



# Part III

## Promoting savings

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# Savings in transition

Economic growth requires rising stocks of productive inputs, encompassing all physical assets, personal skills and knowledge (human capital) together with effective use of these assets. Net investment augments domestic physical assets, while expenditures on education and training develop human capital. While the 1995 *Transition Report* focused on the determinants of fixed investment in the transition, this chapter focuses on domestic savings because of their dominant role in financing physical capital formation. Human capital formation is a vast and vital subject requiring separate treatment.<sup>1</sup> While access to foreign savings can ease the constraint of domestic savings on investment and growth, historically sustained high rates of investment and growth have not been achieved without strong domestic savings.<sup>2</sup> This relationship holds for the financially open industrial and rapidly growing developing countries.

Since domestic investment has been and will continue to be financed mainly from domestic savings in transition economies, sustained high rates of growth require high levels of domestic savings. This surplus needs to be channelled into the most productive investment opportunities. The experiences of the formerly centrally planned economies demonstrate the importance of both the effective intermediation of savings into investment and the selection of those projects with the highest returns. Despite East Asian levels of investment and educational attainment, growth in the planned economies faltered with the returns to investment declining to very low levels in the 1970s and 1980s.<sup>3</sup> In the transition, the productivity of investment appears to have improved somewhat, but aggregate domestic saving and investment rates have fallen sharply. The re-establishment, maintenance and enhancement of economic growth in the transition period will require substantially increased domestic savings, still more effective intermediation of domestic and foreign savings and productive investment.

The rapidly growing East Asian economies demonstrate that high domestic saving and investment rates can help fuel growth. The importance of savings to growth is further reinforced by more systematic evidence on market economies, both industrialised and developing. High-growth economies usually have high rates of saving. In principle, there can be two-way causality between savings and growth (from savings to growth *and* from growth to savings), and both savings and growth can be influenced by further factors, such as the nature of the political system, social and

cultural norms or international technology transfers.<sup>4</sup> A recent study of household savings suggests that higher growth will produce only small increases in aggregate saving rates.<sup>5</sup> This result is consistent with the view that the positive correlation between aggregate savings and economic growth should be attributed primarily to a positive causal effect of savings on growth.

Most transition economies have witnessed a sharp decline in domestic saving rates. This decline has been accompanied by a dramatic shift in the composition of savings towards households and away from enterprises and the general government. This chapter examines factors behind both the decline in aggregate savings and the shift in their composition, as well as the interaction between these two developments. In addition, because of the dominant role of households in wealth accumulation in a market economy and their growing importance in transition economies, the chapter considers the main determinants of household savings and identifies policies which could support greater household wealth accumulation.

The decline in aggregate savings is in large part an outcome of the transition process itself, which eliminated the mechanisms for the accumulation of savings in command economies. The price liberalisation and deep recessions that followed the abandonment of central planning reduced enterprise profitability and thereby enterprise savings. Government savings have also decreased in most transition economies, for both cyclical and structural reasons. This fall reflected a combination of reduced revenues, with a recession-induced decline in the main tax bases and a worsening of tax administration, and of increased expenditure on social security payments and interest on the public debt. Household saving rates rose from their typically very low levels under central planning but not by enough to offset the collapse of enterprise savings and the reduced savings (or increased dissaving) by governments. This chapter examines a number of factors which help to explain why household savings did not offset these declines more fully.

It is expected that domestic savings will strengthen with progress in transition and there is already some indication of this tendency. Improving enterprise profitability is boosting enterprise savings. Economic recovery and fiscal stabilisation measures are reducing government budget deficits and increasing public savings (reducing public dissavings) but this may be fragile. Household savings too can be expected to increase as current income continues to recover.

<sup>1</sup> See Laporte and Schweitzer (1994) and World Bank (1996), Chapter 8.

<sup>2</sup> See Feldstein and Horioka (1980), Deaton (1989) and World Bank (1993).

<sup>3</sup> See Bergson (1987), Ofer (1987) and Easterly and Fischer (1994).

<sup>4</sup> The empirical relationship between GDP growth and savings has been extensively researched. Recent studies by Masson et al. (1996) and Ogaki et al. (1996) have found a direct positive association between GDP growth and private savings. Aghevli et al. (1990) estimated that a once-and-for-all increase of 10 percentage points in the saving rate would raise the average growth rate of real per capita GNP by 1.2 percentage points a year.

<sup>5</sup> See Paxson (1996).



Several measures could be undertaken to reinforce the tendency towards greater household savings and to improve the efficiency of the allocation of household savings. Moving (gradually and probably only part of the way) from the existing pay-as-you-go or unfunded social security retirement schemes towards a fully funded system with individual accounts is one set of reforms under active consideration in a number of countries. Privatising some of the hitherto collectively insured income risks (health, disability and unemployment) may stimulate precautionary savings. The benefits from a higher domestic saving rate and any other efficiency gains would of course have to be weighed against possible adverse distributional consequences of such policies. The measures required to improve the allocation of savings and the quality of intermediation are familiar but sufficiently important to bear restating: improving the asset menu available to households (see Chapter 7), enhancing the supervision and regulation of the financial sector, ending any remaining financial repression, and abandoning institutions, policies, regulations and practices that artificially depress real interest rates. Large-scale financial instability in the banking sectors of many transition economies undermines the financial intermediation process as a whole. Restoring financial stability thus becomes a precondition for improved private savings performance.

### 6.1 Savings under central planning

The centrally planned economies had very high saving and gross investment rates, indeed significantly higher than in the industrialised market economies. The desire of the political leadership of planned economies to “catch up” with industrial and market economy levels of economic activity, and the system of economic planning produced policies based on the belief that centrally specified growth rates could be achieved by forced savings and directed capital accumulation.<sup>6</sup> This relentless drive for expansion and hunger for investment was reflected in very high rates of saving and investment, with savings being much the passive partner in the savings-investment duo. In other words, investment rates were specified and savings adapted to them by diktat.

The growth record associated with extensive capital accumulation was disappointing throughout the planning period, however. Even when output growth was high, during the early decades of central planning, factor productivity and changes in it were poor. Growth reflected mainly increased inputs of physical capital, labour and natural resources. Moreover, returns to investment went into steep decline between the 1950s and the 1980s. In this period the share of gross investment in GNP doubled from 15 to 30 per cent, as planners attempted to boost fading growth rates. However, the return to investment fell sharply, as did the growth rate of output. Poor efficiency in distribution under central planning was prob-

ably chiefly responsible. The diminishing returns to investment may have also been exacerbated by the lack of technical progress in the absence of competition and by the bias of the planners in favour of capital goods that were poor substitutes for labour, thereby exacerbating rather than mitigating the growing relative shortage of labour.<sup>7</sup>

Another striking feature of savings in centrally planned economies (particularly before their partial reform in the 1970s and 1980s) was that enterprise savings were relatively high and household savings low compared with those in market economies.<sup>8</sup> In as much as official statistics were meaningful, they suggested that the general government sector tended to be in fiscal balance, except towards the end of central planning. Planners set input and output prices so that enterprises in aggregate earned substantial surpluses, which were then reallocated to fund planned investment through a complex and often highly discretionary system of taxes and transfers. There was little incentive for households to save, since employment was virtually guaranteed and the state provided social security benefits which eliminated the need to save for a “rainy day” or for retirement and there was little access to durable consumer goods, the purchase of which would have required accumulated savings. There was also only a limited range of financial instruments which households could use to accumulate wealth, primarily domestic (and foreign) currency and deposits in state savings banks.

Since households had little incentive or ability to save, the savings which they did accumulate have been described as involuntary or “forced” due to the unavailability of many types of consumption goods. In practice this was true in the sense that consumption was controlled.<sup>9</sup> However, increased trade and financial links with industrial economies during the 1980s raised household consumption aspirations and made it increasingly difficult for planners to postpone consumption, and aggregate savings and investment ratios began to taper off in the second half of the decade. Planners also recognised that high rates of investment were not producing the expected results in terms of economic performance.<sup>10</sup> At the beginning of transition, past forced savings were reflected in a monetary overhang in the hands of households. Most of this overhang was eliminated by the initial jump in the price level and the subsequent high rates of inflation accompanying price liberalisation.

### 6.2 Aggregate savings performance

Gross saving rates in transition economies were around 30 per cent of GDP at the start of transition in the late 1980s and early 1990s. This rate was above the world average, above the average saving rate achieved by the industrialised market economies and above that achieved by the developing countries as a group.

<sup>6</sup> Kornai (1992) refers to the tendency of central planners to see a virtual one-for-one relationship between an increase in fixed capital investment and economic growth.

<sup>7</sup> See Weltzman (1970) and Easterly and Fischer (1994).

<sup>8</sup> Household savings in Hungary, for example, averaged less than 5 per cent of GDP during 1985-89, compared with industrialised market economies in which saving rates were typically above 10 per cent of GDP over the same period.

<sup>9</sup> See, for example, Conway (1995) and Temprano (1995). However, the non-availability of consumer goods (say because of rationing) will not lead to forced saving if the following two conditions are satisfied: (1) the non-availability is expected to be permanent and (2) work is voluntary. If consumer goods are not available today and are not expected to be available in the future either, households would reduce work effort rather than building up useless financial wealth. The saving arose under central planning partly because there generally was some positive probability of being able to acquire consumer goods in the future and because attendance at work was effectively compulsory (although effort was open to choice).

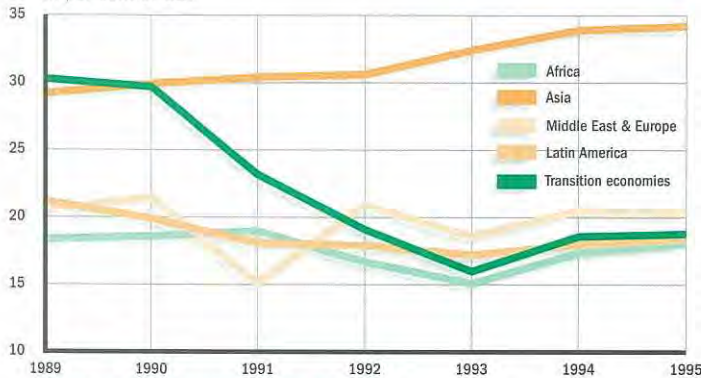
<sup>10</sup> See Ickes (1993).



Chart 6.1

Domestic savings in transition and developing economies, by region

In per cent of GDP

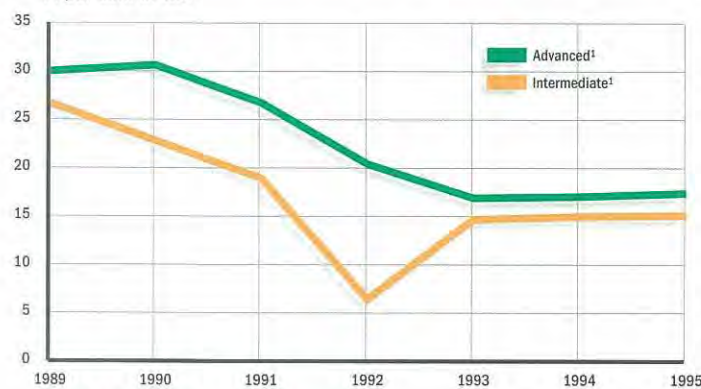


Source: IMF World Economic Outlook, May 1996.

Chart 6.2

Domestic savings by countries' stages of transition

In per cent of GDP



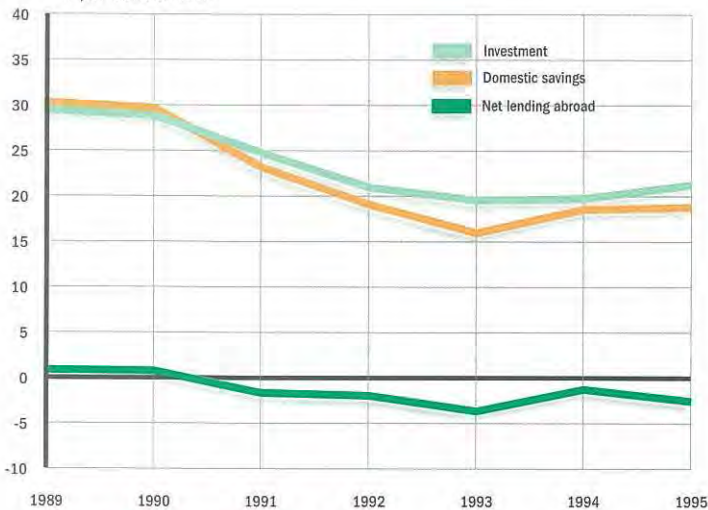
Source: IMF World Economic Outlook database.

<sup>1</sup> Average of countries, grouped by stages of transition, for which data are available.

Chart 6.3

Savings and investment in transition economies

In per cent of GDP



Source: IMF World Economic Outlook, May 1996.

Indeed it was comparable, as Chart 6.1 shows, to the gross saving rate achieved in recent years by fast-growing Asian economies, although it reflected centrally planned investment rather than decentralised savings decisions.

In the initial stages of transition, however, the gross domestic saving rate began to decline, falling – at first gradually to 29 per cent of GDP in 1990 but then declining sharply to just 18 per cent in 1995. Savings in transition involved the shift from centralised investment to decentralised savings as the economic system moved from central planning to market principles. The current saving rate for transition economies is lower than the average world saving rate of 23 per cent of GDP and compares unfavourably with the fast-growing developing countries in the Asia region which by 1995 had raised their saving rate to 35 per cent.

Chart 6.2 depicts the trend in savings by countries at different stages of transition, where a country's stage of transition is measured by the EBRD's transition indicators presented in Chapter 2.<sup>11</sup> It shows that saving rates have declined in all transition economies but, having reached a low during 1992-93, saving ratios are recovering in those countries at advanced and intermediate stages of transition.

It is a major concern that the saving ratio has declined so dramatically in nearly all of the transition economies. The inherited capital stock is of poor quality and not well-oriented to the needs of the market economy (see Chapter 3). There is a continuing need, therefore, for high levels of domestic savings to finance investment in the transition. With more efficient financial intermediation and a better selection of investment projects, there may not be a need for pre-transition saving rates in order to support reasonable growth rates, especially if enhanced creditworthiness permits greater access to foreign saving. However, saving rates of around 23 per cent (the world average) would provide better growth prospects than the 18 per cent rates actually generated in 1995. Unless there are significant capital inflows, the steep decline in the savings share of GDP will have negative consequences for investment. Chart 6.3 shows the very close correlation between domestic savings and investment in transition economies. This feature can be expected to persist throughout the transition and beyond, although the more successful transition economies can expect to gain increased access to international financial markets.<sup>12</sup>

6.3 Composition of domestic savings during the transition

The decline in the aggregate domestic saving rate is due mainly to reduced savings in the enterprise sector and, to a lesser extent, to a reduction in government savings. The share of household savings as a fraction of household disposable income has been rising, but not by enough to offset fully the declines in the other sectors.

<sup>11</sup> See Chapter 2 for a discussion of measuring stages of transition and the classification of countries. Those countries at advanced stages of transition are Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. Those at intermediate stages of transition are Albania, Armenia, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Georgia, Kazakhstan, Kyrgyzstan, Romania, the Russian Federation, Ukraine and Uzbekistan. Those at early stages of transition are Azerbaijan, Belarus, Tajikistan and Turkmenistan.

<sup>12</sup> See Chapter 8.



### Government savings

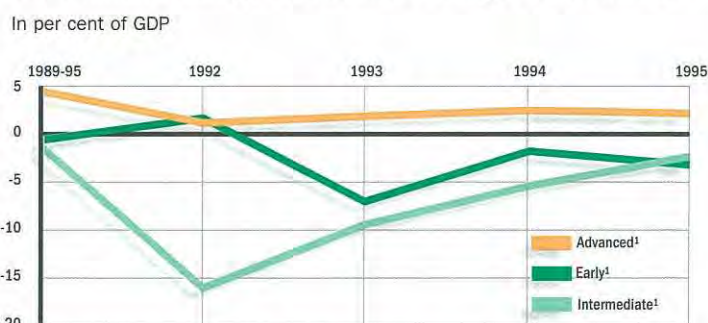
Government savings (the excess of current government revenue over public consumption expenditure) are measured by adding the government budget balance to the capital investment undertaken by the government. The transition economies have been characterised by large government deficits at the initial stages of transition, which have recently begun to decline, particularly in countries at more advanced stages of transition, as fiscal discipline has been imposed and maintained. Nevertheless, in 1995 governments of nearly all of the transition economies ran budget deficits which ranged between 2 and 6 per cent of GDP. In general, countries at an early stage of transition are experiencing higher government and financial deficits, partly the consequence of the large losses which enterprises experienced in the sharp output declines, and drops in revenue, while initially public spending remains high. Deficits in countries at more advanced stages of transition are lower.<sup>13</sup>

Government capital expenditures have fallen sharply since the start of transition. Part of this decline reflects the elimination of capital transfers from governments to enterprises for funding fixed investment, with the decentralisation of both investment and financing decisions. However, rationalisation of general government fixed investment was also required, given the distorted priorities for infrastructure and other types of investment under central planning.<sup>14</sup> That being said, government investment has declined in countries at all stages of transition, falling to 4 per cent of GDP in countries at advanced stages of transition and to 2-3 per cent of GDP in countries at early and intermediate stages.

The data on the general government deficit and public investment point to a significant reduction in government savings by those countries at advanced stages of transition and a swing from savings to dissavings by governments of countries at the intermediate and early stages of transition (see Chart 6.4). In 1995 average government savings were 2 per cent of GDP for countries at advanced stages of transition and around minus 2 per cent for countries at intermediate and early stages of transition.

