Shekel by Shekel: How Israelis Save

By Kerry Pechter *Thu, Feb 14, 2019*

For the last decade, Israeli workers have contributed to mandatory defined contribution savings plans at work and must convert at least part of their savings to a lifetime income stream in retirement. (Photo: The entrance to Jerusalem's new underground train station.

Like Americans and Europeans, Israelis have seen big changes in the way they fund their retirements. Until about 25 years ago, older Jewish Israelis in professional jobs could look forward to generous defined benefit (DB) pensions from one or more former employers.

"Once upon a time, it was simple in Israel," Dan Galai, a fund manager and academic who has had a 50-year career here and in the US, told *RIJ* during a recent interview in his office in the Ramat Gam district of Tel Aviv.

Dan Galai

"If you were in the government, or affiliated with a university, or you had an army career, you got a pension that was paid out of the budget of the government. There were many different pension plans, and the government issued bonds for them with a guaranteed rate. It was an expensive subsidy."

Equally unsustainable were private, multi-premium annuities, called pension insurance policies, said Abigail Hurwitz, an Israeli pension expert currently at the Wharton School in Philadelphia. "They insured individuals who didn't belong either to the government or to any employee union," she told *RIJ*. The annuity factor was set at purchase date, rather than at retirement. As life expectancies in Israel rose, these contracts turned out well for annuitants but disastrously for life insurers.

By 1995, the fragility of this fools' paradise could no longer be ignored. The government eventually bailed out the big pension funds (at a reported cost of about $25 billion), closed them to new enrollment, and replaced them with a voluntary defined contribution system. The feckless practice of setting annuity factors at time-of-purchase for pension insurance policies was ended.

At the start of the 21st century, Benjamin "Bibi" Netanyahu (then Israel's finance minister, now its prime minister) started rationalizing the economy. In 2003, the government broke the big banks' cozy monopoly on financial services, forcing them to divest their mutual (aka "provident") funds. In 2008, the government—acknowledging that the voluntary defined contribution (DC) system, as DC does in the US, left millions of workers without any retirement plan coverage—took a dramatic step and required all employers and workers to contribute to DC plans.

Here's a pocket-sized overview of the post-2008 mixed retirement system to which Israelis have been adjusting. Most Israelis, like Americans, grope their way into retirement, with a grab-bag of DB pensions from long-past employers, pension insurance policies, unspent severance pay accounts, and new mandatory DC accounts. The different accounts from different periods are typically subject to different tax rules. The various elements often require a licensed pension advisor to sort out.

We'll cover the high points of Israel's safety-net pension and its mandatory DC program, which leads to mandatory partial annuitization. Warning: There's a lot of information here. The Israeli retirement system was laid down in a succession of layers, and studying it requires a kind of archaeological excavation through the multi-dimensional strata of time and law.

Basic old age insurance (and health care)

This program, run by the National Institute of Insurance (NII) and funded by a payroll tax, resembles US-style Social Security, but gives all retires the same old age benefit, not counting certain supplements and adjustments. No one receives more than about $1,000 per month.

Abigail Hurwitz

The payroll tax has two tiers. There's a 3.55% employer-paid tax on the first 6,164 shekels ($1,690) of income per month. Then there's a 7.6% employer-paid tax and 7.0% employee-paid tax on income between 6,164 and 43,890 shekels ($12,043) per month. In addition, the employee pays a health insurance tax equal to 3.10% of the first 6,164 in salary and 5% for amounts above that, to 43,890 shekels.

Benefits start at the full retirement age (67 for men, 62 for women). Until age 70, benefits are means-tested, but not after age 70. The flat individual benefit is a modest 1,554 shekels (about $427 a month) in a country where the cost-of-living is comparable to that in the US. At age 80, the benefit notches up to 1,641 shekels ($451). Regarding health care: Israel has a public-private hybrid HMO-based health insurance system, funded by a combination of payroll taxes and co-pays. It continues in retirement.

A retired married couple can receive a spousal supplement of 781 shekels ($215), raising the couples' pension to 2,335 shekels ($640) a month. Those with dependent children receive 492 shekels ($135) per child, up to two. For a retired couple with two dependent children, the pension would be $885 a month. "That's peanuts," a Tel Aviv cab driver told me. "Peanuts!"

Mandatory defined contribution

As Israel grew more market-driven under Netanyahu, the government wanted to shift financial responsibility for retirement onto the public. It made defined contribution plans mandatory, with fixed-percentage contributions from employers and employees.

Today, the employer contributes 6.5% of pay and the employee contributes another 6%. The employer contributes another 6% of salary toward an unemployment ("severance") fund. If the employee never uses it, he or she can take it as a lump sum in retirement.

Employers in Israel aren't plan sponsors per se and aren't supposed to choose plan providers for their workers, although employers can choose their company's default target date fund provider. Employees are intentionally given a lot of freedom to invest as they wish, and to switch investments (and providers?) at will. Every month, the employer sends a bulk contribution to a clearinghouse, which distributes each employee's portion to his or her chosen fund provider.

Older Israeli in Jerusalem's Mahane Yehuda market.

