating the fund's excess return beyond the risk-free interest rate. A high Sharpe Index indicates better performance, i.e. a higher return per standard deviation unit.



The Actuarial Deficit in the New Pension Funds Created by Recipients of Disability Allowance and Survivors' Pension – the Previous Audit raised that disability allowance and survivors' pension recipients created an actuarial deficit, which causes subsidizing between them and the other members of the fund. The follow-up audit raised that the deficiency was fully rectified – the Capital Market Authority settled the cross-subsidy problem between all members through a mechanism that transfers the risk to the pensioner himself and not to all fund members.

Key Recommendations

-  It is recommended that the Capital Market Authority continue to monitor the composition of the balances of the inactive savers who pay the maximum management fees and examine how to reduce the balance.
-  It is recommended that the Capital Market Authority establish clear rules for providing economic incentives in the compensation method of the insurance agents to minimize the influence of extraneous considerations regarding the distribution of pension savings to the client.
-  It is recommended that the Capital Market Authority examine the Reasoning Document and adapt it to the changing needs and technological developments in recent years. It is also recommended that the Authority consider additional ways and tools to handle conflicts of interest in the activities of insurance agents to minimize the influence of irrelevant and non-professional considerations on the activities of insurance agents vis-à-vis clients.
-  It is recommended that the Capital Market Authority develop and optimize the pension consulting market, promote regulation to enable the provision of pension consulting in a digital, advanced, and convenient manner, and examine the pricing model for pension consulting with an overall view of the profitability for all players in the market.
-  It is recommended that the Capital Market Authority examine ways to increase the frequency of pension consulting provided to employees, particularly at critical points in time, such as when starting work, when there are changes in the employee's personal or marital status, and when he retires. This is to ensure the adaptation of the pension insurance to the employee's needs and rights. In addition, it is recommended that the Civil Service Commission and the directors general of the various entities formulate a procedure for referring employees to pension consulting periodically.



Extent of Rectification of the Main Deficiencies Noted in the Previous Audit

The Audit Chapter	The Audit Chapter	The Deficiency noted in the Previous Audit Report	The Extent of Rectification of the Deficiency Noted in the Follow-up Audit				
			Not Rectified	Slightly Rectified	Partially Rectified	Considerably Rectified	Completely Rectified
Cumulative pension	The Capital Market Authority	Most inactive savers paid the maximum management fees.					
Cumulative pension	The Capital Market Authority	All pensioners paid the maximum management fees set in by law.					
Cumulative pension	The Capital Market Authority	Examining the use of a single criterion of management fees in determining a default fund.					
Cumulative pension	The Capital Market Authority	Failure to adjust the yield criterion in the competitive process to select a default fund by an employer or employee organization to the risk level of the portfolio.					
Cumulative pension	The Capital Market Authority	Recipients of disability allowance and survivor's pension create an actuarial deficit causing subsidization between them and the other members of the fund.					



The Audit Chapter	The Audit Chapter	The Deficiency noted in the Previous Audit Report	The Extent of Rectification of the Deficiency Noted in the Follow-up Audit				
			Not Rectified	Slightly Rectified	Partially Rectified	Considerably Rectified	Completely Rectified
The Pension Distribution Market	The Capital Market Authority	Failure to examine the ownership structure of insurance and arrangement agencies.					
The Pension Distribution Market	The Capital Market Authority	Failure to regulate clear rules for providing economic incentives in the insurance agents' compensation method.					
The Pension Distribution Market	The Capital Market Authority	The Reasoning Document does not guarantee that the chosen pension product is best suited to the customer and does not solve the problem of conflict of interest of the insurance agent.					
The Pension Distribution Market	The Capital Market Authority	The absence of an objective pension consultation market.					
The Pension Distribution Market	The Capital Market Authority	Failure to examine the effectiveness of the enforcement.					



Summary

Pension savings are intended to serve as a main source of income after retirement from work and to enable the saver to live with dignity and maintain, to the extent possible, the standard of living he was used to before retirement. Choosing the type of pension savings and matching it to the member's preferences and personal needs considerably affects the pension he is expected to receive. The lack of adequate pension savings may lead to poverty after retirement, requiring public resources to support the pensioners. The findings in this report indicate that the Capital Market Authority rectified some of the deficiencies noted in the Previous Audit Report, mainly in the default funds and the management fees paid by retirees who retired as of February 2022. However, it did not rectify the deficiencies in the pension distribution market, manifested in the inherent conflicts of interest in the activities of pension insurance agents and the absence of an objective pension consulting market. The Capital Market Authority should address deficiencies in the pension distribution market, develop, and improve an objective and advanced pension consulting market to benefit public retirement savings.