Chart 6.4

### Government savings by countries' stages of transition



Source: IMF and IMF World Economic Outlook, May 1996.

<sup>1</sup> Average of countries, grouped by stages of transition, for which data are available.

### Enterprise savings

While relatively detailed information is available on government savings in the transition economies, there are much less extensive data on the savings of enterprises. The trend in enterprise savings in the transition is pieced together, therefore, from our knowledge of enterprise savings under central planning and of developments during the transition.

Under central planning, enterprises accumulated a significant share of domestic savings and served as the main base for taxation, including turnover taxes and a form of profits tax.<sup>15</sup> It is not surprising that enterprise profitability weakened initially in the transition, given severe recession, the large swings in relative prices, the opening to external competition and the emergence of domestic competition. However, reported enterprise profits were often distorted early in the transition by high inflation, and in particular by the accounting treatment of inventories and the depreciation of physical assets.<sup>16</sup> Reported profitability of enterprises should be considered, therefore, along with indicators of their internal cash flows, to provide an additional indicator of operating profits. Table 6.1 shows survey data on the profitability and cash flows of large enterprises in five countries in the region

Table 6.1

### Profitability and cash flows of large firms, weighted by employment, during transition

	Year	Profitable In per cent of total	Positive cash flow	Cannot service all debt	Cannot pay all wages	Cannot pay all suppliers	Total (%)
Bulgaria	1992	20	2	35	32	10	100
	1994	34	9	30	23	5	100
Czech Republic	1992	60	13	7	13	7	100
	1994	81	11	4	3	1	100
Hungary	1992	59	6	15	14	6	100
	1994	68	12	8	11	2	100
Poland	1992	32	19	20	13	16	100
	1994	51	14	6	21	8	100
Slovak Republic	1992	61	17	7	9	6	100
	1993	71	15	3	9	2	100
United Kingdom	1993	93	5	1	1	—	100

Source: Pohl et al. (1996).

<sup>13</sup> See Chapter 4 for a more detailed discussion of fiscal balances and government investment in the transition.

<sup>14</sup> See Chapter 3.

<sup>15</sup> In Hungary, enterprises saved 68 per cent of income in 1985-89, compared with the 5 per cent saving rate of households.

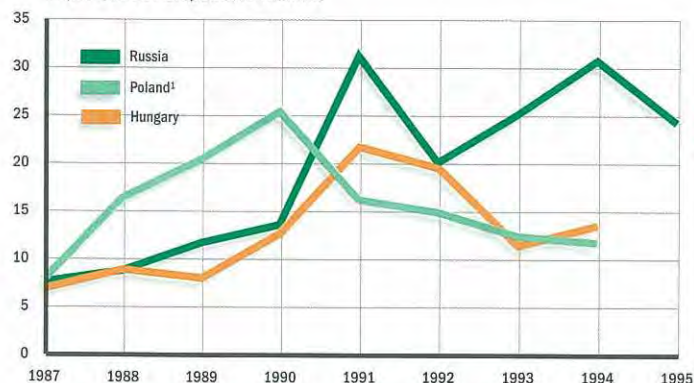
<sup>16</sup> See Chapter 5 of the 1995 *Transition Report*.



Chart 6.5

### Household saving rates in selected transition economies

In per cent of disposable income



Source: IMF, IMF (1995) and *Russian Economic Trends* (1995).

<sup>1</sup> There is a statistical break in the series between 1990 and 1991.

(Bulgaria, the Czech Republic, Hungary, Poland and the Slovak Republic). These data clearly show that by 1992 the profitability of large enterprises was seriously impaired, and many had insufficient cash flows to meet obligations to suppliers, workers and creditors. Given the profitability of enterprises prior to the start of transition, it is reasonable to conclude that enterprise profitability deteriorated sharply initially in the transition, although in some cases brief opportunities existed for the exploitation of monopoly power.

Just as the transition “shock” and ensuing recession severely weakened enterprise profitability, progress in transition and macroeconomic stabilisation can be expected to contribute to its recovery. This expectation is confirmed by the above survey results. These results point to clear improvements in enterprise cash flows and overall profitability in the Czech Republic, Hungary, Poland and the Slovak Republic between 1992 and 1993-94. In addition, large enterprises in Bulgaria also experienced some improvement in cash flows and profitability. However, the overall financial performance of enterprises in Bulgaria, which made slower progress in transition, remained well below that of enterprises in the countries at more advanced stages of transition.

### Household savings

Reliable measures of household savings in the transition economies are as difficult to obtain as those for enterprise savings, with the compilation of data by economic sector still weak in many countries. Also, high inflation causes a number of measurement problems, in particular in capturing the erosion in the real value of financial assets and liabilities by high inflation. Savings as conventionally measured exclude capital gains and losses on existing holdings. That being said, measured household savings relative to GDP is likely to have risen in the transition for two reasons. First, the share of household income in GDP is likely to have risen as enterprise profitability fell. Second, households raised their rate of saving out of disposable income from the very low levels that prevailed under central planning, in part driven by an increased precautionary motive for savings as the uncertainty over future earned income and public pensions increased.

Time series data on household saving rates from before 1989 to 1994 are available for Hungary, Poland and Russia (Chart 6.5). These data point to a rise in saving ratios from about 8 per cent of disposable income in 1987 to the range 12-25 per cent in 1994. The increase in saving rates reflects both an increased motivation and ability for households to save in the transition. The specific factors contributing to increased household saving are discussed below. Lastly, some of the recorded decline in enterprise savings and increase in household savings may be due to investment by small-scale private ventures being counted as increased household savings, as statistics on enterprises are collected typically for larger (and often state-owned) firms.

### Summary

Available evidence points to dramatic shifts in the composition of savings in the transition. A sharp, initial decline in enterprise profitability has been only partially offset by an upturn in household savings. At the same time, government fiscal performance

#### Box 6.1

#### Savings in Hungary

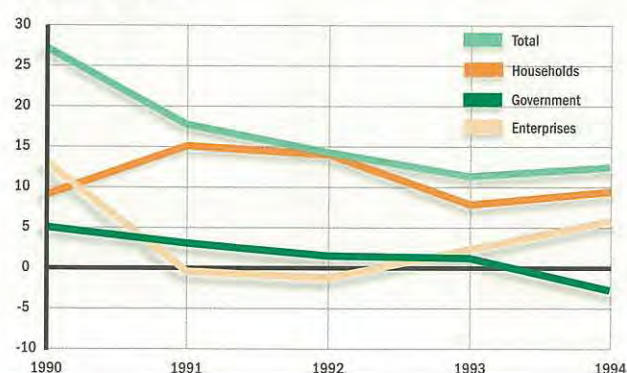
The Hungarian case is a good illustration of what may be considered the broad pattern of savings in transition. The chart below shows how the household saving rate in Hungary increased sharply at the beginning of the transition period in 1990-91 and how this partially cushioned the economy against the decline in saving in other sectors, especially the enterprise sector.

In 1990-91 households developed a greater incentive to save. The means to save was also greater. There was an increase in the share of income going to households, as wage indexation and increased social welfare contributions by employers reduced enterprise profits. High saving in this period may also have been a response to inflation and associated capital losses on the stock of private wealth. After 1991, Hungarian household saving rates declined and within a two-year period the household saving rate had halved before rebounding moderately in 1994.<sup>1</sup> The decline in household saving was a key factor in the deterioration of the aggregate savings-investment balance in 1993.

<sup>1</sup> Unique country-specific factors may also exercise a significant influence on saving at times. For example, the Hungarian government removed the subsidy on mortgage repayments in 1991 and created an incentive to accelerate payments with early-payment discount. Therefore, household savings rose steeply in that year with an inevitable subsequent fall.

### Composition of domestic savings in Hungary

In per cent of GDP



Source: IMF (1995).



deteriorated, with pronounced cut-backs in public investment easing the impact on government savings.

As the transition progressed, the strong shift in the composition of non-government savings was slightly reversed as enterprise profitability recovered. This general pattern is well represented by the experience of Hungary, for which detailed saving data by economic sector are available (see Box 6.1).

#### 6.4 Does aggregate savings depend on the sectoral composition of income?

A key question both for the interpretation of the savings data and for economic policy is whether the aggregate saving rate depends on the composition of income between households, enterprises and the government. Another way of phrasing the issue is: does a redistribution of income among these three sectors affect the aggregate domestic saving rate? This question can be broken up into two parts. First, does the aggregate domestic saving rate depend on the distribution of income between the government and the non-governmental sector (the combined household and enterprise sectors)? The second question concerns the effect on the private saving rate of a change in the distribution of income between enterprises and households. This chapter takes the view that a decrease in government savings can be expected to lower aggregate domestic savings, although less than one-for-one. Redistribution of income from the enterprise to the household sector is likely to reduce the aggregate private saving rate, with enterprise savings falling by more than household savings increases.

##### Government versus non-governmental savings

Consider a decrease in public savings brought about through a decline in tax revenues – for example, with a temporary cut in taxes. Current and future public consumption and monetary policy are assumed to remain unchanged in the sense that the loss of tax revenues now means that there will be a future tax increase (equal in present discounted value to the current tax cut) to cover the shortfall. The current loss of tax revenue thus redistributes lifetime disposable income to the old from the young and to the generations currently alive from future generations yet to be born. The net effect on household consumption today is likely to be positive because those who benefit from the current fall in the tax burden are unlikely to consider fully the consequences of the inevitable future tax increases. The key point is that effective concern by the current generations for their own wealth and well-being is greater than their concern for that of future generations. Public consumption is unchanged by assumption, so total domestic savings (private plus public) decrease.

The empirical evidence is inconclusive as to the precise degree to which non-governmental saving behaviour offsets changes in government savings, but there is some suggestion that changes in public savings are likely to elicit opposite but less than equal changes in private savings. A recent study of industrialised market

economies found a substantial offset of changes in the government fiscal position from private savings, averaging 60 per cent. This implies that changes in government savings can have a significant impact on total domestic savings, but that the decrease in government savings is likely to be accompanied by only a partially offsetting increase in household savings.

##### Enterprise versus household savings

Enterprises in transition economies have traditionally had a much higher propensity to save than households. If a difference in the saving propensity persists into the transition period (even though it may be smaller) the distribution of income between households and enterprises will have important implications for the aggregate saving rate.<sup>17</sup> Many transition economies have experienced a sharp redistribution of income from enterprises to households since the onset of reforms. Several factors have contributed to this. The indexation of wages and pensions has meant that enterprise costs have continued to rise while profits have contracted, reducing the amount of after-tax profit which may be invested. Furthermore, enterprises are contributing a higher proportion of the cost of social security than households. For example, in the Czech Republic employers' social security contributions amount to 37 per cent of the wage bill, compared with 13 per cent for employees. In Hungary, employer-paid social insurance contributions increased from 43 per cent of the wage bill in 1989 to 51 per cent in 1993, largely to cover unemployment compensation. This redistribution of income has resulted in relatively higher household income and savings but, because households have a lower saving rate than enterprises, the aggregate saving rate has declined in all transition economies.

In principle, the saving decisions of households and enterprises are jointly determined. Households are either indirect claimants on enterprises through government ownership, or direct claimants through the ownership of shares in privatised enterprises. In an ideal world, a rise in retained earnings would increase the stock-market value of the enterprise and hence household wealth would be the same as it would have been if the firm had distributed the profits in the form of dividends. Hence, it should make no difference to aggregate savings whether profits are retained by enterprises or distributed to households in the form of dividends (or higher wages). A rise in government enterprise savings should have the same effect, provided that the proceeds are efficiently allocated or re-invested and provided current generations act altruistically *vis-à-vis* future generations. In such circumstances, the enterprise is a veil.

For the veil to be perfect, however, requires efficient capital markets and effective corporate governance.<sup>18</sup> Even in the advanced market economies, there are many features of the economic mechanism which cause the corporate veil to be imperfect. These include, among others, distortions in the tax system, the existence of bankruptcy risk in the presence of limited liability, the presence of liquidity constraints and cash-flow constraints that

<sup>17</sup> Household income refers to household disposable income after taxes and transfer payments. Enterprise income is retained earnings of the enterprise sector after taxes, social security contributions and dividends and equals enterprise savings.

<sup>18</sup> In the case of state-owned enterprises it also requires the effective intergenerational altruism referred to earlier.



affect households and enterprises differently, and the pursuit by enterprises of managerial objectives other than maximisation of shareholder value. All these features are present to an even greater extent in transition economies than in industrialised market economies. In such circumstances the distribution of profits to households in the form of dividends has the potential to reduce aggregate savings, because severely liquidity-constrained households are less likely to save out of household disposable income than enterprises are out of retained enterprise earnings, because retentions by definition equal enterprise savings.

## 6.5 Determinants of household savings

In the transition, households will become the primary source of domestic savings. In general, the main determinants of household saving behaviour are the changing structure of the family and the desire and the capacity to ensure a smooth pattern of consumption over the life cycle of individuals and to insure against unpredictable fluctuations in income. The range of financial instruments and their returns are also important in mobilising household savings for domestic investment. In principle, saving rates could also respond to the expected after-tax rate of return on savings, but empirically no significant effects are found. The composition of savings is, however, sensitive to rate of return differentials among competing savings instruments. Sufficiently high uncertainty about the rate of return on savings (e.g. due to serious instability in the banking sector) may also depress savings.

### Life-cycle saving behaviour

Life-cycle and permanent income theories of consumption and savings imply that the level of consumption depends on long-term expected income and does not respond significantly to transitory fluctuations in current income. For example, individuals save to ensure adequate consumption during retirement or dissave (e.g. by taking out student loans) to obtain a college education when they are young. Household savings are therefore assumed to follow a pattern over the life cycle whereby there is dissaving during the early part of the life cycle and most savings are done during the middle years of life, followed by dissavings during retirement. This has important implications for savings at the aggregate level. The first is that the demographic profile of an economy will have a significant effect on the saving rate. If there is a high proportion of retired people and other dependants, in relation to the working population, aggregate savings are likely to be relatively low. Conversely, a high number of workers in their peak earning years in relation to dependants should mean a high saving rate. Second, policies that affect permanent income are presumed not to affect the saving rate from long-term expected income, as they are translated into corresponding changes in consumption, whereas events that affect only current income but not permanent income are reflected in the saving rate.

The life-cycle and permanent income theories do, however, have important limitations which may be of particular significance in transition economies. The degree to which households are able to spread consumption over their life-time depends on their ability to

borrow and lend, and in transition economies financial markets are often poorly developed. Liquidity constraints may reduce households' ability to spread consumption over the life cycle. Even with well-developed financial markets, future labour income, which is the largest component of wealth for many individuals, cannot be attached by creditors in the event of default and therefore provides poor collateral for consumption loans. With underdeveloped financial markets, even tangible assets may be hard to collateralise. This makes borrowing against future labour income, in order to spread consumption over the life cycle, problematic and costly or even impossible.

Transition can be expected to affect life-cycle savings in three ways. First, if it raises long-term expected income while temporarily reducing actual income (as would be the case during the deep recessions characterising the early stages of even the most successful transitions), this will tend to lower saving rates. Second, to the extent that confidence in the ability of the state's social security retirement schemes and other state pension schemes to provide for an adequate standard of living during one's retirement is undermined by the transition, private savings for retirement can be expected to increase.<sup>19</sup> The demographic structure of the transition economies is also changing (in the direction of a larger proportion of retired people and a higher dependency ratio) in a way that puts downward pressure on aggregate saving rates. Third, the constraints on the ability of the households to borrow in the transition economies may make consumption particularly responsive to changes in current income. These life-cycle effects on savings pull in different directions and it is not yet clear what the net effect will be. Nevertheless, policy-makers will need to take careful account of these three effects on savings in considering measures to promote household savings.

### Precautionary savings

Uncertainty can be expected to exert a strong influence on saving behaviour, with the propensity to save out of permanent income increasing with the uncertainty attached to the future income stream. Precautionary saving behaviour is especially pronounced when strong household aversion to low consumption interacts with an inability to borrow when income is low. This combination can induce households to build up financial wealth to a relatively stable target level so as to hedge against future income uncertainty.

The rise in household savings in the transition economies must in part be attributable to the precautionary motive. This is because many transition economies, especially those at the early stages of transition, are suffering from high and uncertain inflation, declining aggregate output and increased unemployment. In addition, there has been an important permanent change in the need for households to insure privately against a whole range of income risks that had previously been insured collectively.

The responsibility for funding the social safety net has been shifted from state enterprises to the general government and households. As a result of this shift in social provision away from

<sup>19</sup> See Chapter 7 on contractual savings.



the enterprise sector, the general government budgets for health and social welfare have increased significantly in many of the transition economies, often to levels that are viewed as unsustainable. It is therefore to be expected that the years to come will see a further shifting of the burden of social security and risk bearing onto households. Hence, the precautionary motive for savings is likely to become an important reason for increased household savings in the transition and may be expected to result in the accumulation of a stock of financial assets by an increasing number of households in order to insure against future uncertainties. While there is some suggestive evidence, it is, however, difficult to be confident about the precise magnitude of the impact of precautionary motives on saving behaviour by households during the transition thus far.

## 6.6 Policies to promote domestic savings

### Fiscal policies

Both theoretical considerations and available empirical evidence suggest that total domestic savings can be raised by increasing government savings (reducing dissavings). For the advanced transition countries, current government expenditures as a share of GDP are at or above the average level in industrialised market economies. An important element in these high levels are over-extended and poorly targeted pension and social security programmes (see below). In these countries there could be an important contribution to government savings (as well as to macro-economic stability and efficiency) from curtailing expenditures in general and reforming these programmes in particular. For a number of countries at the intermediate and early stages of transition, the ratio of revenues to GDP have declined to dangerously low levels and the priority should be to expand the tax base and to improve tax administration.

