

## Clause 20 of Financial Services Law (retirement plans) 2005 - Israel

January 29, 2006

### Introduction

This document comprises a description of Clause 20 of the new Financial Services Law, actions for consideration, background notes and commentary. This clause introduces a radical change in the administration of retirement benefit plans in Israel and although this law was first published during 2005 and implemented towards the end of 2005, certain inconsistencies remain unresolved. It appears that the employer's ability to control the investment and terms of severance pay assets held as a component of an individual retirement benefit arrangement for current hires will be severely restricted. Awareness, understanding and employer practice are expected to develop during 2006.

In particular, this note includes clarifications based on interpretations which were not available at the time the regulation was first published.

### Summary of new regulation

This regulation endows all employees with the right to select the individual retirement plan and provider to which the employee and employer contribute. This may include employer contributions to advance funding for severance pay. This is likely to affect company costs.

Also, employees are endowed with the right to select an educational training fund<sup>1</sup>, if established, and to transfer funds accordingly. This may incur an increased burden of administration but does not otherwise affect company costs.

### Start date

This regulation became effective November 10, 2005

***The remainder of this note refers exclusively to individual retirement benefit plans, including membership in a multi-employer pension fund, which may or may not include severance pay funding.***

---

<sup>1</sup> Educational Training Funds provide for short terms savings with attaching tax concessions. Typical contribution rates are 7.5% paid by the employer with parallel employee contribution at 2.5% of salary. Employer contributions above the tax ceiling of approximately \$3,000 p.a. are assessed as benefit in kind for tax purposes. Employees may redeem the accumulated fund balance free of tax after 6 years from first deposit date, after 3 years for approved professional training purposes or earlier in case of death.

## Actions

The following actions may be recommended as appropriate to particular circumstances:

1. Restrict company open-ended liabilities to meet the shortfall between individual accumulated severance pay fund and the statutory severance pay amount<sup>2</sup> required in case of involuntary termination;
  - i. Implementation of Clause 14 of the Severance Pay Law<sup>3</sup>. This allows for the company to release the accumulated severance pay fund to the benefit of the leaver in case of involuntary termination in lieu of the usual requirement to release the fund and meet any shortfall between such fund and the statutory severance pay amount<sup>2</sup>. In effect, no shortfall payment will be required. Consequently, the performance of severance pay funding will not affect company costs. This may be implemented for new employees but is not normally practicable for application to current hires;
  - ii. Implementation of "unconditional rights"<sup>4</sup> clause. This may be applied for new employees to offset part of the company liability to meet the shortfall described above.
  
2. Retain control of employer financed severance pay funds:
  - i. For current hires: separate between severance pay funding and retirement funding components such that the employee transfers only the retirement funding component. This is likely to be impracticable without the introduction of revision to the current legislation or the establishment of favorable precedent in the law courts;
  - ii. For new hires: severance pay funding may be paid (by the company) to a separate collective severance pay fund such that a transfer of an individual retirement plan would not include a severance pay component. Consequently the company will retain control of the severance fund. This may be implemented for new employees but is not normally practicable for application to current staff;
  - iii. For new hires: discontinue severance pay funding to external funds. This would incur taxation consequences, impair attractiveness of the benefits package and will affect cash flow;

---

<sup>2</sup> the product of final monthly salary and years' service (subject to at least 12 months' service)

<sup>3</sup> prerequisite conditions: (a) release of the accumulated severance pay fund to the benefit of the employee in case of voluntary termination i.e. without repatriation to the employer; (b) company contributions to retirement benefit at the higher rate of 6% where paid to a pension fund whereas the standard rate of company contribution to retirement benefit is 5% whether to pension fund or Individual Retirement Savings Policy.

<sup>4</sup> "unconditional rights" refers to a relatively recent regulation allowing an agreement between the employee and the employer such that part of the retirement savings fund is reallocated to the severance pay fund. The employer agrees, subject to a period of up to 3 years of employment, to release the severance pay component of the retirement plan to the benefit of the employee in case of voluntary termination.

3. Develop a strategy to retain most employees in the principal company retirement benefit plan. One strategy might include the following:
  - i. Obtain a description of retirement plan design including contribution parameters, benefit parameters, and extent of variation between employees. This might be provided by the principal broker, HR manager or independent advisor;
  - ii. Compile a summary of preferential terms provided by the principal broker in respect of the standard retirement plan offered to current and new employees;
  - iii. Develop a benefit information pack for current and new employees focusing on the advantages of selecting or retaining the standard retirement benefit plan;
  - iv. Communicate to HR staff and possibly to employees;
4. Manage the burden of administration:
 

Seek agreement from the principal broker to undertake the administration of retirement plan transfers and the maintenance of new retirement plans selected by employees exercising their right to choose according to Clause 20. Additional management fees may be incurred;

## Background

### Severance Pay

Employers are obliged, in the case of involuntary termination and subject to at least 12 months service, to pay severance pay in the amount calculated as the product of final monthly salary and years' service. Discretionary bonus and other "contingent" salary components are not normally included for this purpose.

