Investment in pension and insurance sector

Summary of the Operation Performance Evaluation Review

THE PROJECT

This report covers two operations, referred to as ‘the project’. In these two operations, the EBRD made, and then withdrew from, minority equity investments in the companies of a financial services group (the group) active in the EBRD’s region. First, the EBRD invested in the national holding company of the group in one country. The EBRD then exchanged its shares in the national holding company for shares in the regional holding company of the group, and bought more of those shares. Lastly, the EBRD sold part of its acquired shares to the group’s controlling shareholders and swapped the remainder for shares in the group’s national holding company– its previous starting point. Shortly thereafter, the group exercised its call option and repurchased all of the EBRD’s shares in the national holding company.

PROJECT RATIONALE

The aim of the project was to achieve a substantial transition impact by promoting the development of capital markets, increasing the intermediation capacity of the financial sector and contributing to the implementation of comprehensive pension reform.

At the time of the EBRD’s investment, the financial sector was not fulfilling its intermediation role, and developing a functioning capital market was seen as a critical challenge. The EBRD’s aim was to develop the country’s insurance sector by participating in the privatisation of one of the country’s biggest insurance companies, and through post privatisation strategies. In addition, the EBRD wanted to invest in pensions fund managers and identified a suitable pension fund management firm. By maintaining an active policy dialogue with the authorities, the EBRD hoped to be able to be at the forefront of reforms. Having an early presence in the pensions market put the company in a good position to benefit from the introduction of mandatory private insurance.

ACHIEVEMENT OF OBJECTIVES

Overall, the project’s achievement of the following objectives was rated *Good*. They were:
- to promote the development of capital markets;
- to increase intermediation capacity in the sector, and to roll out new products;
- to contribute to comprehensive pension reform, and to provide an alternative to the state pension system;
- to contribute to corporate governance and sound business practices;
- to support health reforms and private health insurance.

OVERALL ASSESSMENT

Overall, the project was rated ***Successful***, showing good performance against most indicators.

The project’s transition impact, both realised and potential, was rated *Good.* The project made strong contributions to post-privatisation work, sector competition and market expansion, as well as supporting pension reform in the target country. The risk to potential transition impact was rated *Low*, as the involved firms were mainly established leaders in the group’s key markets. The group’s management recognised that the EBRD’s investment enabled it to follow through on the privatisation process, and also recognised the contribution that the EBRD made to corporate governance. This project had the capacity to be even more successful as the group expanded into leasing and consumer finance. However, the diverging objectives of the EBRD and the group led to the EBRD's early exit from the investment.

The achievement of objectives was rated *Good*. The Bank's investment performance was rated *Good,* achieving an acceptable net internal rate of return. Company and project financial performance were rated *Satisfactory*: the group's firms were meeting solvency requirements in their markets, but the costs of growth generally and adverse taxation in one of the target countries constrained their profitability. Bank handling was rated *Good*: the sponsor was a leading and aggressive player in its field and its main firms in the target countries were market leaders. The EBRD's early exit was unavoidable due to differences about strategic direction and the pace and manner of growth. Environmental performance was rated *Good,* while environmental change was rated *None*, as the project mainly concerned insurance and financial investment.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The project's transition impact, both realised and potential, was rated *Good*. Developing pension and insurance markets takes several decades of work. While the Bank was involved for only a five-year period from 1999-2004, the group was well chosen, with a competitive management team. The insurance company has been successfully privatised, the pension fund management firm has become a strong force in the pensions business, and capital markets have benefited from their contribution as long-term investors in domestic financial assets. In one of the target countries, where the pension reforms have yet to be fully formulated, much less implemented, the progress and professional approach of one of the insurance groups has been impressive and the company provides strong competition in the market.

The group supported the local management of its firms and spurred their development through skill transfer and good recruitment policies. The project increased competition in the sector and attracted new entrants, including leading international firms, to the market. This then expanded the supply of financial services. The growing industry has also created thousands of jobs in the brokerage and agency segment.

The Bank's Evaluation Department (EvD) rated additionality as *Verified in all respects.* The risks posed in the markets were material but acceptable. The sponsor was an aggressive, entrepreneurial firm whose strategy was to enter markets early in partnership with local firms, which was a source of risk. At the time when these initial investments were made, the group was the only investor of its kind operating in the insurance and pensions sector within the region, and its policy was to invest in "second tier" companies before most of the established players had contemplated entering the market.

BANK HANDLING

Bank handling was rated *Good* overall. Due diligence was carefully exercised and the EBRD selected the sponsor well and enjoyed a good working relationship with senior management within the group. Being appointed to the supervisory board, in particular, enabled the EBRD to exercise and encourage good corporate governance, and this was welcomed by the group. The shareholder agreements granted the Bank certain powers over reserved matters such as mergers and acquisitions and changes to the business plans. However, exercising these powers created a strain that eventually led to first the EBRD, and finally the group itself, applying the exit mechanism.

MAIN OPER ISSUES AND LESSONS LEARNED

Long-term strategic planning is vital in equity investments. Divergence over strategic direction can lead to untimely exit. At entry, the Bank and the investee firm should agree a general strategic plan, plus a financing plan, including financial policies such as leverage and liquidity. A carefully planned budget and a rolling five-year financial strategy, approved annually at supervisory board level, may signal difficulties in advance and help to avoid untimely exits.

Legislation to protect consumers must be a priority when developing insurance and pension fund markets. It will become increasingly important to ensure that legislation is developed to protect customers from the risk of the mis-selling of pension fund and insurance products. In addition to ensuring that adequate legislation and reform is in place at company/industry level, companies investing in immature markets will have to assist in developing adequate legislation to protect consumers. Also, industry associations should adopt codes of conduct and best practice. The EBRD can support these efforts by encouraging its partners to take an active role in such associations and in initiatives to foster good market practice. Technical cooperation monies could be used for this.

The selling of insurance and pensions should be monitored. Where insurance supervision is developing and consumer protection is negligible, ongoing market intelligence at a local level should be used to monitor the market practice of companies. This will enable EBRD representatives at supervisory board level to influence a response to adverse actions.

Investors in pension fund firms should take a long-term view. Pension fund management companies must be given a seven-to-ten-year period to achieve their potential and to demonstrate profitability. This will also enable the EBRD to demonstrate its genuine desire to achieve a readily recognisable return when helping companies in both the transition process and also commercially. The role of the EBRD is to undertake risk and to enable such companies and markets to achieve viability. This requires the EBRD to take a long-term perspective.

Government action to implement pension reform is vital. The government of the target country must actively develop and implement pension reforms in order to create the industry in a reasonable period of time.