The relative burden of taxation on enterprises and households can also have an impact on aggregate savings by shifting the balance between after-tax enterprise profits and disposable household income. Enterprises are more likely to save than households, and shifting the burden of taxation from enterprises to households will therefore raise total private savings, even if the total tax burden on the enterprise and household sectors combined remains the same. Higher retained earnings will boost enterprise investment as the cost of internal finance to the enterprise is lower than the cost of external finance.

A number of countries in the region have trimmed corporate profits tax rates in order to release cash flows for investment. Given the current budgetary pressures faced by governments in many transition economies, it may not be immediately feasible to make significant cuts in corporate profits taxes without severely compromising government revenue. However, increasing the efficiency of tax administration and particularly increasing the coverage of informal sector activities would enable more revenue to be collected. Household incomes, in particular, are supplemented by informal sector earnings. Increasing the efficiency of adminis-

tering household income taxes, in particular, should widen the tax base and enable higher revenue collection, thereby helping to shift the balance of taxation more towards households. In industrialised market economies, around two-thirds of revenue comes from personal income taxes and social security contributions, with corporate income tax playing only a minor role.<sup>20</sup>

### Social security reform

Unemployment, created by recession and enterprise restructuring, has raised the requirements for social security expenditure in most transition economies. Current social security expenditure, including pensions, which comprises between 25 and 35 per cent of GDP in most transition economies and up to 50 per cent in some, is fiscally unsustainable. In comparison, in industrialised market economies transfer payments are typically around 20 per cent of GDP. Measures are gradually being introduced to tighten eligibility criteria and to means-test benefits.<sup>21</sup> There are also moves to shift some of the burden of social security expenditure to households.

Reductions in government expenditure on social security are likely to strengthen the incentives for private savings. Whereas previously households in transition economies relied on government provision of social security, some of the onus of this expenditure is shifting to the private sector. Studies of social security arrangements in the United States have shown that the public provision of social insurance has the effect of depressing household savings, particularly of low-income households.<sup>22</sup> It is argued that increases in social security reduce the perceived need to save to ensure adequate consumption in retirement or in the event of unemployment. This effect is stronger for the poor because social security benefits are a larger proportion of low-income households. Also, because state-funded benefits are usually means-tested, the accumulation of wealth by low-income households is actually penalised.

### Public pension reform

The increasing burden of pension expenditure, combined with low levels of private and public savings, is poised to create substantial difficulties for the future financing needs of the governments of transition economies. As discussed more extensively in Chapter 7, ageing populations in many of the more advanced transition economies in particular are putting a heavy burden on state pension expenditures, and low fertility will exacerbate these problems in the future. This burden is likely to increase if early retirement provisions become more generous, if the tendency for people to live longer (recently reversed in a number of transition economies) resumes or if there are other demographic, legal or regulatory developments which reduce the ratio of workers to dependants. The tendency to index-link pensions when government revenue is declining in real terms is also putting pressure on the budget. One way to curtail the growing expenditure on pensions is to discourage early retirement. Another is to tighten the regulations for people continuing to work while they receive a state pension.

<sup>20</sup> See Burgess and Stern (1993).

<sup>21</sup> Means-testing benefits, while it reduces demands on the budget, has the negative effects of creating or enhancing disincentives to work and save, and of worsening 'poverty-traps'.

<sup>22</sup> See Kotlikoff (1989) and Hubbard et al. (1995).



The way in which pensions are financed also has important implications for aggregate saving behaviour. Many transition economies currently have a pay-as-you-go system which requires workers and their employers to pay contributions through their taxes to the current generation of pensioners. Such a system does not perform well with the current demographic profile of transition economies, which typically have a high number of dependants to workers, unless there is very high productivity growth. Under a fully funded pension scheme, however, a stock of financial assets is accumulated to pay future obligations so that cumulative aggregate contributions plus investment returns are sufficient at any time to cover the present value of future obligations. Moving from a pay-as-you-go system to a well-managed, fully funded, mandatory, defined-contribution scheme, in which people have clearly identifiable individual accounts with pension funds, would also raise the saving rate of the young and the stock of private financial wealth. However, this would carry a high cost for at least one generation, which would have to pay for the pensions of their parents and save for their own "funded" schemes at the same time.

## 6.7 Concluding remarks

This chapter has covered the key determinants of savings at the household and aggregate level in transition economies. The picture which emerges is that aggregate saving rates have shown a dramatic decline during transition and there is some risk of a further decline unless policies are implemented to reverse this downward trend. In some part, the decline in saving rates is likely to reflect the fact that, due to unprecedented declines in real per capita incomes, current income is likely to be significantly below permanent or long-term expected future income.

As economic growth begins to recover, saving rates should recover somewhat. In addition, a redistribution of income from the household sector to the enterprise sector (through profit retention and wage restraint) and to the government (through higher tax collections) can be expected to raise gross domestic savings. However, it is also clear that governments need both to adopt more ambitious policies to restrict their own current spending and to implement policies to promote private savings and to encourage its effective intermediation into productive domestic capital formation. It is hard to visualise effective measures for promoting household savings that do not involve intergenerational redistribution from the old to the young and from the present to future generations.

As the transition economies adapt their inherited social commitments to the market economy, households must take on a large role in domestic savings at a time when the necessary institutional structures for savings in a market economy are only now starting to be built in many countries. Development of some of these institutions and instruments, in particular those for life insurance and private pensions, is the subject of Chapter 7.

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# Mobilising household savings: life insurance and pension funds



Economic transition is about establishing markets and building the institutions to support them. Among different markets, those for income security in old age and in life contingencies have received relatively little attention during the first years of the transition as shorter-term concerns have dominated the agenda. Life insurance and pension funds belong to those elements of market economy that take considerable time to develop, because of their close dependence on financial stability and on the emergence of institutions that bolster confidence and capital market efficiency. However, once the early challenges of transition have been tackled, the potential benefits of a dynamic contractual savings sector deserve increasing attention, especially since governments can play an important, active role in promoting the growth of the sector.

Beyond their direct contribution to widening consumer choices and to peace of mind, contractual savings have the potential to advance reforms in other areas. Two such areas are reviewed in this chapter. First, an institutionally strong pension fund and life insurance sector can supplement state-sponsored pension schemes and over time support their reform. This social dimension of contractual savings could be timely and helpful in transition economies, in many of which social insurance systems are struggling and improved protection of vulnerable strata such as the elderly and the disabled is gaining in priority. The discussion of public pensions reform in transition economies and its implications for contractual savings is briefly reviewed in Section 7.4 of this chapter.

Second, pension funds and life insurance institutions can be important participants in the financial markets. On the one hand, they require some minimum level of soundness and liquidity of financial markets for their operation. On the other hand, they are uniquely able to lengthen the time-horizon of household savings and, by investing in assets of long maturity, they are able to deepen and widen capital markets with attendant benefits for capital formation. In addition, their financial “clout” may enable them to stimulate a range of financial innovations and institutions that support the equitable and efficient operation of capital markets, many of which would also benefit other market participants. The interaction between contractual savings and capital markets is covered in Section 7.5.

Before turning to this discussion of broader benefits from contractual savings for the transition process, Sections 7.1 and 7.2 first provide perspectives on the future growth of the sector and evidence on current developments. There is reason to believe that there is substantial latent demand for contractual savings products, though expansion to levels seen in the advanced industrial economies will take time. While conditions vary between coun-

tries, contractual savings in transition economies are still very much in their infancy. Nevertheless, small private life insurers have begun, in various countries, to challenge the former state monopolies, while the more advanced transition economies are experimenting with private pension schemes.

One of the key areas limiting the growth of contractual savings in many transition economies is the underdeveloped state of government regulation of the sector, particularly regarding effective supervision. In some countries, scandals involving speculative investment vehicles have undermined the public’s trust, a crucial ingredient in the demand for long-term savings instruments. Government has a key role to play in improving confidence by putting in place effective means of consumer protection, and in stimulating demand through a tax treatment which, at least, does not penalise such savings. A discussion of the government’s role in regulation and an overview of the present state of affairs - which is very diverse across countries - is provided in Section 7.3. The Annexes to this chapter contain a detailed, country-by-country presentation of the legal frameworks for life insurance and private pension funds.

## 7.1 Contractual savings and the economic transition

The demand and supply of instruments for contractual savings are subject both to macroeconomic developments and to the emergence of markets and market-based institutions. All transition economies have passed through a period of great macroeconomic uncertainty and extensive structural change. As uncertainty gradually diminishes, the appetite for longer-term financial contracts is likely to increase (even though lower uncertainty can dampen aggregate savings, as discussed in Chapter 6). At the same time, the structural change that characterises the economic transition also implies high productivity of capital and consequently the potential for rapid economic growth. Since evidence suggests that the demand for contractual savings products in established market economies tends to increase more rapidly than income, the growth of the contractual savings sector is likely to be even higher than that of GDP.

These consequences of price stability and growth are not unique to the transition process. However, there are also three important reasons why progress in transition, in a more narrow sense, could shift preferences in favour of contractual savings products. First, voluntary contractual savings expand opportunities for consumer choice. Savings instruments on offer under central planning were generally limited to basic banking products, primarily savings deposits. While life insurance was generally available, its terms were unattractive and the product range very limited. Private pension funds were unknown. Liberalisation may therefore transform the latent demand for a more diverse range of financial products into effective demand by establishing the necessary markets.



Second, contractual savings represent the long-term end of financial intermediation. The matching of long-term liabilities with appropriate assets continues to be very difficult and costly - or offer very low returns - even in the most advanced transition economies. As long as the securities markets, and the know-how, institutions and legal frameworks to support them, remain underdeveloped, long-term contracts will tend to be much riskier than shorter-term forms of savings. Ineffective consumer protection (regulation and supervision) further raises perceived risks and increases the appeal of retail banking products which are felt to carry implicit or explicit government guarantees.<sup>1</sup> As the transition advances, progress in these areas should gradually make contractual savings products more attractive. In fact, as Section 7.5 suggests, the development of the contractual savings industry and of capital markets in the region can mutually reinforce each other.

Third, the transition economies had - and some continue to have - state pension systems that were more comprehensive and generous, but also much more costly, than those of countries at comparable income levels. The incentive to purchase contractual savings products under these conditions, with other factors held equal, is likely to be lower than in other middle-income countries. The collective insurance of risks limits the need, while high payroll taxes reduce the scope, to provide for income security on an individual basis. Transition partly implies shifting responsibilities away from the state and to the individual, and contractual savings are key instruments for managing the increased personal responsibility for risks.<sup>2</sup> To the extent that social insurance is slimmed down - by design or *de facto* for lack of funds - contractual savings would take over some of its functions.

In spite of these factors, which point to latent unmet demand and a growing role for contractual savings as the transition progresses, it would seem unrealistic to expect a rapid expansion within a few years to levels seen in advanced market economies. Improvements in some of the key areas limiting demand, including institutional weaknesses (of providers and regulators) and the underdevelopment of capital markets are by their nature long-term propositions. There are also a variety of factors which are likely to slow down the supply response to increased demand in the short term. These include the weakness of insurance distribution systems, such as brokers, agents and retail banking networks (through the combined provision of banking and insurance services) and the significant capital needs for business expansion.

## 7.2 Development of contractual savings

The volume of contractual savings in transition economies varies substantially across countries, but tends to be small. Private pension plans have emerged in only a handful of countries. Life insurance, which was provided by state-owned institutions under

central planning, shows more activity, but remains well below levels in industrialised market economies. However, there is evidence of rapid growth in both forms of savings.<sup>3</sup> Developments are far from homogeneous across the region, but closely mirror differences in the general progress of market-oriented transition.

### Life insurance

Table 7.1 presents indicators of the development of life insurance, with premium revenues serving as a proxy measure for the extent of service provision. Since the structure of insurance products varies between countries, aggregate data provide only a partial picture of the trends. One case where the volume of premiums collected can be somewhat misleading is the Russian Federation. A majority of policies concluded in Russia in 1994 and 1995 had maturities of less than one year, representing salary substitutes motivated primarily by tax advantages. After changes in legislation early in 1996 this market collapsed. The evidence presented in the following should be read with this in mind.

The importance of life insurance differs greatly among countries. There is some evidence of a positive link between progress in transition and the volume of premiums as a share of GDP (the insurance penetration ratio). In Table 7.1, countries have been listed in declining order by their stage of transition in 1995.<sup>4</sup> Where data were available insurance penetration in 1995 varied from 0.02 per cent of GDP in Uzbekistan to 0.8 per cent in the Czech Republic. Among the more advanced transition economies, the Czech Republic, Hungary and Poland, for instance, have relatively large insurance penetration ratios, but in Estonia this ratio is comparatively small. The average for advanced industrial economies was more than 4 per cent in 1994, while developing countries showed a very differentiated picture, with insurance penetration ratios generally lower in Latin America than in the transition economies and higher in East Asia.

While the sector continues to be small, its growth rate between 1993 and 1995 has surpassed that of GDP in 10 of the 15 countries for which data covering this period were available. In the Russian Federation, for instance, the ratio of premium income to GDP grew by a factor of 2½ between 1993 and 1995, in the Czech Republic and Hungary it grew by a factor of 1¼, and in Belarus by a factor of 9. Sketchy evidence on the pre-transition period suggests that there was a sharp drop in insurance penetration rates in the early 1990s. In Romania, life insurance premiums had all but vanished by 1993 after having reached a GDP-share of 0.3 per cent in 1990. Total insurance penetration (including non-life classes) in the Russian Federation fell from 2.9 per cent to 0.8 per cent of GDP in the same period. Table 7.1 thus suggests a rapid "rebound" after 1993.

<sup>1</sup> However, liabilities of former state life insurance monopolies may carry similar implicit guarantees, and the more advanced transition economies have introduced policyholder compensation funds.

<sup>2</sup> The debate over the extent of public versus private responsibility for old-age income security is certainly relevant but controversial in many market economies as well.

<sup>3</sup> Some forms of life insurance - e.g. term life and whole life - do not represent savings in the traditional sense of accumulating assets over time; they do, however, represent savings in an actuarial, "probabilistic" sense.

<sup>4</sup> Information on progress in transition for 1995 rather than 1996 has been utilised to better coincide with the date of the information presented in Table 7.1. The ranking is derived from the unweighted average of transition indicators presented in the 1995 *Transition Report*, Table 2.1.



Table 7.1

## Indicators of the development of life insurance

Country	Insurance penetration rate (premiums in per cent of GDP)			Premiums collected in 1995 (In per cent of region total)		No. of providers Of which: state controlled		Premiums per provider (US\$ m)	Insurers' market shares (In per cent)		Comparator insurance penetration rates Premiums in per cent of GDP		
	1993	1994	1995	(US\$ m)		Total			Top 5	Foreign <sup>2</sup>	Country		Year
Czech Republic	0.64	0.72	0.80	353	8.3	15	0	23.5	99.0	6.50	Canada	2.73	1994
Hungary	0.53	0.60	0.66	287	6.7	12	0	23.9	88.0	99.50	France	5.24	1994
Poland	0.57	0.60	0.63	764	17.9	13	1	58.7	99.5	4.90	Germany	2.7	1994
Estonia	0.14	0.11	0.09	4	0.1	5	1	0.7	99.0	<1.0	Italy	1.13	1994
Slovak Republic	0.58	0.54	0.53	72	1.7	11	1	6.5	99.0	–	Japan	6.49	1994
Slovenia	0.36	0.50	0.72	129	3.0	9	na	14.4	93.1	–	UK	6.64	1994
Croatia	0.11	0.76	0.17	–	–	na	na	–	–	–	USA	3.98	1994
Lithuania	0.27	0.95	0.17	13	0.3	15	1	0.9	99.3	–			
Latvia	0.34	0.30	0.40	18	0.4	12	1	1.5	97.2	–	OECD	4.26	1994
Bulgaria	0.60	1.82	–	–	–	30 <sup>1</sup>	1	–	–	–			
Moldova	–	–	0.48	8	0.2	17	na	0.5	–	–	Argentina	0.1	1988
Russia	0.25	0.40	0.61	2,541	59.6	2,700 <sup>1</sup>	130 <sup>1</sup>	0.9	29.5	–	Brazil	0.12	1988
Romania	0.02	0.03	0.04	14	0.3	14	3 <sup>1</sup>	1.0	27.7	–	Chile	1.77	1990
Albania	–	–	0.80	16	0.4	1	1	16.2	–	–	Korea	8.56	1989
Uzbekistan	–	–	0.02 <sup>1</sup>	1	–	52 <sup>1</sup>	1	0.0	–	–	Malaysia	1.36	1989
Ukraine	0.27	0.54	0.12	41	1.0	600 <sup>1</sup>	6	0.1	–	–	Mexico	0.49	1989
Belarus	0.04	–	0.33 <sup>1</sup>	30 <sup>1</sup>	0.7	40	1	0.7	65.7	–	Pakistan	0.39	1987
Kazakstan	–	–	0.07 <sup>1</sup>	11 <sup>1</sup>	0.3	53 <sup>1</sup>	na	0.2	–	–	Singapore	1.69	1990
											Thailand	0.83	1989
											Turkey	0.16	1990
Total/Average	–	–	–	4,262	100	–	–	–	–	–			

Sources: Transition economies: calculated on the basis of data provided by the national authorities.

OECD countries: OECD *Insurance Statistics Yearbook* 1987-94.Developing economies: UNCTAD *Statistical Survey on Insurance and Reinsurance Operations in Developing Countries, 1983-90*.<sup>1</sup> Life and non-life.<sup>2</sup> 1993, except Poland 1st half 1994; source: Sigma (1995).



