

March 2012

CONCENTRATION OF INVESTMENTS AND SYSTEMIC RISKS IN
ISRAEL'S LONG-TERM SAVINGS FUNDS:
PROBLEMS AND POLICIES

A Report Prepared for the Committee on Increasing Competitiveness in the Economy

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I. INTRODUCTION AND EXECUTIVE SUMMARY

This report describes analysis that I have conducted and conclusions that I have reached with respect to the concentration of investments in business groups by Israel's long-term savings funds. Long-term savings funds include pension funds, provident funds and other funds intended for long-term savings, and these funds serve as the backbone for the country's retirement system. I will refer to these funds collectively as "LTS funds." This work was undertaken for the Committee on Increasing Competitiveness in the Economy (the "Committee") appointed by the Prime Minister of Israel, the Minister of Finance, and the Governor of the Bank of Israel.¹ I was engaged to serve as the outside expert for the Committee and to prepare a written report providing my analysis and recommendations.

Because of the broad scope of the work that I have undertaken and the opinions and recommendations that I have provided, I have divided my final report into several reports. Two reports, which provide details about my engagement, focus on two main subjects examined by the Committee: the use of pyramidal structures and the control of financial firms.² This report focuses on a third important subject to which the Committee's final recommendations refer: the concentration of investments in business groups by LTS funds.³

The subject of this report is one to which I have devoted considerable attention throughout my engagement. In my interim expert report, I stressed the importance of addressing problems of systemic risks by imposing meaningful limits on the proportion of LTS funds' portfolio of investments that can be invested in a single large business group, as well as the

¹ The members of the Committee, which was headed by the former Director General of the Ministry of Finance, Mr. Chaim Shani, include Prof. Eugene Kandel, Head of the National Economic Council in the Office of the Prime Minister; Prof. Shmuel Hauser, Chairman of the Israel Securities Authority; Dr. Karnit Flug, Assistant Governor of the Bank of Israel; Mr. David Zaken, Supervisor of Banks at the Bank of Israel; Mr. Gal HersHKovitz, Budget Director; Prof. Oded Sarig, Commissioner of Capital Markets, Insurance and Savings; Adv. Avi Licht, Deputy Attorney General; Prof. David Gilo, Antitrust Commissioner; and Dr. Gitit Gur-GershGoren, Economics Department Director in the Israel Securities Authority.

² See Lucian Bebchuk, "Control of Financial Firms in the Israeli Economy: Problems and Policies, A Report Prepared for the Committee on Enhancing Competitiveness," March 2012; Lucian Bebchuk, "Corporate Pyramids in the Israeli Economy: Problems and Policies, A Report Prepared for the Committee on Enhancing Competitiveness," March 2012.

³ I may submit later a supplementary report on measures concerning excessive leverage and bondholder protection that would be worthwhile adopting to supplement the Committee's recommendations.

proportion that can be invested in large business groups in the aggregate.⁴ Given my view on the importance of such limits, I was pleased that the Interim Committee Report recommended that the limits on such investments be examined.⁵ I subsequently prepared for the Committee proposals for tightening these limits, and this report largely draws on memoranda I submitted to the Committee on this subject. My work on this subject has benefited from data and information received from the Bank of Israel and from the Capital Markets, Insurance, and Savings Department of the Ministry of Finance (the “Capital Markets Regulator”), and I am grateful to each of these organizations and governmental units and their staffs for their assistance.

The Committee’s final report recognizes that the existing concentration of investments creates systemic risks. The Committee’s final report also expresses support for new limits proposed by the Capital Markets Regulator. These limits would prohibit LTS funds from investing more than 10% of their portfolio in a single business group, or more than 40% of their portfolio in five such groups (the “10/40 Limits”). I share the Committee’s view that the Capital Markets Regulator’s decision to impose these limits is a positive step. However, as this report explains, this step does not go far enough, and it would be desirable to adopt substantially tighter limits.

A useful benchmark for the appropriate limits can be found in the meaningful restrictions currently imposed on the ability of banks to concentrate assets in a single or a few business groups. Even using substantially higher limits than those that apply to banks would result in much lower limits than the 10/40 Limits. In particular, it would be desirable to adopt limits for LTS funds that would prohibit investment of more than 5% of their portfolio in a single non-financial group, or aggregate investments of more than 25% of their portfolio in securities of all the non-financial groups each of which represents at least 2% of the portfolio. In order to address transition issues and concerns about disorderly short-term adjustments, the rules should provide for a significant transition period (e.g., four years), during which time those LTS funds that were not in compliance with the adopted limits would not be required to dispose of securities held, but would be prohibited from buying additional securities that would increase the extent to which the LTS fund did not comply with the adopted limits.