It is customary, although not required by law<sup>5</sup>, for employers to fund in advance at the rate of 8.33% of each monthly salary to meet a large portion of this liability. In case of involuntary termination employers make a direct payment to meet the shortfall between the accumulated severance pay funds and the statutory amount of payment prescribed by law based on final salary and service as described above.

Funding at 8.33% may be paid to an individual retirement benefit arrangement, in which case the terms of Clause 20 apply, or to a collective severance pay arrangement.

Employers may implement Clause 14 of the Severance Pay Law or "unconditional rights" in order to mitigate the liability to meet the shortfall described above.

<sup>5</sup> *except to the extent determined by individual or collective work agreements*

## Retirement Benefit Plan

It is customary, although not required by law<sup>5</sup>, for employers to contribute at the rate of 5.00% to 7.50% to a retirement benefit plan (in addition to the severance pay funding at 8.33% described above). Employees pay parallel contributions at the rate of 5.00%. Such plans typically include retirement annuity or capital sum benefit, life assurance and long term disability income benefit.

## Administration

It is customary for larger employers to appoint a principal broker to administer the employee individual retirement benefit plans. Typically the broker is remunerated through insurance commissions and, in some cases, with fixed headcount fees paid directly by the employer.

## Comment

The application of this right to accumulated balances in retirement and severance pay funds is not well defined. Employers are obliged to accede to employee requests to transfer to a new retirement plan provider, typically an insurance company, multi-employer pension fund or bank provident fund. Employers may continue to prescribe the plan administrator (typically an insurance broker).

In general there is limited clarification available pertaining to the new legislation and some questions will be answerable only after analysis of future court actions.

In the case that an employee transfers the retirement plan to a new provider, then if this also includes the transfer of future severance pay funding (paid by the company) and accumulated severance pay funds (based on deposits paid by the company in the past) this is likely to affect the future accumulation of severance pay funds due to changes in investment performance or management charge structure. Poorer returns on the severance pay funding will increase the company liability to meet the shortfall payment made by the company in case of involuntary termination. This may be mitigated as described above.

Preferential terms negotiated with a principal plan administrator (the appointed broker) will provide incentive for current and new hires to retain the standard company retirement plan. In particular, many or all of the preferential terms which may be achieved with an appointed broker expecting the bulk of the business may be unobtainable for an individual employee with an alternative provider. The new legislation prohibits any conditions to be imposed by the employer to encourage employees to utilize a particular provider and we need to seek confirmation that preferential terms provided by one broker-insurer do not contravene this requirement. In practice, if the principal provider is unsuccessful in retaining most of the employees in the main plan, then the ability to maintain preferential terms will be impaired.

An employer may not impede an employee's freedom of choice.

Penalties for noncompliance include fines of up to \$88,000<sup>6</sup> for an individual and up to \$350,000<sup>6</sup> for a corporation.

<sup>6</sup> Approximate USD equivalent

Particular difficulties might include:

- a) The principal broker may not necessarily service retirement arrangements of a particular provider selected by an employee;
- b) Current employees may choose to transfer their accumulated severance pay fund to a new arrangement with poorer returns than the standard retirement benefit plan. This will increase the company payment required to meet the shortfall mentioned above;
- c) A large number of employee transfers away from the standard plan may undermine the continuation of preferential terms attaching to a standard company plan;

## Conclusion

The new regulation transfers responsibilities regarding structure and level of retirement, life assurance and long term disability provision from the employer to the employee. Employer obligations pertaining to such benefits, if any, are in respect of contribution payments<sup>7</sup>.

The additional burden of administrating transfers to new plans at the request of an employee will normally be undertaken by the principal broker, this subject to agreement and terms.

Control of company funded individual severance pay funds is transferred to the employee and may affect future company costs to meet the shortfall described above. Employers may take steps to eliminate or mitigate this effect in respect of new hires. Effective action in respect of current hires is limited.

My comments above relating to legislation and regulation may be used as guidelines. Review by local legal council is recommended before implementation of any changes. Further, although any change in the design of the retirement plan is unlikely to affect the tax status for company or employee, final review by the payroll manager and/or tax advisor is recommended.

An early meeting between your benefits manager and/or advisor together with the principal broker in Israel would be appropriate.

## Further discussion

Please contact me.

*Maurice Brandman A.I.A., F.I.L.A.A.*

Actuary and consultant

---

<sup>7</sup> not required by law except to the extent as determined in individual or collective work agreements