The Russian Federation had by far the largest share of aggregate premiums collected in the region, measured in US dollars, with almost 60 per cent (however, note the caveat above). Adding the Czech Republic, Hungary, Poland and Slovenia, these five countries accounted for around 95 per cent of the life business.

In many countries the number of operators in the life insurance field appears out of proportion with the volume of premiums collected. Entry was facilitated by very low minimum capital requirements which were often not adjusted with inflation (see Section 7.3). As a consequence, in 1995 average premiums collected per provider surpassed US\$ 1 million in only six of the 16 countries for which data were available. Apart from Albania, the average size of insurers in the advanced transition economies of eastern Europe is by far the largest. Evidence on market concentration in Table 7.1 and correspondence with insurance supervisory authorities, however, suggest that many registered life insurers are in fact dormant or near-dormant. The top five companies account for the vast majority of written policies in most countries except Russia and Romania.

The former state legal monopolies over insurance have been eliminated in all countries. In many, state providers have been majority privatised (the Czech Republic, Estonia, Hungary) or are in the process of privatisation. The privatisation of Poland's large former state monopoly company PZU Zycie - which has a share of 95 per cent of the life market<sup>5</sup> - has been complicated by its serious capital deficiency (a solvency margin below 5 per cent).<sup>6</sup> In the Slovak Republic, the state continues to hold approximately 50 per cent of the former monopoly Slovenska Poistovna. While these companies still dominate the market in most countries, their market share is being eroded by the entry of private competitors.

While foreign insurers have entered most markets in eastern Europe, their operations generally represent little more than footholds. An exception is Hungary, where foreign insurers dominate. However, from low levels, foreign insurers' market share has been growing quickly in the Czech Republic and Poland. Market entry by foreign providers has been restricted in Bulgaria<sup>7</sup> and in Romania.<sup>8</sup> In the CIS their participation has so far been negligible because of an unsettled regulatory environment and a restriction to minority shares in joint ventures.

### Private pension funds

Unlike life insurance, private pension funds are new to the economies in transition, with no precedent in the pre-transition period. As discussed below, their emergence is closely bound up with the provision of old-age pensions under social insurance schemes. Despite decades of collective savings for retirement, a culture of private provision for old-age income is slowly evolving.

<sup>5</sup> Falush (1996).

<sup>6</sup> The solvency margin is, in its simplest form, defined as the ratio of (shareholder and free) capital over (technical and other required) reserves.

<sup>7</sup> A new insurance law is expected to be approved in 1996 which will permit foreign entry from 2002 (see section 7.3).

<sup>8</sup> Only joint ventures are permitted.

<sup>9</sup> Apart from the mandatory versus voluntary nature of schemes, coverage ratios are influenced by the sectoral make-up of an economy, tax treatment, the gender distribution of the labour force, the importance of part-time employment and other factors.

<sup>10</sup> De Ryck (1996)

Table 7.2

### Pension Funds

Country	Number of funds	Number of Members (1,000)	Total assets (in per cent of GDP)
Czech Republic	44	1125	0.14
Hungary	212	247	0.16
Russia	1,000	na	0.03
France	—	—	3.4
Germany	—	—	5.8
Italy	—	—	1.2
Japan	—	—	44.7
Switzerland	—	—	79.5
The Netherlands	—	—	88.5
United Kingdom	—	—	79.4
United States	—	—	59.1

Data from June and July 1996. End 1993 data for comparator countries.

Source: Correspondences with supervisory authorities and De Ryck (1996).

Only three countries in the region have passed laws dealing specifically with the establishment and operation of pension funds, and in three others laws have been drafted. Table 7.2 provides some information relating to these countries.

Private pension funds are significant only in the Czech Republic and Hungary, although even there the share of assets in GDP remains quite small. Nevertheless, a remarkable number of funds have been set up in the short period since legislation was passed, covering more than one million people in the Czech Republic (approximately one-quarter of the working population) and 250,000 in Hungary. In comparison, western European private pension plans achieved coverage ranging from 5 per cent in Italy to 48 per cent in the United Kingdom (voluntary schemes), to between 80 and 100 per cent in Denmark, the Netherlands and Switzerland (where schemes are mandatory or quasi-mandatory).<sup>9</sup> Assets in the Hungarian funds reached approximately Ft 6.6 billion (US\$ 47.3 million) at the end of 1995 against Ft 446 million one year earlier. Funds in the Russian Federation have been operating in a legislative vacuum, and have as a consequence been unable so far to attract significant contributions. Anecdotal evidence suggests that many of these funds have assets under management equivalent to only a few thousand dollars. In comparison, at end-1993 pension fund assets in the Netherlands, Switzerland, United Kingdom and United States represented between 60 and 90 per cent of GDP, while in Belgium, France, Germany, Italy and Spain (where state-pension systems dominate) they represented between 1 and 5 per cent only.<sup>10</sup>

There are interesting structural differences between the Czech and Hungarian pension funds. Whereas personal plans are characteristic of the Czech Republic, the market in Hungary is dominated by



sectoral and employer-based funds (which each attract around 40 per cent of all fund members). Approximately 60 per cent of the contributions to Hungarian funds are provided by employers, who are attracted by allowances on corporate income and social security taxes.<sup>11</sup> In the Czech Republic, the net tax effect for employers appears to be neutral, which may explain why they are less likely to set up workplace funds.<sup>12</sup> In both countries, only defined-contribution pension plans were on offer, whereas defined-benefit plans dominate in western Europe.<sup>13</sup> This difference may reflect the need for a greater degree of sophistication in financial markets to provide defined-benefit plans (for example, indexed instruments).<sup>14</sup>

### 7.3 Regulation and supervision of contractual savings

Governments in the region can make, and in some countries have already made, important contributions to the development of contractual savings by establishing supportive legal and regulatory frameworks and by clarifying the tax treatment of these instruments. The rationale for regulation is both economic and, at times, political.<sup>15</sup> Economic reasons for regulation are rooted in consumer protection. Contractual savings involve payments today for benefit promises in the future, sometimes decades away. Since individual claimants cannot be expected to monitor the financial soundness of contractual savings institutions, governments help to ensure that companies will be around to honour their obligations (solvency regulations, prudential requirements). While there is a solid case for financial regulation, it should aim for a sensible trade-off between risk mitigation and returns to savers. There is little gain from “safe” investments if they have yields that are insufficient to cover needs in contingencies and old age.

A second economic reason for regulation derives from a lack of familiarity and understanding of these products. Contracts are often complex, and by setting product and disclosure standards, regulators seek to ensure consumer fairness. Government action is further motivated by the knowledge that a functioning contractual savings sector can reduce pressures on state pensions. This is one of the reasons why contractual savings are sometimes supported by tax benefits. Finally, there may be broader political objectives involved in regulation when investment guidelines give a heavy preference to government securities or to domestic over foreign investments.

The legislation covering contractual savings institutions is outdated in some of the transition economies, and unsettled in most of them. Consistency of existing laws with other commercial legislation remains mostly untested. Legislation on pension funds has been passed in only three countries (the Czech Republic, Hungary and the Slovak Republic). Where pension funds have

been set up in others (Bulgaria and the Russian Federation), they operate in a legal vacuum and with considerable uncertainty. As legislation is reformed over the coming years, existing blueprints from market economies can provide only a partial guide.<sup>16</sup> The management of contractual savings during the transition process is in many ways more complicated than in stable market environments. Challenges include institutional weaknesses such as the shortage of experience of local providers, regulators and consumers. At the same time, underlying asset and liability risks are high. In addition to the immaturity of capital markets, asset-liability management and product pricing are further hampered by the negative impact that the economic transition has had on demographic mortality and morbidity in some countries.<sup>17</sup> This makes statistical tables based on past trends to be of only limited value.

The considerations detailed above suggest that the initial regulatory regime should be tilted towards prudence and based on a level of complexity consistent with available skills. As discussed below, on the basis of legislative evidence, tight investment restrictions appear to have been imposed in most countries of the region.

The key objective for governments should be to build up strong and capable regulatory authorities, preferably independent from yet accountable to governments, with the discretion that would allow them to respond to changing conditions. The fact that many of the aspects of the contractual savings business are in a state of flux, with sophistication gradually increasing, suggests that regulations that are sensible today may be less so in the future. The legislative and regulatory framework should be flexible enough to reflect such improvements – for example, by allowing an increasingly wider range of permissible investments. Clearly, a restrictive regulatory regime may trade-off significant portfolio yields for the intended gain in safety. Where “safe” assets, such as government paper, carry low or negative real rates of interest, this may be a very high price to pay. This dilemma is sharpened by the relative youth of life insurance and pension plans (that is, the maturity of liabilities tends to lie far in the future); in these circumstances, real return strategies based, for instance, on equity and real estate would generally receive preference over income strategies involving more liquid, finite-term securities and deposits.

#### Current regulatory regimes

Outlines of the present regulatory framework and legislative drafts for life insurance and pension funds in the region are presented in the tables in the Annexes.<sup>18</sup> For ease of reference, key cross-country comparisons are contained in Tables 7.3 to 7.5. A number of features are worth highlighting.

<sup>11</sup> Tax treatment and regulation are discussed below in Section 7.3.

<sup>12</sup> Communication by Keith Exall, William Mercer Ltd, London.

<sup>13</sup> Defined-contribution plans are essentially savings vehicles providing no guarantee as to the eventual pay-out value of the plans, which can generally be taken out either as a lump-sum or applied to the purchase of an annuity. In defined-benefit plans, the pension income is pre-determined and a lifetime annuity after retirement would be an integral part of the plans.

<sup>14</sup> Legislation also favours defined-contribution plans in these countries. Among other things, defined-contribution plans present few problems of portability, which is a significant advantage for labour mobility in a period of great structural change.

<sup>15</sup> The discussion of the rationale for regulation draws on Skipper (1993).

<sup>16</sup> Appropriate regulation is a much-debated topic in industrialised market economies also; opposing views have, for instance, held up passage of an EC Directive on pension funds.

<sup>17</sup> Some of the social costs of transition are analysed in the *Transition Report* 1995, Chapter 2.

<sup>18</sup> The information is based on responses by supervisory authorities to a mail questionnaire and on the analysis of the relevant legislative texts where available. Responses were incomplete and the tables should not be viewed as providing a full description of the state of affairs.



Table 7.3

## Life insurance cross-country comparison of regulations

Country	Minimum capital requirement (local currency) (US\$ 000) <sup>1</sup>		Numbers of supervisory staff	Reinsurance abroad permissible	Life/non-life activity separation	Cross-border services permissible	Permissible share of foreign ownership	Taxation of premiums, investment income and benefits <sup>2</sup>
Belarus	ECU 150,000	190	40	Yes <sup>3</sup>	No	No	≤49% or branches	DTT <sup>4</sup>
Croatia	DM 1m <sup>5</sup>	674	7	Yes	No	No	Unlimited	DTE <sup>6</sup>
Czech Republic	CZK 70m	2,518	20	Yes	No	No	Unlimited	DTT <sup>7</sup>
Estonia	EEK 12m	983	11	na	Yes	No	Unlimited	TET
Hungary	HUF 250m <sup>8</sup>	1,645	35	Yes	Yes	No	Unlimited	DEE
Kazakhstan	40x min. wage	na	20	Yes	na	No	≤50%	na
Latvia	LVL 600,000	1,083	20	Yes	Yes	No	Unlimited	DEE
Moldova	MOL 50,000	110	10	Yes	No	na	Unlimited	DEE
Poland	PLZ 2m	786	22/64 <sup>9</sup>	Yes	Yes	No	Unlimited <sup>10</sup>	DTE <sup>11</sup>
Romania	ROL 25m	9	na	Yes <sup>3</sup>	No	No	No <sup>12</sup>	TEE
Russia	RUR 150m	29	200	na	No	No	≤49%	na
Slovak Republic	SKK 50m	1,645	6	No	Yes	No	≤45%	DTT <sup>7</sup>
Slovenia	ECU 800,000	1,014	6	Yes <sup>3</sup>	No	No	Unlimited	DTE
Ukraine	ECU 100,000 <sup>13</sup>	127	50	na	No	No	≤49%	na
Uzbekistan	na	na	na	na	No	No	Unlimited	na
Albania <sup>14</sup>	ALL 30m	319	—	na	na	na	≤40% or branches	na
Bulgaria <sup>14</sup>	BGL 200m <sup>15</sup>	1,053	—	na	Yes	na	≤49% <sup>16</sup>	na
Lithuania <sup>14</sup>	US\$ 1m	1,000	—	na	Yes	na	na	DEE

Source: Annex 7.1.

<sup>1</sup> Average exchange rate for June 1996.<sup>2</sup> "D": deductible; "T": taxed; "E": exempt. First position refers to premiums, second to investment income and third to benefits.<sup>3</sup> Only after exhausting domestic capacity.<sup>4</sup> Investment returns subject to VAT (20 per cent) and profit tax (30 per cent).<sup>5</sup> DM 2m for multiple classes.<sup>6</sup> Investment returns are taxed according to corporate tax.<sup>7</sup> Taxation of 15 per cent on premiums-benefits differential.<sup>8</sup> HUF 100m Organisational Capital and HUF 150m Security Capital for joint-stock life insurance companies.<sup>9</sup> 22 members employed in the Ministry of Finance and 64 in the independent supervisory office.<sup>10</sup> An informal limit of 30 per cent is applied.<sup>11</sup> Investment returns are taxed according to corporate tax (45 per cent).<sup>12</sup> Foreign insurers can establish branches for the purpose of conducting business with foreign companies only.<sup>13</sup> ECU 0.5m with foreign participation.<sup>14</sup> Draft of new law.<sup>15</sup> Reserve requirement enters in force in Jan. 1997.<sup>16</sup> After Council of Ministers approval.

Most striking perhaps is the diversity of legislation. In life insurance, cross-country variations may be partly linked to differences in the age of the legislation. Recent laws, especially in eastern Europe, have often begun to be modelled on EU Directives. Minimum capital requirements in life insurance, expressed in a common currency (Table 7.3) range from a negligible US\$ 9,000 in Romania to US\$ 2.5 million in the Czech Republic, approximately two-and-one-half times the minimum recommended by the European Union. These differences are partly explained by a combination of inflation and lags in the legislative process, but partly also by timing and progress in transition. Many countries appear to have pursued a policy of liberal entry early in the transition process to allow entrepreneurial initiative in the face of a dearth of capital, and subsequently adjusted required capital upwards to filter out non-viable ventures (by forcing them to merge or liquidate).

Another interesting feature concerns market entry by foreign providers (see Table 7.3), an issue of particular importance when countries are small. Domestic monopolies in life insurance have

been largely abolished. However, entry by foreign providers is restricted to minority holdings in joint ventures in all CIS countries except for Moldova and Uzbekistan. In contrast, most eastern European countries permit free entry, with legal restrictions only in Albania and Bulgaria (minority shareholdings) and Romania (no foreign providers allowed except branches conducting business with foreign companies). No transition economy permits the cross-border sale of policies.

Restrictions on the investment portfolios of life insurers again differ substantially across economies in transition, as they do in the industrialised market economies. Table 7.4 provides a cross-country comparison.<sup>19</sup> At the liberal end of the scale, Ukraine applies a "prudent man" rule to all asset classes.<sup>20</sup> Hungary, at the other end of the scale, closely circumscribes insurers' investment choices. With few exceptions, restrictions on share portfolios in the transition economies are tighter than in most advanced market economies, while those on real estate are broadly comparable. Another interesting feature are the minimum investment requirements for state bonds imposed by some countries (Belarus,

<sup>19</sup> In all countries except Croatia, restrictions apply to technical reserves only, therefore allowing some investment leeway for well-capitalised institutions.<sup>20</sup> The prudent man rule allows insurers to allocate their portfolios without specific restrictions, provided that investments cover liabilities in a prudent way, as judged by the supervisory authority. Consumer protection in this case relies on a significant degree of sophistication of providers and supervisors. Among industrialised market economies, only Spain allows such freedom. See Dickinson and Dinenis (1996).



Table 7.4

**Life insurance portfolio regulation**

investment limits in per cent of reserves

Country	State bonds	Corp. bonds	Listed shares	Unlisted shares	Real estate
Moldova	≥10	≤40	≤10	≤5	≤40
Russian Federation	≥10	na	na	na	≤40
Bulgaria	≤25	≤25 <sup>1</sup>	≤30	≤15	≤25 <sup>1</sup>
Hungary	≥30	≤10	≤10	≤5	≤20
Slovenia	≥30	≤25	≤10	na	≤30
Belarus	≥40	na	≤15	≤15	≤25
Croatia <sup>2</sup>	≤40	≤40 <sup>3</sup>	≤40 <sup>3</sup>	≤10	≤50 <sup>4</sup>
Kazakhstan	≤80	na	na	na	≤20
Czech Republic	unlimited	unlimited	≤10	na	≤25
Estonia	unlimited	unlimited	≤30	≤15	≤25
Latvia	unlimited	unlimited	≤30 <sup>5</sup>	≤30 <sup>5</sup>	≤25
Poland	unlimited	≤5	≤30	≤15	≤25
Ukraine	unlimited	unlimited	unlimited	unlimited	unlimited
Slovak Republic	unlimited <sup>6</sup>	unlimited	≤15	na	≤25
Romania <sup>7</sup>	statute	statute	statute	statute	statute

Albania, Lithuania, Uzbekistan – investment shares to be announced once laws are in force.