Because this report focuses on the limits that should be imposed on non-financial groups, I do not discuss the appropriate limits on the ability of LTS funds to allocate monies to financial

⁴ The interim expert report that I submitted to the Committee on October 9, 2011 was attached as an appendix to the Interim Committee Report, available at <http://mof.gov.il/Lists/CompetitivenessCommittee/Attachments/36/2011-1111.pdf>. My interim expert report is also available at <http://www.law.harvard.edu/faculty/bebchuk>.

⁵ See Interim Committee Report, p. 11, recommendation 14.

groups (or to other types of investments). Because financial groups are heavily regulated and closely supervised, investing in financial groups has thus far involved lower risks. In any event, the question of appropriate limits on the allocation of monies to such groups poses different issues that should be considered separately.⁶

The analysis presented in this report proceeds as follows:

- Part II of the report discusses why LTS funds deserve close attention from Israeli policymakers and considers the concerns regarding investor protection and financial stability that should guide policymaking;
- Part III explains why both current regulations and the proposed 10/40 Limits do not adequately address these concerns;
- Part IV discusses the specification of desirable limits on investments by LTS funds;
- Part V considers appropriate transition arrangements that should accompany the adoption of desirable limits in order to avoid disorderly adjustment by LTS funds;
- Part VI considers potential costs of, and objections to, the proposed arrangements; and
- Part VIII concludes.

II. POLICY CONCERNS AND OBJECTIVES

The risks taken by LTS funds deserve special attention from Israeli policymakers for several reasons. First, the aggregate value of assets managed by LTS funds is substantial, and represents a substantial proportion of Israeli financial assets. Because LTS funds represent such a substantial proportion of Israeli financial assets, significant shocks to the value of their investments have significant consequences for financial stability and the state of the economy.⁷

Second, the nature of the beneficial investors in LTS funds – a large number of small investors, many of whom are unsophisticated and dependent on their investment in LTS funds to fund their retirement – make it important for policymakers to protect these investors.

⁶ Similarly, in this report I do not consider the appropriate constraints on the proportion of each LTS fund's portfolio that may be invested in individual non-financial firms; current regulations (as well as the Capital Markets Regulator's proposal) set such limits at half of the level specified for proportion of the portfolio invested in non-financial groups.

⁷ See "Report of the Committee for Determining Parameters for Reference by Institutional Investors Providing Credit by Means of Acquiring non-Government Bonds, February 2010 (hereinafter, the "Hodek Committee Report")," p. 7 (stating that the fact that the public's long-term savings represent one-third of the financial assets of Israel's citizens, which provides a basis for applying standards that are not necessarily identical to those applied to other asset management activities).

Third, government policies provide a significant tax subsidy to LTS funds, and this subsidy is partly responsible for the significant flow of investments to these funds. This tax subsidy also makes governmental regulation of the risks undertaken by LTS funds especially appropriate.

Fourth, the nature of LTS funds implies that a substantial decline in the value of their investments may put pressure on the government to provide a “safety net” to protect the beneficial investors in the LTS funds. The possibility of such governmental support gives the government a further reason to be concerned about risks incurred by LTS funds.

The focus of this report is on the risks that arise from the concentration of investments by LTS funds in one or more Israeli non-financial groups. Data that I have received from the Bank of Israel, and the analysis by the Bank of Israel attached as Appendix 4.2 to the Committee Interim Report, indicates that LTS funds invest a significant proportion of their portfolios in Israeli non-financial groups. This increases the importance of ensuring that LTS funds do not produce risks that are excessive either from the perspective of the LTS funds’ beneficiaries or from the perspective of financial stability.

These concerns are strengthened by the conclusions of the Hodek Committee. The Committee concluded that institutional investors had not performed adequately in terms of pricing risks and bringing about effective contractual design of corporate bonds, and that debt securities had frequently been issued in the Israeli capital markets with a “covenant-lite” design of “inferior quality” that lacked standard protections of bondholder interests.⁸ Such inferior contractual design can result in elevated risks for the holders of debt securities. For example, investors in many of the debt securities issued in the Israeli capital markets receive little protection from the possibility that the value of the equity cushion on which such investors rely will be eroded by a firm making large dividend payments or pledging the firm’s assets as collateral to new debtholders.