Employees typically send their contributions to a "pension fund" or a "provident fund;" the latter resemble mutual funds. The first offers a combination of retirement savings, life insurance and disability insurance, and contributions to them are capped because their returns are partly subsidized. Contributions to pension funds are tax-free up to a certain amount and excess contributions spill over into other investments.

The government evidently subsidizes the pension funds (not the provident funds) by allowing them to hold special government bonds, which yield a guaranteed 5.75% return (a slice of which 2% to the insurer that manages the fund). Up to 30% of a pension fund's asset pool can consist of these special-purpose bonds.

The default investment options for participants in pension funds are like target-date funds. These funds have a 10% allocation to the subsidized bonds for people under 50. The allocation rises to 40% at age 50 ad to 60% at age 60 and thereafter in retirement. This glidepath, as in the US, serves as a buffer against sequence-of-returns risk.

Competition between fund providers is designed to keeps a lid on fees. Israelis pay a two-fold fee on their pension contributions. First, there's an expense ratio for each contribution. Second, an expense ratio is charged on accumulated savings (assets under management). The fees for the two default funds, selected through a government bidding process in 2016, are especially low.

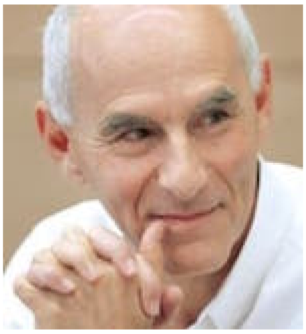
The two default providers are Meitav Dash Investments Ltd. and Halman Aldubi Investment House Ltd. Meitav Dash charges a one basis-point (0.01%) management fee on accrued savings and 131 basis points (1.31%) on each monthly deposit. Halman Aldubi collects an even slimmer one-tenth of one basis point (0.001%) management fee on accrued savings but charges 149 basis points (1.49%) on monthly deposits. As in the US, the default funds are popular.

In addition, employers may contribute on their employees' behalf to tax-favored "study funds," which can be withdrawn tax-free after a six-year minimum holding period. As in the US, contributions to pension funds and provident funds are tax-deductible up to a cap. The precise tax rules in Israel are too complex to address here.

Mandatory annuitization

Distribution from Israeli DC plans is more structured than distribution from 401(k) accounts in the US. In the US, distributions from tax-deferred accounts, either in the form of annuity payments, lump sums, or systematic withdrawals, are all taxed as ordinary income. Most US retirees resist taking distributions from tax-deferred accounts until the required age, 70½.

Israel, by contrast, drives partial annuitization (but only of savings since 2008) through a combination of requirements and incentives. Retirees must convert at least part of their tax-deferred savings to a lifetime income stream and pay no income tax on the portion that's annuitized, up to a limit. Lump-sum withdrawals from pension funds can face up a significant tax. (Forced annuitization was less of a jolt to Israelis than it might be for Americans, since it mimicked their earlier DB pensions.)



Oded Sarig

Most of the new DC pensions are structured as life-with-20-years-certain annuities. “In order to qualify for the tax benefit, the retiree has to annuitize for life. But within that restriction you can select the number of years you want the benefits to last,” said Oded Sarig, a former chief of the Ministry of Finance’s Capital Market, Insurance and Savings Authority, in an interview with *RIJ*. “You can annuitize with 10 years or 20 years certain,” he added. “You can have joint-and-survivor contracts.”

The standard tax-free income stream is about 4,400 shekels or about $1,200 a month. A recent law, called Amendment 190, adds a new tax break for lump-sum withdrawals, a chance for additional tax-free monthly income from provident funds, and tax-free disbursements at death before age 75. (Amendment 190 is new and complicated, and this description could be flawed.)

An Israeli retiree who owns a provident fund would need to transfer it to a pension fund in order to convert to a monthly income stream. This would not entail buying an individual fixed income annuity from a life insurer, as in the US. The retiree would simply switch from contributing to his or her pension fund to receiving an income from it.

The first monthly payment is determined by dividing the retiree’s assets by a “conversion factor” based on gender, life expectancy at annuitization and an assumed interest rate (currently 4%). The current conversion factor for a payout from a post-2008 savings is about 200. Someone who saved a million shekels in a pension fund could, if they annuitize the whole amount, buy a 5,000-shekel-a-month annuity at today’s rates.

This income, like the income from a variable immediate annuity in the US, can rise or fall, depending on the returns of the underlying portfolio. A retiree’s portfolio would contain almost 100% bonds, 60% of which would be the subsidized special government bonds.

To spread the impact of potential volatility up or down, fund managers use a “smoothing” mechanism. Payments adjust to portfolio performance over rolling three-year periods instead of every month or year, so that the impact of a transient shock to the fund doesn’t fall on one unlucky cohort of retirees. “The participants bear the risks,” Sarig said. “It’s a form of mutual insurance. If the fund runs into problems, the retirees’ income comes down.”

If all this sounds like a hot mess, it is. In a coffee shop in Yehud, a 69-year-old retired electronics engineer and Army officer, Moshe Shahar, said his wife handles the details of his many retirement accounts. He’s nostalgic for the simpler, more generous DB pensions of the rapidly receding past. “The new system has turned out to be a nightmare,” he said, “You get much less than with the old pensions.”