For comparison:					
G-7 countries	Mortgage loans	Other domestic (foreign) debt and debt securities	Domestic (foreign) listed shares	Unlisted shares	Real estate
Canada	unlimited	unlimited (≤10)	≤5–25 (≤10) <sup>8</sup>	≤5–25 <sup>8</sup>	≤10
France	unlimited	≤10 (unlimited)	≤65 (≤65) <sup>8</sup>	≤65 <sup>8</sup>	≤40
Germany	≤50	≤50 (≤5)	≤30 (≤6)	≤10	≤25
Italy	≤50	≤50 (≤50)	≤20 (≤20) <sup>8</sup>	≤20	≤50
Japan	≤50	≤50 (≤30)	≤30 (≤30) <sup>8</sup>	≤30 <sup>8</sup>	≤20
United Kingdom	≤10 <sup>8</sup>	≤10 (unlimited)	unlimited (unlimited)	≤10 <sup>8</sup>	unlimited
United States (New Jersey)	≤60	≤60 (≤5)	≤15 (≤5) <sup>8</sup>	≤15 <sup>8</sup>	≤10

Source: Annex 7.1 for transition economies, Dickinson and Dinenis (1996) for comparator countries.

<sup>1</sup> The limit applies to corporate bonds, mortgage loans and real estate as a whole.<sup>2</sup> As a percentage of total assets.<sup>3</sup> The limit applies to listed shares and corporate bonds as a whole.<sup>4</sup> The law is not clear on this item.<sup>5</sup> The limit applies to listed and non-listed shares as a whole.<sup>6</sup> At least 30 per cent of reserves have to be invested in bank deposits.<sup>7</sup> At present investment shares have to be agreed by the Supervisory Authority and written into the company statute. The draft of the new law will prescribe investment shares.<sup>8</sup> For these classes of investment combined.

Table 7.5

**Pension funds**

Country	Minimum capital requirement	Foreign participation permissible	Taxation <sup>1</sup>	Portability	Investment limits (in per cent of total assets)			
					State bonds and cash (min.)	Other state securities (max.)	Listed shares (max.)	Real estate (max.)
Czech Republic	CZK 20m (US\$ 750,000)	Unlimited	TTT <sup>2</sup>	Full no fee	unlimited	unlimited	unlimited	unlimited
Hungary	HUF 20m (US\$ 160,000) <sup>3</sup>	Unlimited	EEE	Full with fee	10	30	60	30
Lithuania	TBA	TBA	EET	Full no fee	TBA	TBA	TBA	TBA
Poland	TBA	TBA	EET	Full no fee	10	30	30	10
Russia	na	na	TTT	Full no fee	TBA	TBA	TBA	TBA
Slovak Republic	SKK 30m (US\$ 1 m)	na	EET	Full no fee	unlimited	unlimited	na	20

Source: Annex 7.2.

<sup>1</sup> "T": taxed; "E": exempt. First position refers to contributions, second to investment income and third to benefits.<sup>2</sup> State subsidy for contributions instead of exemption. Information refers to June/July 1996.<sup>3</sup> The minimum capital requirement of HUF 20m is required for funds established as legal entities separate from the sponsor.



Hungary, Moldova, Russian Federation and Slovenia). While these may be in part motivated by prudence, such restrictions are often meant to ensure a flow of investable funds into government debt markets.<sup>21</sup> Only in six countries do the insurance laws restrict foreign investments, but general exchange restrictions would apply in others.<sup>22</sup> It is an interesting question whether such limits reduce or, in fact, increase the riskiness of portfolios, with real exchange rate volatility traded off against the greater liquidity of foreign assets.

Reflecting differences in liabilities and the implicit real return commitment of pension funds,<sup>23</sup> investment regulation is more liberal in this sector (see Table 7.5). An important difference is that life insurance promises are often fixed in nominal terms while those of pension funds are not. Consequently, instruments with a pre-determined redemption value at maturity are a particularly important tool for the asset and liability management of insurers.

The structure and effectiveness of supervision is difficult to compare across countries. However, correspondence with the authorities suggests that supervisors tend to focus largely on entry requirements for providers. Expertise for solvency assessments in life insurance is often in short supply, and outside some of the more advanced transition economies financial information from providers is often considered to be unreliable. The number of staff of the supervising agencies is, in some cases, low by international standards (see Table 7.3).

Lastly, it is interesting to note differences in tax regimes. Taxation is a key factor determining demand for contractual savings, in particular by companies. However, since it is beyond the scope of this chapter to analyse incentive effects in detail, only a brief description of taxation is provided. In life insurance, premiums are deductible from taxable income up to certain limits in all countries for which the information was available, except Estonia and Romania.<sup>24</sup> While various countries also exempt investment income on the invested reserves and benefits accruing to individuals from taxation, others tax both. Either fiscal income objectives or the aim to provide strong incentives for purchasing insurance appear to have guided taxation in most countries, rather than the application of a consistent principle of tax neutrality (for example, between current and future consumption).

In pensions, taxation differs almost diametrically between Hungary (exemption of contributions paid by corporations, investment income and benefits) and the Czech Republic and Russian Federation (taxation at all three stages). However, the Czech Republic provides direct subsidies for contributions up to a certain level. Laws or draft laws in Lithuania, Poland and the

Slovak Republic appear consistent with savings-consumption neutrality in that savings are taxed only once in the contribution-to-benefit cycle.

## 7.4 Reform of public pensions systems and development of contractual savings

While progress in transition, macroeconomic stabilisation and strengthened government regulation serve to underpin the development of contractual savings, the structure and size of this sector in the long term will be significantly shaped by public pensions and their reform. This is particularly true of the role of private pension funds in the provision of retirement incomes. The wide variation in the size of private pensions in industrialised market economies reflects the profound impact that these policies - in conjunction with taxation - can have in the sector.

Old age and disability income protection under central planning rested on publicly managed pay-as-you-go (PAYG) pensions<sup>25</sup> and on the largely free provision of certain basic goods and services (such as health care, utilities and housing). These pension systems have come under considerable financial strain during the transition process (see Box 7.1). PAYG pensions, particularly in south-eastern Europe and the CIS, often barely cover subsistence levels and there is considerable uncertainty concerning the states' ability to honour their pension liabilities in the future. The former collective insurance against income risks has, in fact, given way to a large degree of private responsibility for ensuring personal income security. The formalisation of this state of affairs, by redefining public and private roles and methods of financing old age security, is under discussion in many of these countries. Proposals, some of which have begun to be implemented, range from slimming down the public PAYG systems to introducing mandatory, privately managed and funded "second pillars", as with recent reforms in Latin America.

### Reform proposals

Efforts to reform the public PAYG systems in most transition economies are directed at raising retirement ages, limiting occupational privileges, strengthening the link between contributions and benefits (for example, by lengthening the base for calculating pension entitlement to cover as much as possible of the working lifetime) and establishing clear rules of indexing.<sup>26</sup> These could be supplemented by provisions for voluntary, privately funded pension plans, supported within certain limits by tax incentives or subsidies.

Proposals that are gaining increasing currency in the Baltics, Hungary and Poland, however, would go beyond these reforms in changing the basic nature of mandatory pension provision by placing a large share on a fully funded, and possibly privately

<sup>21</sup> Among industrialised market economies, only Japan imposes minimum requirements on state bonds. See Dickinson and Dinenis (1996).

<sup>22</sup> In Bulgaria the permission of the Ministry of Finance is required, in Kazakhstan foreign investments are limited to 50 per cent of technical reserves, in Lithuania share investments have to be made on the National Stock Exchange, in Moldova less than 15 per cent can be invested in foreign currencies, in Poland foreign investments are explicitly excluded, and the Russian Federation requires 80 per cent of assets to be invested domestically.

<sup>23</sup> This commitment is explicit in the case of defined-benefit schemes.

<sup>24</sup> In general, deductibility applies only to contracts of a minimum duration.

<sup>25</sup> In PAYG schemes, current pension benefits are paid out of current (payroll) taxes without necessarily building reserves except for short-term liquidity. Shortfalls would be covered by budgetary transfers.

<sup>26</sup> EC Commission (1996).



## Box 7.1

## Financial strains on social security systems in the economies in transition

Public pension reform is a vast and much debated topic throughout the world.<sup>1</sup> In many countries, the issue has come to the fore since slackening economic growth and demographic ageing have combined to drive up the rates of contribution needed to sustain PAYG systems, and will do so further on the basis of demographic trends. The problems faced by transition economies represent an extreme and particularly acute version of these tendencies, sharpened by the initial contraction of incomes, the loss of administrative control over income sources and the importance of incentives (and the weight of payroll taxes) in the newly decentralised economic systems. Some evidence of the financial pressures is contained in the adjacent table.

## Several points are noteworthy:

Demographic dependency ratios (number of people over 60 divided by the number of those aged 20-59) in many transition economies are comparable to those in industrialised market economies. However, populations in the Caucasus, Central Asia and Poland tend to be younger.

Combined with an inherited nearly universal coverage of pensions systems and often high income replacement ratios,<sup>2</sup> this explains why the share of pensions in GDP in a large number of transition economies is approximately the same as in the industrialised market economies and far higher than in countries of comparable per capita income in Latin America and East Asia.

The share of pensions in GDP, however, varies significantly among transition economies, and tends to be much greater in eastern European countries than in the Baltics and CIS. In some cases, this reflects lower demographic dependency ratios, but more crucially it is a consequence of differences in the real value of pensions.

A large share of pensions in GDP points to a significant financial burden on the active population. This situation is worsened by the large wedge between the demographic dependency ratio and the system dependency ratios (number of contributors to the public pension schemes divided by the number of current beneficiaries). The difference arises from the relatively low general retirement ages and occupation-specific privileges, substantial early retirement as part of enterprise restructuring efforts, and tax avoidance and evasion (by joining the informal sector). A particularly extreme case is Bulgaria, where almost one pensioner is "supported" by each contributor.

While conditions obviously vary between countries, the combination of the above tends to result in: (i) high and increasing contribution rates, further strengthening the incentive for system evasion – payroll taxes to finance public pensions range from 20 per cent in Estonia to 45 per cent in Poland, whereas the highest rate in the European Union (Italy) is 27 per cent; (ii) low pension benefits, placing many pensioners on subsistence incomes and thus reducing the attractiveness and insurance value of the public pensions system; and (iii) increasing recourse to general budgetary revenues, adding to existing fiscal pressures. In their present form, public pensions systems in many transition economies may therefore be unsustainable.

<sup>1</sup> There are many publications on the topic. See World Bank (1994), Vittas and Skully (1991) and Arrau and Schmidt-Hebbel (1995) on reforms in developing market economies. Comprehensive pension reforms, generally in the direction of funding and the creation of personal accounts, have been implemented with growing frequency in Latin America (Chile 1981, Mexico 1991, Peru 1993, Argentina and Colombia 1994) and in some industrialised market economies (Switzerland 1985, Australia 1992).

<sup>2</sup> The ratio of pension benefits to final (or some average) income.

## Public pension systems in transition economies, selected countries

Country	Male retirement age <sup>1</sup>	Demographic dependency ratio <sup>2</sup> (in per cent)	System dependency ratio <sup>3</sup> (in per cent)	Pension expenditures (in per cent of GDP)	Year
Albania	–	17	37	5.9	1994
Armenia	65 <sup>4</sup>	22	34	6.7	1994
Azerbaijan	60	19	–	4.7	1995
Belarus	60	33	49	10.3	1995
Bulgaria	60	37	87	8.0	1995
Czech Republic <sup>5</sup>	60	32	42	9.1	1995
Estonia	60	32	52	6.7	1995
Georgia	60	30	45	11.0	1992
Hungary	60	36	59	10.3	1994
Kyrgyzstan	60	20	34	2.4	1993
Latvia	60	33	51	9.8	1995
Lithuania	60 <sup>6</sup>	30	53	4.8	1994
Moldova	60	26	–	4.1	1994
Poland	60	28	49	14.6	1995
Romania	60	29	62	6.5	1993
Russian Federation	60	31	46	5.5	1993
Slovak Republic <sup>5</sup>	60	32	42	9.9	1995
Slovenia	–	29	54	13.7	1994
Ukraine	60	36	–	8.0	1995
Uzbekistan	60	15	34	2.6	1993

Averages<sup>7</sup>

Eastern Europe,				
Baltics and CIS	60.0	30.0	48.3	7.3
Asia	55.5	15.3	11.4	1.9
Latin America	60.8	14.9	21.0	2.0
OECD Countries	64.4	32.9	39.2	9.2

Source: Fox (1993), The World Bank (1994), IMF, OECD and local authorities.

<sup>1</sup> 1991

<sup>2</sup> Number of people over 60 divided by the number of those aged 20-59, 1990.

<sup>3</sup> Ratio of contributors to the public pension schemes over current beneficiaries, 1990.

<sup>4</sup> 1996.

<sup>5</sup> Male retirement age, demographic dependency ratio and system dependency ratio refer to the former Czechoslovak Republic.

<sup>6</sup> 1994.

<sup>7</sup> All averages are weighted except for the system dependency ratio of Asia, Latin America and OECD.

managed, basis with individual retirement accounts. From the point of view of social security finance, the main advantage of such a system lies in the direct link it establishes between individual contributions and benefits. While this link could in principle be achieved within PAYG systems, the greater flexibility and lack of transparency of these tend in practice to prove too great a political temptation. In the short term, lower contributions and higher benefits are politically attractive.

Movement towards fully funded pension schemes would also have an important impact on other parts of the economy. In labour markets, elimination of ex-ante income redistribution, particularly in defined contribution schemes,<sup>27</sup> can lessen the incentive for tax avoidance, which is strong in some PAYG schemes (for instance, by

<sup>27</sup> Defined benefit plans, whether on an individual or group basis, have an insurance feature and thus lead to ex-post redistribution of incomes. On an ex-ante basis, redistributive features may be built into occupational defined-benefit plans as part of employer-designed incentives.



Table 7.6

**Asset structure of pension funds (1994) and life insurance (1989)**

Arranged by increasing portfolio share of equities in pension funds – in per cent

	Share of assets invested in equity		Share of assets invested in fixed income incl. mortgage loans		Percentage of assets invested in real estate		Percentage of assets invested in short term and other investments	
	Pension funds	Life insurance	Pension funds	Life insurance <sup>1</sup>	Pension funds	Life insurance	Pension funds	Life insurance
Germany	11	4	75	88	11	6	3	3
Switzerland	11	6	64	76	16	16	9	3
Denmark	22	11	65	81	9	3	4	5
Japan	29	22	63	44	3	6	5	29
Netherlands	30	na	58	44	10	8	2	18
Belgium	36	14	47	72	7	8	10	7
United States	52	6	36	86	4	3	8	6
Ireland <sup>2</sup>	55	49	35	35	6	8	4	8
United Kingdom	80	56	11	23	6	16	3	5

Sources: Pension funds - De Ryck (1996). Life insurance - Dickinson (1993).

<sup>1</sup> Corresponds to bonds, mortgage loans and other loans.<sup>2</sup> Data for life insurance refer to 1995; Source: Irish Insurance Federation.

joining the informal sector).<sup>28</sup> In the capital markets, pensions funding could have a rapid and profound effect on the volume and structure of the supply of funds. Under certain plausible conditions, national savings rates would rise, with beneficial effects on investment and the balance of payments (see Chapter 6). Proponents therefore point out that, as a result of efficiency gains and faster accumulation of capital, mandatory funded pensions pillars could stimulate economic growth.<sup>29</sup> It should be noted, however, that experience with these schemes is still limited outside a few developed, primarily “Anglo-Saxon” economies, and the response of economic aggregates has proved to be very hard to identify.

While these arguments may ultimately sway the debate in some countries in favour of the introduction of mandatory funded schemes, there are difficult challenges which would need to be overcome.<sup>30</sup> Chief among them is to ensure that old-age incomes are sufficient and savings are adequately protected. The states’ responsibility in this respect is particularly important where schemes are mandatory. Another issue that needs to be addressed is the pace of “transition” from the present system to a funded one.<sup>31</sup> While such reforms are being debated, contractual savings in transition economies will continue to be based on voluntary contributions. To the extent that the institutions which support this sector are built up and strengthened in the process, it will be easier in the future to transfer a greater share of mandatory retirement provision to a privately managed, fully funded basis.

## 7.5 Contractual savings and financial market development

The growth of contractual savings institutions can contribute to the development of a country’s financial markets in important ways, but growth is also dependent on operating conditions in those markets. A number of characteristics set contractual savings institutions apart from other intermediaries and determine both their need for supporting financial services and instruments and their influence on financial market developments. Potential benefits relate to the product and maturity structure of markets, to financial innovations and to institutions supporting financial services. Greater efficiency in financial intermediation, particularly at the long-term end of the market, could enhance growth and facilitate economic restructuring.

### Contractual savings and capital market structure

The contractual savings industry can shift the structure of demand for financial assets towards longer maturities. Apart from regulatory requirements and taxation, the selection of long-term portfolios in this sector is primarily a function of the nature of liabilities. The average duration of liability cash flows tends to be – contractually or actuarially<sup>32</sup> – long and relatively firmly predetermined. On the one hand, this time horizon permits investment strategies based on long-term real returns – for example, by taking positions in equity and property. On the other hand, the interest guarantee implicit in many life insurance contracts (and defined

<sup>28</sup> Distortions of labour market decisions in PAYG systems, compared with pensions based on personal retirement accounts, can have various sources. They affect labour demand where minimum wage legislation prevents the cost of payroll taxes from being fully shifted to the worker. They affect labour supply in the formal sector where there are redistributive features built into the pensions formula. For example, in defined benefit PAYG schemes, the relation between real interest rates and wage growth is important. When the real interest rate is higher than the rate of real wage growth, the present value of future benefits can be lower than that of contributions.

<sup>29</sup> A key condition is, naturally, that there are adequate investment opportunities so that the marginal productivity of capital does not fall significantly. This is a complex question which goes beyond the objectives of this chapter (a discussion can be found in Arrau and Schmidt-Hebbel, 1995). The conditions for capital market efficiency, which are related to this issue, are taken up in Section 7.5.