Moreover, the flaws in contractual design identified by the Hodek Committee not only make the bonds of each issuing company more risky, but also increase the correlation among the risks posed by bonds issued by different firms within the same business group. In the absence of effective limitations on dividends, controllers that need liquidity at the top level of a pyramidal group can be expected to increase the extraction of dividends upwards in the pyramid from the full range of lower-level companies in the pyramid. This prospect increases the correlation among the returns from the bonds of such lower-level companies, even when such lower-level companies operate in different sectors of the economy.

⁸ See Hodek Committee report, *supra* note 7, pp. 8-9, 20-29.

The above discussion suggests that limits on the concentration of investments in large non-financial groups would be desirable even if policymakers focused solely on the optimal level of diversification for each LTS fund (ignoring the existence of other LTS funds). However, the existence of others LTS funds, and their common tendency to invest in the same large non-financial groups, raises systemic risk considerations that strengthen the need for limits on such investments. The prospect that all or most LTS funds might suffer significant losses due to the failure or financial distress of a large business group, and that they might do so at the same time that such failure or distress was itself imposing costly disruptions in the economy, raises significant concerns regarding financial stability. No individual LTS fund has an incentive to take into account the effect of the correlation of its investments in non-financial groups with the investments of other LTS funds, and with other factors in the economy. For this reason, the optimal limit on each LTS fund's investment in large business groups is likely to be lower than may be optimal if the portfolio of such a LTS fund was considered in isolation from that of other LTS funds.

Finally, it is important to emphasize the wide range of investment choices that are available to LTS funds, which make it unnecessary for LTS funds to allocate a significant proportion of their assets to investments in a small number of large non-financial groups. LTS funds are not expected to operate like hedge funds or private equity funds, which make substantial bets on a small number of concentrated investments. Rather, given that they aggregate the retirement savings of a large number of individuals, LTS funds are expected to diversify among asset classes and among the many possible investments within each asset class.

It is important to keep in mind throughout the discussion below that Israel's LTS funds can invest not only in Israel's largest non-financial groups, but also a vast array of other investments, including (i) securities of numerous other non-financial firms trading on the TASE; (ii) securities of many financial firms trading on the TASE; (iii) securities of the huge number of financial and non-financial firms trading on other exchanges around the world; (iv) government bonds of Israel and other countries; (v) loans issues to, and deposits in, banks; (vi) private equity funds, hedge funds and venture capital funds; and (vi) real estate, or loans secured by real estate. In short, there are many options other than those of Israel's largest non-financial groups among which LTS funds can allocate their funds.

III. INADEQUACY OF EXISTING AND PROPOSED REGULATIONS

In the past, LTS funds have not faced any meaningful constraints on their ability to concentrate their investments in a small number of large non-financial groups. Although LTS funds have been limited to investing no more than 15% of their funds in a single business group, my understanding is that this threshold is considerably in excess of the investment by any LTS

funds in a single business group, and is therefore practically irrelevant. To illustrate the practical irrelevance of this constraint, note that this constraint would allow an LTS fund to invest 100% of its portfolio in seven business groups.

The 10/40 Limits proposed by the Capital Markets Regulator constitute a step in the right direction, and the Regulator's willingness to move in this direction is most welcome. In my view, however, even after a move to the 10/40 Limits, constraints on investment concentration would be far more lenient than is desirable.

To begin, the 10/40 Limits do not seem to be based on a conclusion that the 10/40 Limits represent optimal limits. Rather, the 10/40 Limits appear to be driven by a desire to lower the current thresholds to levels that would still be above the current investment levels of LTS funds, and therefore not require LTS funds to sell holdings. As a result, the 10/40 Limits cannot address problems with the current concentration of investments, but could at most seek to prevent these problems from worsening in the future.

Furthermore, the 10/40 Limits would permit LTS funds to invest an unnecessarily large proportion of their portfolios in large Israeli non-financial groups. There is no reason for an LTS fund to invest 40% of its portfolio in only five Israeli non-financial groups. Recall that the vast array of investments available LTS funds includes (i) securities of numerous other non-financial firms trading on the TASE; (ii) securities of many financial firms trading on the TASE; (iii) securities of the huge number of financial and non-financial firms trading on other exchanges around the world; (iv) government bonds of Israel and other countries; (v) loans issues to, and deposits in, banks; (vi) private equity funds, hedge funds and venture capital funds; and (vi) real estate, or loans secured by real estate. In short, there are many options other than those of Israel's largest non-financial groups among which LTS funds can allocate their funds. With such a vast array of available investments, there is hardly a shortage of options that could justify allocating up to 40% of the portfolio to five business groups.

The reluctance of the Capital Markets Regulator to lower limits on investment concentration to levels similar to those advocated in this report appears to be partly motivated by concerns that adopting such limits would require a number of LTS funds to adjust their investment levels and could thereby lead to disorderly selling. However, to the extent that any LTS funds currently hold more than 5% of their portfolio in a single non-financial group, or more than 25% of their portfolio in a number of large Israeli business groups, such concentration should be viewed as a source of concern, rather than an acceptable state of affairs that should be accommodated by setting limits that are comfortably above current investment levels. Furthermore, even if it were desirable to avoid forcing LTS funds to sell securities in the current circumstances, this should not lead to limits that are higher than optimal; at most, it would

suggest supplementing such limits with transition arrangements, such as those proposed below, that are designed to avoid forcing LTS funds to sell investments during a specified period. In short, concerns about transition issues should not interfere with or even delay the setting of optimal limits on investment concentration.

The reluctance of the Capital Markets Regulator to adopt optimal limits on investments also appears to be based on a concern that strict limits may have unintended consequences in terms of limiting LTS funds' investments in banks. However, as noted earlier, the limits imposed on investments in non-financial groups need not be identical to those set for investments in financial groups. As a result, a desire to avoid limiting investments in Israeli banks by LTS funds should not determine the choice of limits on investments in non-financial groups by LTS funds.

The reluctance of the Capital Markets Regulator to adopt meaningful limits appears to also be motivated in part by expectations that the Committee's recommendations would require some existing corporate pyramids to reorganize their structures, and that such reorganization could be facilitated by the availability of funding from LTS funds. In my view, the limits on pyramidal levels recommended by the Committee are a consideration that weighs in favor of (rather than against) the immediate adoption of meaningful limits on the concentration of investments by LTS funds. Such limits would not impede sales of companies in pyramidal structures to buyers that are not part of Israel's largest non-financial groups. To be sure, such limits may make it more difficult for controllers of existing pyramids to retain control of companies in lower pyramidal levels by using debt financing to buy out public equity investors. However, such a shift from equity finance to debt finance would create highly leveraged structures, and would be an undesirable outcome of the recommended limits on pyramidal levels.

Finally, one aspect of the Capital Markets Regulator's existing regulations exacerbates concerns regarding the 10/40 Limits. After the Hodek Committee issued its report, the Capital Markets Regulator adopted regulations that sought to prevent LTS funds from purchasing any debt securities issued pursuant to a prospectus that suffered from the shortcomings in contractual design that the Hodek Committee identified. However, the Capital Markets Regulator did not limit the ability of LTS funds to purchase similar bonds that either had been issued before the rules came into effect, or that are issued as part of an existing series based on a prospectus issued before the rules came into effect. The distinction made by these regulations is thus not based on the nature and risks posed by the bonds, but on the date when the prospectus was issued. The rules implemented by the Hodek Committee therefore do not prevent LTS funds from investing in bonds whose contractual design the Hodek Committee identified as creating undesirable risk. In assessing the 10/40 Limits, policymakers should take into account the substantial discretion that LTS funds have to purchase risky bonds with problematic terms issues by the business groups in which they invest a significant proportion of their portfolio.

IV. SETTING MEANINGFUL LIMITS

To limit the impact of the problems identified above, it is desirable to place meaningful constraints on the extent to which LTS funds may invest in any large Israeli non-financial groups, as well as in such non-financial groups in the aggregate. As with many other cases of financial regulation, "the devil is in the details:" in this case, an important question is the specification of appropriate numerical limits on investments in non-financial groups.

A useful benchmark that can be used by Israeli policymakers in considering appropriate numerical limits is found in the constraints that the Banking Regulator imposes on concentration of banks' funds in one or more business groups. Under the regulations imposed by the Banking Regulator, a bank may lend up to 25% of their "Tier 1 and Tier 2" capital to a single business group and may lend up to 120% of their Tier 1 and Tier 2 capital to "large borrower groups," which are defined as those groups to which the bank lends more than 10% of its Tier 1+2 capital. As of the end of 2010, the average ratio of Tier 1+2 capital to total assets in the five main Israeli banks was 10.7%. Given this ratio, the regulations imposed by the Banking Regulator imply that, on average, a bank may invest 2.675% of its total assets in a single business groups, or 12.84% of its total assets in all large groups (i.e., those groups receiving loans valued at more than 1.07% of the bank's total assets). If limits for LTS funds limits were set similarly to the limits that apply to banks (appropriately rounded), then LTS funds would be limited to investing no more than 2.5%–3% of their portfolio in a single non-financial group, and no more than 12.5%–15% of their portfolio in all non-financial groups in which the LTS funds invests more than 1% of the portfolio.