<sup>30</sup> Succinct discussions of the challenges of pension systems reform can be found in Arrau and Schmidt-Hebbel (1995), de Fougères (1995) and Diamond (1993).

<sup>31</sup> The basic problem is that current contributors (or tax payers) are doubly burdened under a “transition”, first by the need to sustain pensioners who did not have an opportunity to build up personal pension accounts, and second by the need to save for their own pensions. Governments have in fact a large implicit pension liability which needs to be addressed. A good discussion and simulations of “transition” in the transition economies can be found in World Bank (1994) and Fox (1993).

<sup>32</sup> The maturity of whole-life and term-life policies and annuity contracts is actuarially predetermined in the sense that the timing of cash flows can be derived from mortality tables on an expected but relatively certain basis.



Table 7.7

**Asset structure of personal sector, 1990**

In per cent

	Equity	Bonds	Loans	Deposits <sup>1</sup>	Life insurance and pension funds
UK	12	4	0	29	47
Netherlands	6	8	0	29	54
Germany	6	18	0	48	22
Italy	22	18	0	49	12
France	34	3	0	51	12
Canada	21	6	2	39	28
Australia	17	13	0	34	36
US	19	10	1	30	33
Japan	13	5	0	53	23

Source: Davis (1995).

<sup>1</sup> Liquidity and deposits.

benefit pension plans) exposes them to risks which suggest that contracts be matched by assets of broadly similar duration.<sup>33</sup>

An analysis of the structure of personal financial assets in industrialised market economies reveals that the “indirect” portfolio of households held via pension plans and life insurance policies tends to be far heavier in equities and long-term fixed income securities than direct investment portfolios (compare Tables 7.6 and 7.7). This is quite generally true in spite of sharp differences in the particular choices of long-term instruments across these countries.<sup>34</sup> While the share of personal financial assets in liquid form and in bank deposits ranges from 29 per cent (United Kingdom) to 53 per cent (Japan), short-term investments of contractual savings institutions represent generally less than 10 per cent of their assets. In the United Kingdom, where funded pension plans are particularly prominent, domestic pension funds alone accounted for 34 per cent of all shares listed on the London Stock Exchange in 1993, with a further 17 per cent held by insurance companies and only 18 per cent by individuals.<sup>35</sup>

The particular structure of the balance sheets of contractual savings institutions could have significant benefits for investment and public finance in the transition economies. External funding for enterprise investment is often available only to a select number of “blue chip” companies and even then tends to come only in the form of short-term debt.<sup>36</sup> Wider availability of equity finance would help to reduce leverage and thus sensitivity to short-term shocks. Longer-term finance more generally, via equity and corpo-

rate bonds, would reduce refinancing risks for capital investment. A lengthening of the average maturities of capital supply would extend yield curves and, to the extent that yield curves at meaningful maturities are presently defined at all, may make them less steep. If the aggregate volume of financial savings is raised by the greater diversity of instruments available to households this would exert downward pressure on the cost of capital, given that financial markets in the transition economies are not fully integrated internationally. Government debt finance by means of domestic securities could benefit in similar ways.

There are interesting financial complementarities between commercial infrastructure and contractual savings. Investment amortisation periods in commercial infrastructure tend to exceed the current debt maturity frontier in all transition economies by a wide margin. At the same time such investments can offer stable long-term cash flows which are attractive to the contractual savings sector. This issue is taken up in Chapter 4.

### Product innovation

Financial innovation refers to the creation of new instruments which repackage financial risks or returns.<sup>37</sup> Given their potential importance, contractual savings institutions can have a significant influence on the creation of instruments that meet their particular requirements, such as protection from the effects of inflation on long-term contracts, liquidity and – at a greater level of sophistication – hedging strategies. Inflation-indexed instruments that prevent the erosion of nominal claims – which have not yet been introduced to the region<sup>38</sup> – could be especially valuable in the environment of the transition economies.<sup>39</sup> The liquidity requirement of contractual savings institutions – referring to rapid marketability at stable values – could also stimulate the securitisation of financial claims.<sup>40</sup>

While some innovations may not be on the immediate agenda in transition economies, the experience of Chile demonstrates that even relatively undeveloped financial sectors can with some efficiency create securities “tailor-made” to suit the needs of contractual savings institutions (see Box 7.2). This increases the marketability of long-term loans backed by real assets and could thus stimulate bank lending to sectors such as housing, commercial real estate and utilities. Chile also permits the issuing of fixed-income CPI-indexed bonds in the secondary market backed by CPI-indexed mortgage loans, provided a bank guarantees the bonds.<sup>41</sup>

<sup>33</sup> Interest rate risk arises if investments are held too short such that interest rates may fall and remain low when funds require reinvestment, or that funds are held too long and increases in rates depress the market value of fixed income securities.

<sup>34</sup> Broadly speaking, differences in portfolio structure are explained by differences in the depth of securities markets, in the structure of liabilities, in regulatory restrictions and in investment culture (Davis, 1995; De Ryck, 1996).

<sup>35</sup> The balance was accounted for by unit trusts (6.6 per cent), foreign entities (16.3 per cent) and other UK based investors (7.9 per cent) (De Ryck, 1996).

<sup>36</sup> See *Transition Report* 1995, Chapters 5 and 10, for evidence on the structure of enterprise funding.

<sup>37</sup> See Davis (1995).

<sup>38</sup> However, in early September 1996, the Bulgarian National Bank announced that it planned to introduce securities whose yields would be linked to inflation.

<sup>39</sup> Inflation-hedging is particularly important where pension promises or pension-related insurance are linked to final salaries. In many industrialised market economies, apart from the United Kingdom, authorities have been reluctant to permit or encourage inflation indexation in the financial markets for fear that this would contribute to inflation inertia. The argument appears to rely primarily on a political economy rationale that unprotected savers would constitute an effective constituency against overly expansionary monetary policies.

<sup>40</sup> Securitisation refers to the pooling of non-liquid assets (such as mortgage or other loans, credit card receivables etc.) as backing for the issuance of tradable securities.

<sup>41</sup> See Arrau, Valdes-Prieto and Schmidt-Hebbel (1993).



Box 7.2

Capital market development in Chile<sup>1</sup>

The Chilean experience shows that the process of capital market deepening is strongly encouraged by the growth of pension funds. In December 1981, seven months after contributions to private pension funds became mandatory, 99 per cent of portfolios (amounting to 1 per cent of GDP) were invested in government debt and bank instruments, including mortgage-backed securities. By December 1991, private pension funds reached US\$ 12.2 billion or 32 per cent of GDP. Of this amount, 23 per cent was invested in corporate equities, 16 per cent in corporate bonds, and 12 per cent in mortgage bonds. Additional long-term reserves are kept by insurance companies to back annuity pensions. While certain aspects of the organisation of the Chilean pensions system have been subject to debate - such as the relatively high administrative and marketing costs of funds competing for contributors - its contribution to the development of the capital market is not in doubt.

The strong growth of the capital market was reflected by the following features, as shown in the table in this box:

<sup>1</sup> Based on Arrau, Valdes-Prieto and Schmidt-Hebbel (1993).

- (i) Stock market capitalisation increased from about 20 per cent of GDP in 1981 to 88 per cent in 1991-92. After a 1991 stock price increase that raised average price-earnings ratios to 14, closed companies have shown a growing trend to go public and to accept standard record-keeping and auditing practices, encouraged by better access to pension fund financing.
- (ii) Bonds have been placed directly by large companies into pension funds and insurance companies. The bond market has been improved by a new risk-classification industry, which also classifies bank securities and insurance company annuities.
- (iii) The life insurance sector has grown rapidly to provide survivorship and invalidity reinsurance to pension fund management companies and annuity pensions to pensioners of the new system.
- (iv) Other institutional investors like mutual (open-ended) funds and foreign investor funds have emerged, increasing the diversity of market participants.
- (v) The trading volume of fixed-income securities has grown dramatically, although stock turnover is still low.

Capital market developments in Chile 1980-92

	Stocks	Fixed income instruments (In per cent of GDP)	Stock market capitalisation	Corporate bonds	Mutual funds	Foreign capital country funds	Insurance company reserves (US\$ million)	Gross domestic product	Pension funds
1980	1.8	0.2	29.9	51	714	—	na	27,600	—
1981	1.1	0.3	20.7	96	681	—	na	32,600	298
1982	0.6	3.3	22.7	415	611	—	584	24,300	876
1983	0.3	5.6	13.3	266	188	—	454	19,000	1,265
1984	0.2	5.8	12.7	203	104	—	515	19,200	1,653
1985	0.3	10.7	13.2	101	125	—	427	16,000	1,743
1986	1.7	25.5	23.9	64	215	—	458	16,800	2,254
1987	2.6	31.1	27.5	149	295	—	566	18,900	2,936
1988	2.8	37.3	30.2	440	375	—	753	22,100	3,644
1989	3.3	48.8	37.6	906	364	106	1,031	25,400	4,998
1990	2.8	50.5	40.5	1,349	479	502	1,313	27,800	7,364
1991	6.0	38.6	88.6	1,889	908	1,023	1,834	31,300	10,773
1992	5.5	60.4	87.6	2,064	910	1,244	2,655	37,700	12,243

Source: Arrau, Valdés-Prieto, Schmidt-Hebbel (1993).

“Architecture” of financial markets

A final and important aspect of financial market development relates to the institutions that inform and facilitate securities transactions and that protect the rights of claimants. Again, the potential contribution of insurers and pension funds derives from their particular needs. Given their limited ability to monitor asset quality directly (compared with commercial banks), contractual savings institutions are dependent on published financial information and third-party credit assessments in order to contain transaction costs. Prudent insurance companies and pension funds have therefore an interest in supporting the development of a wide range of services, such as credit rating, accounting and auditing services.

For reasons of prudence and regulation, contractual savings institutions tend to invest in companies on a portfolio basis and not as

controlling investors. Each institution on its own thus tends to have only a modest influence on the issuer or obligor. In some industrialised market economies, the influence of institutional investors has thus been credited with improvements in disclosure standards, listing requirements and other legislation protecting the rights of minority shareholders.<sup>42</sup> Where formal legislation is still lacking, their financial prowess – compared with individual investors – can generate the necessary pressure and incentives for such standards to be implemented. In the process, they may nudge financial markets towards practices that are rule-based (rather than informal) and transparent. Reflecting the portfolio nature of their individual holdings, the contribution of contractual savings institutions to enterprise governance tends to rely more on the threat of “exit” than on “voice”, although a more active involvement has been registered in South Africa.<sup>43</sup>

<sup>42</sup> Including for instance protection against insider dealing, pre-emption rights, equal voting rights, and equal rights in take-overs.

<sup>43</sup> See Vittas and Michelitsch (1995).



From a development perspective, it is important to note that most of these factors carry positive externalities. These arise from the fact that other capital market participants may also benefit from them.

### Financial market preconditions and positive feedback

While the discussion so far suggests that contractual savings institutions could contribute to financial sector development in the transition economies, there is a problem of sequencing reforms and institutional development. On the dimensions of capital market development distinguished above – the breadth and depth of markets and the quality of supporting institutions – most transition economies still perform rather poorly (see Chapter 2 of this Report and Chapter 10 of the 1995 *Transition Report*). As long as there are few safe and liquid assets to invest in, and the architecture of financial markets remains incomplete – with transaction costs correspondingly high – it is hard for fund managers to build satisfactory risk-return profiles. Risks would tend to rise the greater the volume of funds relative to existing market size. But when funds are small, the positive feedback effects that might arise are limited. There is thus a question of what the minimum conditions are for setting this process in motion, and what investment strategies could be adopted in the present financial settings.

Contractual savings institutions cannot step ahead of the development of competitive banking systems. For their liquidity management, they need to rely on deposits handled with reasonable efficiency, and rapid and large transactions require well-functioning payment and settlement systems operating at low cost. However, deposits alone are a poor basis for long-term investment strategies. Among higher-yielding instruments, well-organised and active markets in government debt, offering a broad range of maturities, would generally be the first to meet the contractual savings sector's criteria for risk, return and duration. Teething problems of domestic securities markets could be altogether side-stepped by investing abroad. However, for significant portions of the portfolio this would be sensible only where real exchange rates have achieved a certain degree of stability. In many countries, restrictions would be imposed by balance of payments policies.<sup>44</sup>

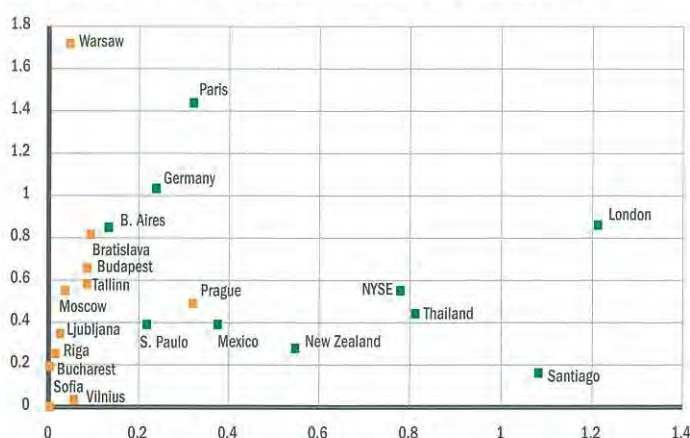
As discussed on a country-by-country basis in Chapter 2 (Annex 2.1), banking systems in the transition economies are generally at an intermediate stage of development. However, government securities issues are still quite uncommon in the region. In 1995 the only countries with a significant volume of new domestic government bond issues of over one-year duration were Bulgaria (which issued new bonds equivalent to 5.9 per cent of GDP), Hungary (2.4 per cent), and the Czech Republic (1.7 per cent). Shorter-term issues are developing rapidly in a wide variety of countries, including, for instance, Albania, Kazakhstan, Lithuania, Poland

and the Russian Federation. With inflation continuing to fall, and pressure on governments to develop non-inflationary deficit finance, demand by contractual savings institutions could stimulate a lengthening of maturities.

The scope of privatisation in the region and the growing liquidity of stock markets could allow a relatively early role for investments in company shares. Stock market profiles are still influenced by the chosen privatisation mode, with initial capitalisation and the number of listings relatively high in countries such as the Czech Republic, the Russian Federation and the Slovak Republic, which implemented voucher privatisation schemes. As shown in Chart 7.1, the stock market capitalisation in the Czech Republic in mid-1996 compared well with some western European countries. Nevertheless, as activity and share prices have picked up recently in markets such as Budapest and Tallinn (which gave preference to direct sales in their privatisation programmes) and Warsaw (where broad-based privatisation got under way only recently),<sup>45</sup> capitalisation has also risen substantially.<sup>46</sup> Liquidity, as measured by the ratio of turnover to capitalisation, appears to be quite high in some of the stock markets of the region. However, there is evidence that activity is often concentrated in a small number of “blue-chip” shares, while trade in others is limited for reasons such as poor asset quality or a lack of market transparency.<sup>47</sup>

Chart 7.1

### Characteristics of share markets in mid-1996 1



Source: FIBV 1995 Annual Report, 1996 World Economic Forum, local exchanges

1 Prague and Bratislava, listed shares. Listed and unlisted shares for all other transition economies. Data for non-transition economies refer to 1995.

Bolivia's “capitalisation” programme, elements of which have entered the discussion in countries such as Poland, could provide an additional avenue for pension fund equity investment.<sup>48</sup> The programme entails the transfer of shares in certain valuable assets held by the state (for example, oil and gas sectors and utilities) to pension funds, thus offsetting part of the pension liability of

<sup>44</sup> From the perspective of the contractual savings sector's contribution to financial market development, foreign investment would obviously be somewhat counterproductive, but the achievement of safe and sufficient returns for old age and life contingencies should be the principal motive in guiding placement policies.

<sup>45</sup> Monthly turnover on the Warsaw stock exchange multiplied almost by a factor of three between 1995 and the first half of 1996.

<sup>46</sup> Note that for Prague, Bratislava and Warsaw, as well as all non-transition economies, only listed shares are reflected in Chart 7.1. For other transition economies, the line was hard to draw and both listed and unlisted shares are reflected.

<sup>47</sup> The low liquidity of many stocks in Russia appears often to reflect the unwillingness of insiders (among the main beneficiaries of privatisation) to relinquish control.

<sup>48</sup> See Sinn and Sinn (1996) for a description of this programme.



governments to previous contributors to the PAYG scheme and making explicit the attribution of assets to earlier “savers”. Management control and shares proportionate to the contribution of fresh investment finance are assigned to strategic investors.

This discussion suggests that policies should support a step-by-step build-up of contractual savings, avoiding large demand surges for financial assets but aiming for positive feedback to financial sector development. The Chilean experience, in which a contractual savings sector was built virtually from scratch under difficult macroeconomic conditions, again provides a useful reference (see Box 7.2).

Lastly, could contractual savings institutions destabilise the banking system? Efficient securities markets backed by substantial contractual savings could provide strong competition to the bank loan market. This competition is beneficial for savers and investors but could be problematic where banks are forced to maintain high margins as a result of bad loan portfolios, a common problem in many transition economies. Highly rated borrowers may be driven away from banks and into securities markets, forcing banks into more risky business segments. While these points have to be acknowledged and banks should ready themselves for the competition, developments on securities markets are unlikely to be so fast as to be immediately threatening. In the longer term, the evolution of a new division of labour for banks and securities markets is natural and raises economy-wide efficiency.