Indeed, there is a reasonable basis for holding a view that the optimal limits on investments in business groups may be lower for LTS funds than for banks. In particular, the "business model" of a bank relies on the bank closely monitoring its large borrowers, including through use of private information about such borrowers. Given that banks engage in intensive monitoring and interacting with large borrowers, when a borrower requires additional funds, there may be efficiency gains when those funds are lent by a bank that has an existing relationship with the borrower, rather than by another bank. In contrast, the "business model" of an LTS fund does not include obtaining private information about companies in which the LTS fund invests, close monitoring of such companies, or active engagement with them. Accordingly, requiring LTS funds to further diversify their investments would not involve forgoing benefits from monitoring and engagement of the kind undertaken by banks.⁹

⁹ For a discussion of the differences between the business models of banks and LTS funds noted in this paragraph, see the Hodek Committee Report, *supra* note 7, pp. 72-74.

As a result, it would be desirable for Israeli policymakers to adopt limits on investments by LTS funds in business groups that do not substantially exceed the limits to which banks are now subject. A conservative approach would be to adopt initial limits that are roughly twice the limits currently applicable to banks. Thus, it would be desirable for Israeli policymakers to set limits that would, at a minimum, prohibit LTS funds from investing more than 5% of their portfolios in the securities of any single non-financial group, and prohibit LTS funds from investing more than 25% of their portfolios (in aggregate) in non-financial groups in which the LTS fund has invested more than 2% of their portfolio. The adoption of such limits (unlike the 10/40 Limits) could, over time, address the concerns generated by the existing concentration of investments in Israeli business groups by LTS funds.

V. TRANSITION

If the above limits were adopted without any transition arrangements for LTS funds that did not currently comply with the requirements, the new limits would require such funds to sell securities immediately. To allow for an orderly transition to these requirements, appropriate transition arrangements should be adopted.

In particular, the requirements should provide for a significant period (e.g., four years) during which time any LTS fund not complying with the limits would not be required to dispose of securities, but would be prohibited from purchasing additional securities that would increase the extent of the LTS fund's noncompliance. This arrangement would allow for an orderly transition during the substantial period when LTS funds would not be forced to sell investments. However, during this period, LTS funds would still be expected to move gradually toward the specified limits, as bonds in which the LTS funds have invested come to maturity. Because a large proportion of outstanding corporate bonds will mature over the next several years, this transition arrangement is likely to move LTS funds significantly closer to compliance with the specified limits even during the transition period.

Note also that the suggested approach would not limit the ability of affected non-financial groups to raise funds from sources other than LTS funds. Non-financial groups could raise funds from abroad, or from Israeli capital sources other than LTS funds (e.g., from banks, mutual funds and alternative investment funds). I now turn to the question of whether requiring non-financial firms to raise funds from these sources would impose any undesirable costs.

VI. POTENTIAL COSTS AND OBJECTIONS

A. Loss of Efficient Investment Opportunities for the Israeli Economy?

Are rules that may prevent LTS funds from making additional investments in large business groups likely to result in significant costs to the Israeli economy from the preclusion of potentially efficient investment opportunities? This is not a concern that should be given significant weight, for three reasons.

First, even assuming that certain opportunities for investments in the Israeli economy are uniquely available to large business groups, to the extent that such opportunities are efficient, the business group could fund such investments from sources other than LTS funds. Relative to smaller Israeli firms, Israel's large business groups have scale, expertise, and international presence that allows them to access foreign capital markets. As a result, if a large business group has a unique, efficient investment opportunity for which it would not be able to obtain financing from LTS funds due to the proposed limitation, it can be expected to raise finance for such an investment opportunity from abroad. Of course, foreign capital might be more demanding than a LTS fund in terms of the contractual protections it requires, which might make it less attractive for the business group to finance a given project. However, if a business group would pursue an investment opportunity only if the investment could be fully financed with capital from Israeli LTS funds that do not insist on adequate protections, and not if the business group would have to raise finance from more demanding foreign capital sources, it is not clear that an investment in this opportunity would be socially efficient.

Second, many of the business opportunities for investments in the Israeli economy that large business groups have been pursuing are not investments that are uniquely available to large business groups. Some such investments have been pursued by large business groups not because those investments arose inside such groups, but because the flow of institutional money to large groups provided such groups with an advantage over other Israeli firms in pursuing outside opportunities. Therefore, to the extent that greater limits are placed on the flow of monies from LTS funds to large business groups, these opportunities may well be taken up by other firms within the Israeli economy.

Third, a significant proportion of the investments made by Israel's large business groups in recent years has been in opportunities abroad (including, for example, investments in foreign real estate, financial institutions and petroleum distribution chains). Placing limits on the flow of Israeli retirement monies to finance foreign investments by large business groups would not reduce the social benefit from investment in the Israeli economy. Furthermore, it is far from clear that such limits would impose material cost on the ability of LTS funds to diversify their

investments internationally. Should such funds wish to obtain exposure to the returns from investments in (for example) real estate, financial institutions or petroleum distribution chains abroad, there are many alternative ways to obtain such exposure other than through the intermediation of Israel's large business groups.

B. Lost Opportunities for LTS Funds' Investors?

I now turn to consider the claim that the suggested limitations would disadvantage the beneficial investors in LTS funds by denying such investors opportunities to make additional investments in Israel's large business groups that would benefit such investors. There is little reason to assume that such additional investments offer above-average returns that would materially improve the returns of LTS funds. The large business group should not be expected to offer the LTS funds any better terms than the market terms on which the large business group could obtain capital from other sources.

To attach weight to the concern that the suggested limitations would deprive LTS funds of the opportunity to benefit from above-average returns, it is necessary to assume that investments in large business groups offer such opportunities for above-average returns that LTS funds are able to identify, but which foreign investors fail to appreciate. Given the concerns expressed by the Hodek Committee regarding the pricing of risks by Israeli institutional investors, Israeli authorities should not proceed on the basis of this assumption.

If the suggested limitations are implemented, where will LTS funds invest monies they can no longer invest in large business groups? There is little cause for concern that, if the proposed limitations on investments in large business groups are implemented, LTS funds will have insufficient opportunities for investment. LTS funds would still have available to them a vast array of investments choices. It is possible, for example, that the limitations may lead LTS funds to greater investment in Israeli non-financial firms that are not part of the largest non-financial groups, or to larger investment abroad. These outcomes should not be viewed as undesirable.

C. Undesirable Difficulties in Rolling Over Debts?

Another potential concern relates to the transition period, and especially the potential problems from starting this process during a period when some large business groups may already face financing difficulties. In particular, such concerns may suggest that, absent unrestricted funding from LTS funds, some business groups may have difficulty rolling over existing debt, and, as a result, existing public bondholders (including LTS funds) may suffer losses. As explained below, however, even if large business groups may have some difficulties

rolling over debt, such difficulties do not provide a sound reason not to implement the suggested restrictions.

Consider a business group that has a debt to LTS funds that is due in 2013 and that, in the absence of the limitation, could be expected to roll over such debt by repaying the LTS funds using monies obtained by issuing a new series of bonds to the LTS funds. Assume further that, if the suggested limitations are implemented, the business group will no longer be able to obtain monies by issuing new debt to the LTS funds, and will be forced to obtain other financing. In one possible scenario, the business group would be successful in obtaining outside financing, and the bonds of the LTS funds will be fully repaid. But what if the business group is unable to obtain such financing, and as a result the LTS funds face the possibility of not being fully repaid? In this scenario, would it be desirable for the debt to be rolled over by the business group issuing new bonds to the LTS funds and repaying the existing bonds?

In actual fact, such an outcome would likely not serve the interests of LTS funds' beneficial investors. If the business group is unable to obtain rollover financing from outside sources, this may reflect an assessment by outside sources that the value of the business group's assets is lower than the amount of the debt that needs to be refinanced. In such a case, the LTS funds may be better off facing this difficult reality immediately, assuming control of the business group, and obtaining whatever value currently exists in the business group, rather than rolling over the debt and giving shareholders a "free option" at the LTS funds' expense. When the only way to roll over debt owed to LTS funds is by issuing new debt to the LTS funds, such a rollover would likely make LTS funds' investors worse off.

VII. CONCLUSION

The ability of LTS funds to concentrate investments in a small number of Israeli non-financial groups raises serious concerns. Neither the regulations that are currently in place nor the 10/40 Limits proposed by the Capital Markets Regulator adequately address these concerns. It would be desirable to impose meaningful limitations along the lines suggested in this report. Such limitations, if adopted with the proposed transition arrangements, would contribute both to financial stability and to the protection of investors in LTS funds.