## 7.6 Concluding remarks

Contractual savings have received relatively little attention so far in the discussion of the transition towards market economies. However, a close look at the characteristics of the contractual savings sector and the evidence from other countries suggest that it has significant potential to contribute both directly and indirectly to progress in transition. Key points in this chapter are that contractual savings can facilitate the reform of financially strapped public pension systems in the region, as well as contribute to the development of local capital markets and the institutions which support them. However, effective and enduring contractual savings institutions require effective regulatory frameworks and minimum conditions regarding financial markets. A significant role for contractual savings belongs to more advanced stages of transition rather than earlier ones.

In developing contractual savings, there is an important role for governments and foreign companies and scope for external support from official sources and international financial institutions (IFIs). Governments can contribute to the development of the contractual savings sector above all by protecting consumer interests. This should be supplemented with measures that strengthen property rights and transparency in the capital markets. The participation of foreign providers in building up a contractual savings sector should be sought – rather than hindered as is the case in some countries of the region – since this can help to overcome the shortage of skills, capital and confidence which represent major

bottlenecks in the development of the sector. Finally, IFIs and official donors such as the European Union can support this process by providing technical assistance to governments and providers of contractual savings products, and through capital participations in local and foreign contractual savings institutions.

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## Albania

**Law of**  
draft

### General issues

Life insurance activity started in March 1996. The state-owned Insurance Institute is to be privatised. Insurance companies may take the form of joint-stock companies and mutual insurance companies.

### Investment regulation

(Art. 45) Insurers can invest in bank deposits, short and long-term state bonds, listed and unlisted shares, real estate and other. Portfolio restrictions are yet to be announced.

### Supervision and disclosure

An Insurance Supervision Committee will be created with the power to grant, suspend and revoke licences; to request from insurers any information and documents necessary for auditing; to conduct on-site inspections; and to impose sanctions. The draft law is fairly detailed on issues such as mergers and divisions, liquidation and rules on foreign companies. (Art. 87) Insurers shall publish systematically documents according to the Insurance Supervision Committee directives.

### Market entry

Minimum capital requirement for joint-stock companies is 30m leks. Foreign participation is permitted up to 40% of capital. Foreign companies can obtain authorisation to perform insurance activity through branches. Cross-border services are not permitted.

### Taxation

na

### Product regulation

Insurers may be authorised to provide supplementary insurance for risk of body injury, accidental death and disability stemming from an accident or death.

## Belarus

**Law of**  
13/10/95

### General issues

Insurers may be represented by state organisations, joint-stock companies, limited or additional liability companies. Reinsurance abroad is permitted after saturation of the domestic market and with the authorisation of the insurance supervisors. Life and non-life activities are not separated.

### Investment regulation

(Art. 36) Investment of reserves shall obey principles of diversification, profitability and liquidity. Insurers can invest technical reserves in the following assets with the following limits: state bonds >40%; municipal bonds <10%; bank deposits <20%; shares <15%; real estate <25%.

### Supervision and disclosure

There is an independent State Insurance Surveillance Body (SISB) with 40 staff and an annual budget of US\$ 75,000. (Art. 40) The SISB issues, suspends and revokes licences. (Art. 41) It monitors the compliance with the legal requirements and can apply sanctions for violations of the law. It decides upon compulsory liquidation. The SISB determines a solvency margin. (Art. 38) Insurers shall publish an annual audited financial statement in the form and terms set by the SISB.

### Market entry

Minimum capital requirement is ECU 150,000. (Art. 6) Foreign participation in domestic insurers is limited to 49%. Foreign insurers can open branches but cannot sell foreign policies. Cross-border services are not permitted.

### Taxation

Insurance premiums are tax deductible. Investment return subject to value added tax of 20% and profit tax of 30%. Benefits taxed according to the income tax law.

### Product regulation

Actuarial rules for premium calculation are approved by the SISB. Insurers can sell the following policies: pure endowment, pure life, annuity insurance.

## Bulgaria

**Law of**  
draft of 01/06/92

### General issues

(Art. 9) Life and non-life insurance activity are separated. (Art. 13-16) Insurers may operate as joint-stock companies or mutual societies.

### Investment regulation

(Art. 48) Insurers may invest the insurance fund only in Bulgaria and with the following limits: state bonds and other securities guaranteed by the state <25%; bonds of local companies, mortgage loans and real estate <25%; listed shares <30% (<10% of the nominal value of the stock of the acquired company); unlisted shares <15% and only in companies submitting an annual balance sheet. Investments abroad are permitted subject to authorisation by the Ministry of Finance.

### Supervision and disclosure

(Art. 25) The Department of Insurance Supervision (DIS) has the power to grant licences after approving a business plan for the first three years of operation; to revoke licences; to resolve on mergers; (Art. 27) to inspect the overall activity of the insurers; to place an insurer in liquidation. It determines solvency margins. (Art. 28) Insurers have to submit to DIS an annual balance sheet together with the necessary enclosures regarding the state of each type of insurance. There has been no insurance supervision to date.

### Market entry

The minimum capital requirement is 200m leva (in force from January 1997). Foreign joint ventures with a foreign ownership limit of 49% are permitted after approval from the Council of Ministers. No foreign insurers are permitted to enter the market until 2002. Cross-border services are not permitted.

### Taxation

na

### Product regulation

na



## Croatia

**Law of**  
10/02/94

### General issues

(Art. 4) Insurance activity may be performed by joint-stock companies and mutual insurance companies. Life and non-life activities are not separated. (Art. 7) Reinsurance abroad is permitted.

### Investment regulation

(Art. 54) Investment in real estate and private shares is permitted up to 50% of total assets with a limit of 10% for any one investment in real estate. Investments in loans secured with mortgages <40% of total assets. Investments in listed shares and other securities such as bonds <40% of total assets.

### Supervision and disclosure

The Supervisory Directorate for Insurance Companies (SDIC) employs 7 staff. (Art. 59) The SDIC issues licences after approving a business plan for the first three years of activity; it suspends and revokes licences; it controls the accuracy of annual financial reports; it monitors the compliance of insurers' activity with the law; declares liquidation. (Art. 13) Life insurance companies must appoint a reserve manager. (Art. 60-61) Insurers must publish annual financial reports.

### Market entry

Minimum capital requirement DM 1m, increasing to DM 2m if the company covers various classes of insurance. There are no privileges for public insurers. Foreign participation is permitted without limits in domestic companies or through the establishment of a new company. Cross-border services are not permitted.

### Taxation

Insurance premiums are tax deductible except when they are paid by employers on behalf of employees. Investment returns are taxed as any other corporate income. Benefits are tax exempt.

### Product regulation

Insurers can sell the following policies: pure endowment, pure life, annuity insurance, mixed life insurance.

## Czech Republic

**Law of**  
26/04/91.  
Amends: 09/12/93; 23/02/94; 29/03/95

### General issues

(Sec. 2) Insurance activity may be performed by joint-stock companies and cooperatives. A blocked account with a security deposit has to be opened prior to submitting a licence application. Life and non-life activities are not separated. Reinsurance abroad is permitted.

### Investment regulation

(Art. 9 law 1994) Technical reserves can be invested in state bonds; bonds issued by banks; corporate bonds; real estate (<25%); listed shares (<10%); bank deposits, with <15% of bank capital stock for any one deposit; more than 20% of reserves cannot be deposited in any one single bank.

### Supervision and disclosure

The Department of Financial Markets Insurance Sector and Pension Funds (Supervisory Authority: SA) in the Ministry of Finance employs 20 staff. (Sec. 17-23) The SA issues, revokes and suspends licences. It can impose fines (Sec. 11) and recommend specific policies to be adopted by the insurers. The SA decides on liquidation and mergers. Solvency requirements are in line with EU directives but not established by the law. (Sec. 15a) Insurers must document their solvency to the SA. Annual financial statements must be published.

### Market entry

There is a minimum capital requirement of CZK 70m. Foreign participation is permitted in the form of joint-stock companies with no participation limits. No cross-border services permitted.

### Taxation

Insurance premiums are tax deductible. Returns on investment are taxed. A flat 15% tax is paid on the difference between benefits and paid premiums.

### Product regulation

Actuarial rules for premium calculation are approved by the SA. Insurers can sell the following policies: pure endowment, pure life, annuity insurance.

## Estonia

**Law of**  
11/1992.  
Amends: 15/02/95; 13/03/96

### General issues

(Art. 24) Insurers may operate as joint-stock companies and mutual insurance associations. Life and non-life activity are separated.

### Investment regulation

(Art. 49) Investment of technical reserves can be made in the following assets and with the following limits: state bonds, Bank of Estonia bonds and securities issued by local authorities; corporate bonds; mortgage loans and bank deposits: no limits; real estate (except for agricultural), <25%; listed shares, <30%; non-listed shares, <15%. Investment in non-listed shares is permitted only if investee companies submit their annual reports to the insurance companies.

### Supervision and disclosure

There is an independent supervisory authority employing 11 staff. (Art. 60) The Estonian Insurance Supervisory Authority (EISA) has the right to grant, suspend and revoke licences. (Art. 63) It has the right to verify the solvency of companies. (Art. 64) It has the power to demand additional reports other than the annual report requested by the Law on Statistics; to conduct audits on premises. Solvency regulations are in line with EU directives but not established by the law. The Law on Statistics requires insurance companies to report annually to EISA but there is no legal obligation to publish financial statements.

### Market entry

(Art. 29) The minimum capital requirement is EEK 12m. There is no restriction on the participation or foundation of subsidiary companies by foreign insurers. Cross-border services are not permitted.

### Taxation

Insurance premiums are not tax deductible. Investment returns are tax exempt. Benefits are taxed according to the income tax law. Life insurance companies are taxed at 1% on net collected premiums only.

### Product regulation

Actuarial rules for premium calculation are approved by the EISA but no standard tables are yet in force. Insurers can sell the following policies: pure endowment, pure life, annuity insurance, and mixed life insurance where benefits depend on marriage or birth.



## Hungary

### Law of

01/01/96

### General issues

(Sec. 6) Insurers may operate as companies limited by shares, cooperatives or mutual associations. (Sec. 45) Life and non-life activities are separated. Reinsurance abroad is permitted.

### Investment regulation

(Sec. 84-89) The law contains detailed prescriptions regarding the investment of assets. In particular (Sec. 86) insurers have to keep >30% of liquid assets in state bonds and domestic securities issued by the central bank. Insurers may keep <25% of liquid assets in bank deposits; <10% in corporate bonds; <20% in real estate; <10% in listed shares; and <5% in non-listed shares.

### Supervision and disclosure

The State Insurance Supervising Authority (SISA) employs 35 staff. It is an independent body reporting to the Ministry of Finance. (Part 8) The SISA issues insurance licences after approving a regulated business plan. (Chpt IV) SISA can impose fines, restrict activity, withdraw licences, institute liquidation proceedings. The insurer must employ a senior actuary, legal adviser, head of accounting and internal auditor with high professional experience. (Sec. 92-93) (Schedule 5) The law specifies the method of calculation of the minimum solvency capital. The government regulates the content of the annual report. (Part 10) Special rules apply to the disclosure of insurance secrets in case of suspected drug trafficking, money laundering, terrorism, illegal arms trade.

### Market entry

There are two minimum capital requirements: companies limited by shares have a (Sec. 46, 2a) minimum "organisational" capital requirement of HUF 100m and a (Sec. 80, 1a) minimum "security" capital requirement of HUF 150m. Foreign participation is permitted in the form of joint-stock companies or cooperatives with no limits on the foreign shareholding. Cross-border services are not permitted although companies operating in foreign trade can take insurance abroad.

### Taxation

Insurance premiums are tax deductible up to a HUF 50,000 ceiling. Investment returns are tax exempt. Benefits are tax exempt.

### Product regulation

There are no official actuarial rules for premium calculation set by the SISA, but these have to be agreed by both insurers and SISA through a compulsory licensing system for new products. (Schedule 2) Insurers can sell the following policies: pure endowment, pure life, annuity insurance; life insurance with risk related to marriage and birth.

## Kazakhstan

### Law of

Decree 03/10/95

### General issues

The law does not specify the legal form that insurance companies can take, referring instead to the Civil Code. (Art. 8) Reinsurance abroad is permitted.

### Investment regulation

(Art. 37) Insurers shall invest insurance reserves with the following portfolio limitations: state securities <80%; real estate <20%; bank deposits <80% with a limit of 50% of total deposits in any one bank; foreign currency and securities in foreign currency <50%. Listed and non-listed shares are not mentioned by the law.

### Supervision and disclosure

The State Insurance Authority (SIA) employs 20 staff. (Art. 40) The SIA issues, suspends and revokes licences and monitors the compliance with the normative. No business plan for the first years of activity is required to obtain a licence. (Art. 42) The SIA carries out audits on established reports. On-site inspections are not mentioned by the law. (Art. 38) As a guarantee for solvency, the maximum obligation of an insurer in a single agreement cannot exceed 10% of the amount of the insurer's own resources. Although the law provides that SIA has to audit financial reports it does not establish the compulsory publication of reports.

### Market entry

The minimum capital ("the charter fund") requirement is 40 times the minimum wage irrespective of organisational form and type of ownership. Foreign participation is permitted up to 50 per cent of shares. (Art. 11) No cross-border services permitted.

### Taxation

Private persons: Insurance premiums are tax deductible. Legal persons: Insurance premiums are not tax deductible and have to be accompanied by a tax payment of 30%. A tax of between 5% and 50% is paid on the difference between benefits and paid premiums.

### Product regulation

There are no official actuarial rules for premium calculation set by the SIA due to the lack of actuaries. (Art. 5) Any interest of a citizen or a legal entity may be subject to insurance except for unlawful interests.

## Latvia

### Law of

08/01/95.

Amended; 24/08/95 (Superv.)

### General issues

(Art. 3) Insurers can be joint-stock companies and mutual insurance associations. Life and non-life activities are separated. Reinsurance abroad is permitted.

### Investment regulation

(Art. 17) A prudent man rule for investment is accompanied by the following limits: investment in any one single company, <10% of technical reserves; 30% investment limit in listed and non-listed shares; 25% in real estate. No limits are imposed on state bonds, NBL securities and bank deposits.

### Supervision and disclosure

The State Insurance Supervision Inspectorate (SISI) within the Ministry of Finance employs 20 staff. (Art. 3, 24 and 26) The SISI issues, suspends and revokes insurance licences. The SISI (Art. 18) determines the solvency margin to be respected by the insurer. (Art. 28) A protection fund compensates 100% of losses in case of insolvency of life insurers. A separate law "On State Insurance Supervision Inspectorate" regulates the supervision activity of the SISI. (Art. 8) Insurers shall provide the SISI with all requested information irrespective of the confidential nature of the documents. Annual financial statements shall be audited by the SISI.

### Market entry

Minimum capital requirement of 600,000 lats. The only state company will be privatised and does not enjoy any privileges. Foreign participation is permitted with no limits. Cross border services are not permitted.

### Taxation

Private persons: Insurance premiums are tax deductible. Legal persons: Insurance premiums are tax deductible only for contracts lasting more than five years. Investment returns are tax exempt. Benefits are tax exempt.

### Product regulation

Insurers are free to sell new products provided they send a copy of the contract to the SISI. No official tables are used for the calculation of premiums and the SISI does not employ actuaries. A new amendment of 07/08/96 in force from January 1997 will require life insurance companies to employ at least one actuary.



## Lithuania

### Law of

draft of new law

### General issues

Insurers may operate as joint-stock companies and mutual insurance associations. Life and non-life activities are separated.

### Investment regulation

Reserves may be invested only in government bonds, corporate bonds, mortgage loans, real estate (except agricultural), shares listed in the national stock exchange and bank deposits. Investment limits are to be set by the Ministry of Finance.

### Supervision and disclosure

At present the supervision is performed by the Board of Insurance Affairs (BIA) which is to be reorganised into the State Insurance Supervision Institution (SISI) under the new law. The BIA consists mainly of insurance company representatives. The SISI will determine new solvency margins and capital adequacy requirements once operational. Life insurance companies should employ at least one actuary. There are no special requirements for information disclosure at the moment. The new law will require mandatory auditing and publishing of annual reports.

### Market entry

Minimum capital requirement of US\$ 1m. The State insurance company has monopoly over mandatory insurance. This covers some types of property insurance of legal entities and life insurance of some professions.

### Taxation

Insurance premiums are tax deductible up to four times the minimum wage. Investment returns are tax exempt. Benefits are tax exempt.

### Product regulation

No official tables are used for the calculation of premiums but in practice such premiums have to be agreed within the BIA. Insurers are free to sell pure endowment, pure life, annuity insurance and other life insurance policies with benefits linked to marriage or birth. Supervision on products is very limited.

## Moldova

### Law of

15/06/93

### General issues

Corporate bodies of any legal and organisational form, established to exercise insurance activities are recognised as insurers. Life and non-life activities are not separated. Reinsurance abroad is permitted.

### Investment regulation

Insurers may invest resources with the following limits: government paper >10% of reserves; real estate <40%; bank deposits <40%; non-government securities <40%; loans to policyholders <30%; foreign currency <15%; cash >5%.

### Supervision and disclosure

The supervisory office within the Ministry of Finance employs 10 staff. It issues, suspends and revokes licences. It has the duty to control that tariffs are based on sound grounds. It has the power to request information from insurers and auditors. Insurers have to submit detailed quarterly profit accounts and balance sheets. Failure to do so may mean suspension.

### Market entry

Minimum capital requirement of MOL 50,000. Foreign participation is permitted with no limits.

### Taxation

Insurance premiums are tax deductible. Investment returns are tax exempt. Benefits are tax exempt.

### Product regulation

There are no specific restrictions on policy terms and price. Term assurance, health and disability insurance are currently marketed.

## Poland

### Law of

28/07/90.

Amends 08/06/95

### General issues

Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. Life and non-life activities are separated. Reinsurance abroad is permitted.

### Investment regulation

(Art. 63) Insurers may invest reserves only in Poland and with the following limits: non-state bonds <5%; real estate <25% (<5% for any one single estate); listed shares <30%; non-listed shares <15%; bank deposits <20%.

### Supervision and disclosure

There are two bodies supervising the insurance market. The Department of Insurance within the Ministry of Finance employs 22 staff and is responsible for licensing and legislation matters. The State Insurance Supervision Office (SISO) employs 64 staff and is responsible for current supervision. (Art. 82) The SISO shall issue, suspend and revoke licences; inspect insurance activity; attend general meetings. Solvency regulations are in line with EU directives but not established by the law. (Art. 46) The insurer is obliged to report quarterly and annual financial statements to SISO signed by the management and actuary. The insurer shall present to the Ministry of Finance, together with the balance sheet, a calculation of the solvency margin and evidence of the possession of own funds in the amount of the solvency margin.

### Market entry

(Art. 39–39a) By law, there is no limit on foreign participation but there is an informal limit of 30%. Full foreign entry is to be permitted after 1999 in the form of branches and agencies. The creation of companies with foreign participation requires the permission of the Ministry of Finance. Minimum capital requirement of PZL 2m. Cross-border services are not permitted.

### Taxation

Insurance premiums are tax deductible. Investment returns are taxed according to a corporate tax of 45%. Benefits are tax exempt.

### Product regulation

Actuarial rules for premium calculation are approved by the Department of Insurance in the Ministry of Finance and their application is controlled by the SISO. Insurers can sell different types of policies: pure endowment, pure life, annuity insurance or mixed insurance.



## Romania

### Law of

47/91; 547/91; 136/95

### General issues

(Art. 3) Insurers may operate as joint-stock companies and limited liability companies. (Art. 10) There is no separation between life and non-life activities but separate accounting is required. (Art. 6) Reinsurance abroad is permitted after saturation of the domestic market.

### Investment regulation

(Art. 20) Insurers can invest part of their capital and reserves in bonds, real estate and bank deposits, subject to limits stipulated in the company statute.

### Supervision and disclosure

Within the Ministry of Finance (MoF) the Office for Supervision of Insurance and Reinsurance Activity (OSIRA) grants, suspends and revokes licences. With the observance of the law 136/95, insurers contribute with 0.5% of gross premiums to a Protection Fund managed by the MoF through the OSIRA. OSIRA can call extraordinary meetings of shareholders and decide on partial or total termination of activity. Insurers have to publish annual financial reports.

### Market entry

Minimum capital requirement of ROL 25m. Foreign insurers can establish branches for the purpose of conducting business with foreign companies only. In all other cases joint ventures only are permitted. (Art. 6) No cross-border services are permitted.

### Taxation

Insurance premiums are not tax deductible. Investment returns are tax exempt. Benefits are tax exempt.

### Product regulation

Insurers can sell the following policies: with-profits endowment, term assurance, annuities.

## Russia

### Law of

01/01/93

### General issues

(Art. 2) Insurance activity may be conducted in the form of "insurance organisations" or mutual insurance societies. (Art. 28) There is no separation between life and non-life activities although separate accounting is required.

### Investment regulation

Insurers may invest total reserves in the following assets and within the following limits: >10% in securities issued by the state and local authorities; <40% in real estate (with a maximum of 50% of total real estate investments in any one investment); <50% in bank deposits (with a maximum of 40% of total bank deposit investments in any one deposit); <10% in foreign currency (for insurers forming reserves in roubles only); >5% in current accounts used for supporting current insurance payments. Not less than 80% of total reserves should be placed in the territory of Russia.

### Supervision and disclosure

The State Insurance Supervision Office of the Russian Federation (Rosstrakhnadzor) employs 200 members of staff and it has 18 regional offices. It grants licences after approving a feasibility study and a business plan for the first year of activity. It can also suspend and revoke licences. In the first half of 1996 Rosstrakhnadzor pulled 266 insurance (life and non-life) licences and another 230 licences were suspended. Rosstrakhnadzor determines formats of accounting and reporting; it has the right to request documentation in addition to the annual reports; it can impose sanctions; it controls adequacy of tariffs and solvency of insurers. The minimum solvency ratio (defined by the ratio of total assets over total liabilities) is 5% of reserves for life insurers; for mixed insurers it is 5% of life reserves and 20% of non-life reserves. At present, there is no on-site inspection. (Art. 29) Insurers must publish annual accounts after verification by independent auditors. Rosstrakhnadzor is to be disbanded and its functions assigned to the Ministry of Finance.

### Market entry

Minimum capital requirement of RUR 150m. Foreign insurers are only admitted in joint ventures with maximum participation of 49%. No cross-border services permitted.

### Taxation

Insurance premiums on short-term policies are not tax deductible for both private and legal persons. Investment returns are taxed at a profit tax of 13%. Benefits are tax exempt only when premiums are paid by beneficiaries.

### Product regulation

na

## Slovak Republic

### Law of

24/1991.

Amends: 25/92; 197/92; 306/95; 136/96

### General issues

(Art. 2) Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. Life and non-life activities are separated. (Art. 10) A deposit of SKK 1m has to be made when applying for a licence. Reinsurance abroad is not permitted.

### Investment regulation

(Art. 13 306/95) At least 30% of reserves must be invested in bank deposits. (Art. 9 136/96) Insurers cannot invest more than 15% of technical reserves in any one bank. Investment of technical reserves is limited to: <25% in real estate; <20% in mortgage bonds; <15% in listed and non-listed shares. Insurers can invest in state bonds, deposit certificates and other securities issued by municipalities and economic institutions.

### Supervision and disclosure

The Department of Insurance within the Ministry of Finance is in charge of supervision and employs 6 staff. (Art. 17-21) The Ministry of Finance grants, suspends and revokes licences and verifies the solvency of companies. It can levy fines and suggest corrective measures. The Ministry of Finance (Art. 14a 306/95) has to continuously inspect the legality and regularity of the activities conducted. Solvency regulations are in line with EU directives but not established by the law. On site inspections are not mentioned by the law. Information disclosure is required by the Civil Code and Commercial Law, according to the insurer's legal form.

### Market entry

Minimum capital requirement of SKK 50m. (Art. 5 197/92) Foreign insurers are only admitted in joint ventures with 45% as maximum participation. Contracts can be concluded in foreign currency. No cross-border services permitted.

### Taxation

Insurance premiums are tax deductible. Investment returns are taxed. A flat 15% tax is paid on the difference between benefits and paid premiums.

### Product regulation

Actuarial rules for premium calculation are provided by the Statistical Office. However, insurers are not forced to comply with these rules. Insurers can sell different types of policies: pure endowment, pure life, annuity insurance or mixed insurance.



# Slovenia

Law of  
11/94

**General issues**

Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. There is no branch separation between life and non-life activities, although separate accounting is required. Reinsurance abroad is permitted once domestic capacity is exhausted.

**Investment regulation**

(Art. 75) Insurers have to invest >30% of mathematical reserves in government bonds. Insurers may invest mathematical reserves with the following limits: <30% in domestic real estate; <25% in listed bonds; <10% in listed shares with a limit of <1% in any individual investment.

**Supervision and disclosure**

The Insurance Supervisory Authority (ISA) within the Ministry of Finance employs 6 staff and several consultants on a temporary basis. (Art. 91) The ISA grants licences subject to the approval of a business plan; it also may suspend and revoke licences. (Art. 94) The ISA may inspect on the premises all books, book-keeping documents and other acts. (Art. 99) Insurers shall establish internal supervision in order to continuously inspect the legality and regularity of the activities conducted and are fined for failing to do so. (Art. 71) The solvency margin is set at 4% of mathematical provisions multiplied by the higher of the percentage of own shares over gross annual premiums and 85%. (Art. 72) A life insurance guarantee fund is to be not less than SLT 120m. (Art. 75) Insurers shall keep a regular list of investment by types to be submitted to the ISA twice a year.

**Market entry**

Minimum capital requirement of ECU 800,000. Majority participation by foreign insurers is possible. No cross-border services permitted.

**Taxation**

Insurance premiums are tax deductible for policyholders. Insurance companies have to pay 5% tax on collected gross premiums. Investment returns are subject to a profit tax of 25%. Benefits are tax exempt.

**Product regulation**

Mortality and population tables exist but standards for mathematical reserves are still to be set. The Slovenian Insurance Bureau (Association) has to adopt insurance standards set by the ISA.

# Ukraine

Law of  
07/03/96

**General issues**

Insurance activity can be conducted in the legal forms established by the law "on economic companies". Mutual insurers are permitted. Life insurers may not transact in other classes and separate accounting is required. (Art. 44) Foreign citizens and legal persons enjoy equal rights to Ukrainian citizens and legal persons. Reinsurance abroad is permitted.

**Investment regulation**

(Art. 30) Insurance reserves may be invested in bank deposits, real estate, state and non-state securities and long-term credits according to a prudent man rule.

**Supervision and disclosure**

The Committee for Supervision of Insurance Activity (CSIA) employs 50 staff. (Art. 16) The CSIA sets requirements for insurance contracts. (Art. 36) The CSIA issues insurance licences after approving a regulated business plan; it establishes the rules for formation and allocation of reserves. The CSIA may impose administrative fines and institute liquidation proceedings. (Art. 34) Insurers shall publish their audited annual balance sheet in the format established by the CSIA. (Art. 32) A Fund of Insurance Guarantees may be set up in the form of a separate legal person.

**Market entry**

(Art. 29) Minimal statutory fund of ECU 100,000 (ECU 500,000 with foreign participation). Foreign participation is permitted with a maximum participation of 49%. No cross-border services permitted.

**Taxation**

na

**Product regulation**

Policy conditions are set by the regulator but official actuarial rules are not enforced due to the lack of actuaries in the CSIA.

# Uzbekistan

Law of  
06/05/93;  
Amended: 26/09/94

**General issues**

na

**Investment regulation**

The law does not specify investment limits and almost 100% of reserves are deposited with banks.

**Supervision and disclosure**

There is no supervisory and licensing body. There is no regulation on minimum reserve requirements. Insurers have to publish annual financial reports.

**Market entry**

Foreign participation is permitted through branches or joint ventures. No limits on shareholdings are mentioned by the law. No cross-border services permitted.

**Taxation**

na

**Product regulation**

na

Source: Country legislation and communication with supervisors.



# Czech Republic

Law of  
16/02/94

**General issues**

The law refers to private funds for old age pensions determined on a voluntary defined contribution basis only. Invalidity pensions can be organised also on a defined benefit basis. The pensionable age for an old age pension may be not less than 50 years of age. Participation in more than one pension fund is forbidden. There is full portability after 12 months of contributions.

**Investment regulation**

Any proportion of the fund can be invested in bonds and shares listed in the stock exchange and real estate. Restrictions on investment apply to any one particular company and share issues. International investments are not precluded.

**Fund control, supervision and disclosure**

A Board of Directors deals with the day-to-day management of funds. Effective influence of members on fund governance is limited. A supervisory board monitors the activities of the fund. State supervision is guaranteed through the Ministry of Finance which authorises new funds and has the right to attend members' meetings and inspect documentation. Pension funds have to publish financial reports twice a year.

**Market entry**

There is a minimum capital requirement of CZK 20m to form a pension fund.

**Taxation**

Pension funds are not subject to VAT or insurance tax. The government supplements contributions with direct transfers. Contributions, investment returns and benefits are all taxed.

# Hungary

Law of  
01/11/93

**General issues**

The law on Voluntary Mutual Benefit Funds (VMBFs) covers the provision of both defined benefit and defined contribution schemes. Provision and membership are voluntary. The fund can be paid out at retirement as a lump sum payment or transformed into an annuity. An asset manager may be appointed and 33 funds out of 200 have one.

**Investment regulation**

Assets in which funds can invest are divided into four classes with equity and property falling into the most hazardous class. Funds worth less than HUF 10m can invest only in the first two classes. Funds worth more can invest in all four classes with the following limitations: >10% in state securities with less than one year maturity and one-year deposits; <30% in other state and National Bank securities and mortgage bonds; <60% in listed shares and bonds, and bonds of more than one year maturity backed by mortgages; <30% in non-listed shares, bonds, security documents issued by municipalities, land and unencumbered property, and member loans.

**Fund control, supervision and disclosure**

A Board of Directors deals with day-to-day management, control of the fund lies in a General Meeting of members and a supervisory board monitors the activities of the VMBF. State supervision is guaranteed through the Pension Funds Supervisory Committee. This grants licences to new funds after the approval of a financial plan. It has the right to attend members' meetings, inspect documentation, nominate an independent auditor and impose fines. It decides on merger, splitting and liquidation of funds. At the end of the financial year, the Board of Directors has to draw up a financial plan for the following year. An insurance of at least 30% of the book value of the assets must be taken.

**Market entry**

Funds can be established on a regional, occupational or trade basis with a minimum of 15 members. No minimum capital requirement exists for mutual pension funds. A minimum capital requirement of HUF 20m is required for funds established as legal entities separate from the sponsor. Funds can be foreign owned but must have domestic establishment.

**Taxation**

Contributions made by employers are exempt from social security tax (42.5%) up to HUF 20,000 per person. Employees can deduct 50% of the total contributions from taxable income up to an annual HUF 100,000. Benefits are tax free after three years of membership.

# Lithuania

Law of  
draft

**General issues**

At present there is no law on non-state pension funds. According to the draft law, non-state pension funds will be fully funded, defined contribution schemes with voluntary participation, subject to compulsory participation to the social security system. Pension accounts are fully portable and can be inherited without any restriction during the period of contribution.

**Investment regulation**

Pension funds may invest only in securities recognised by the Securities Commission. The law will specify relative shares.

**Fund control, supervision and disclosure**

The Securities Commission will be in charge of granting licences, subject to the approval of a business plan for the first four years of operation. It seems that a separate supervisory authority will not be created. The Securities Commission has the right to suspend, revoke licences and assign a temporary administrator for a suspended pension fund. Pension funds have to submit reports to the Securities Commission twice a year. Reports are public. Once per quarter, the board of a pension fund must submit to all participants information on their accounts.

**Market entry**

Minimum capital requirements and terms for foreign participation will be determined by the Securities Commission.

**Taxation**

Employees' contributions are tax deductible up to 15% of salary. Employers' contributions are deductible up to the same percentage of total salaries.



## Poland

**Law of**  
draft

### General issues

At present there is no law on non-state pension funds. The draft law establishes two types of pension funds: 1) corporate funds and 2) funds open for individual membership. Pension funds will be created on a defined contribution basis and will be voluntary. Full portability is assured. A fund member will acquire the right to obtain pension benefits after reaching the statutory retirement age (60 for men and 55 for women), given at least 10 years membership of the fund. Physical disability represents an exception and entitles to a disability pension until reaching retirement age.

### Investment regulation

The law will define the investment policy of the funds along the following lines (suggested guidelines of the draft law in brackets): what part of capital may be invested abroad and in what investments; what minimum part of capital should be invested in state bonds and National Bank securities (>30 – 40%); what minimum part of capital should be held in cash or short-term securities (>10%); what maximum part of capital may be invested in listed shares (<30%); non-listed shares (<5 – 10%); real properties (<5 – 10%); what maximum level of investment in securities of the same issuer would be admissible.

### Fund control, supervision and disclosure

The State Pension Fund Supervision Office will be created with the power to issue, revoke and suspend licences; to approve pension plans; to decide on the liquidation of the fund; to exercise current supervision of compliance with the law and statutory principles of investing the fund capital; to make recommendations. A special Guarantee Fund managed by a state supervisory authority will be created in order to cover losses incurred by funds in case of bankruptcy of a bank or an insurer. The capital of the Guarantee Fund will consist of 1%–2% of each pension fund capital.

### Market entry

Minimum capital requirements and terms for foreign participation will be determined by the State Pension Fund Supervision Office.

### Taxation

Employees' contributions will be income tax deductible up to a percentage to be defined.

## Slovak Republic

**Law of**  
01/07/96

### General issues

According to the law, pension funds can be established as the result of an agreement between employers and employees (trade unions). The law establishes that accounts are fully portable. Benefits can be withdrawn in the form of a lump sum or as annuities managed by the pension fund.

### Investment regulation

Pension funds can invest in the sponsor up to 10 per cent of their assets; in listed shares with a limit of 5 per cent for any one issue; in real estate with a limit of 3 per cent of assets for any one investment and a cumulative limit of 20 per cent of assets. Other asset classes are not restricted by specific maxima.

### Fund control, supervision and disclosure

Pension funds are managed by employers and employees, although employees cannot be appointed to the management and supervisory boards. The government of the Slovak Republic has 6 months from the time of application for licensing pension funds with the approval of the Ministry of Finance and the Ministry of Labour. Among the documents to be provided in the licence application there has to be a business plan with a projection for the first years of activity. All documents are public.

Supplementary pension insurance companies are required to create reserve funds at a level of at least 0.5 per cent of their annual income for the purpose of covering unexpected fluctuations in economic operations. The state does not guarantee the solvency of the pension funds but monitors their economic activity and observance of the law. The Ministry of Finance decides on mergers with the approval of the anti-monopoly commission. In case of compulsory liquidation the Ministry of Finance appoints a liquidator and the bankruptcy law is applicable. Pension funds are required to produce annual financial reports and provide the Slovak Statistical Office with all requested information.

### Market entry

Pension funds have to be non-state entities with a minimum capital requirement of SKK 30m.

### Taxation

Contributions enjoy tax advantages. Employees' contributions are tax deductible. Employers' contributions are considered an expenditure item up to 3 per cent of the wage bill. Investment returns are tax exempt while benefits are taxed at a special rate of 15%.

Source: Country legislation and communication with country supervisors.