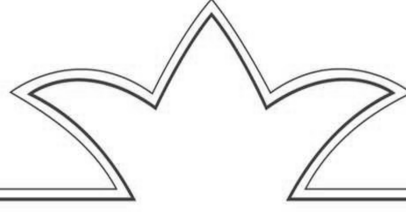

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The Role of Nonbank Financial Intermediaries

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Abstract

The state of development of nonbank financial intermediaries (NBFIs) is a good indicator of the financial system's development as a whole. NBFIs include all the financial institutions which are not classified as commercial banks. Such institutions have the common characteristic of mobilizing savings and facilitating the financing of different activities, but they do not accept deposits from the public at large. NBFIs play an important dual role in the financial system. On one hand, they complement the role of commercial banks by filling the gaps in their range of services. On the other hand, they compete with commercial banks, thus forcing them to be more efficient and responsive to the needs of their customers.

This paper focuses on contractual savings institutions, namely pension funds and life insurance companies — their role and the determinants of their growth. It also offers a brief review of the role and development of leasing and factoring companies, as well as the insurance sector, venture capital companies and mutual funds. Besides presenting an overview of the developments of that sector in a number of selected countries, a section is devoted to examining the recent growth of NBFIs in Egypt, especially that of contractual savings institutions and securities market. The paper concludes that greater openness is key to the growth of the NBFIs sector.

ملخـــــص

تعد درجة تطور مؤسسات الوساطة المالية غير البنكيه مؤشر جيد لمدى تطور النظام المالى. وتضم مؤسسات الوساطة المالية غير البنكيه كافة المؤسسات الماليه باستثناء البنوك التجارية. هذا، وتتميز هذه المؤسسات بخاصيه مشتركه ألا وهى تعبئة المدخرات وتسهيل تمويل الأنشطة المختلفة، مع عدم قبولها إيداعات الجمهور بشكل عام. وتلعب هذه المؤسسات دوراً مزدوجاً: فمن ناحية، تقوم هذه المؤسسات بدور تكميلى لدور البنوك التجارية عن طريق تنويع الخدمات التى تقدمها؛ ومن ناحية أخرى، تقوم بدور منافس للبنوك التجارية، مما يساعد على رفع مستوى كفاءة تلك البنوك وعلى سرعة استجابتها لمتطلبات العملاء.

تركز هذه الورقة على دراسة الأبعاد المختلفه لمؤسسات الادخار التعاقدى وخاصة صناديق المعاشات وشركات التأمين على الحياة. وبصفة خاصة يتم التركيز على دور تلك المؤسسات وعلى محددات نموها، وكذلك تطور دور شركات البيع الايجارى وشركات تحصيل الديون التجارية والصناديق التعاونية. وبالإضافة إلى ما تقدم يتم تحليل التطورات الأخيرة فى قطاع مؤسسات الوساطة المالية غير البنكية فى مصر وخاصة مؤسسات الادخار التعاقدى وسوق الأوراق المالية، وذلك فضلا عن تحليل تطور هذه المؤسسات فى مجموعة أخرى من الدول المنتقاه. وتنتهى الدراسة إلى أن مزيدا من الانفتاح يعد أمرا حتميا لنمو قطاع مؤسسات الوساطة المالية غير البنكيه.

I. Introduction

Nonbank financial intermediaries (NBFIs) are a mixed bag of institutions. Traditionally, they included all financial institutions not classified as commercial banks. Since the assimilation of building societies and other thrift deposit institutions with commercial banks as institutions that accept deposits as well as make loans, NBFIs have come to include mainly leasing, factoring and venture capital companies as well as various types of contractual savings and institutional investors — pension funds, insurance companies and mutual funds. The common characteristic of these institutions is that they mobilize savings and facilitate the financing of different activities, but do not accept deposits from the public at large.

NBFIs play an important dual role in the financial system. They complement the role of commercial banks, filling gaps in their range of services, but they also compete with commercial banks and force them to be more efficient and responsive to the needs of their customers. Most NBFIs are also actively involved in the securities markets and in the mobilization and allocation of long-term financial resources. The state of development of NBFIs is usually a good indicator of the financial system's development as a whole.[1]

This paper focuses on contractual savings institutions, namely pension funds and life insurance companies, which are by far the most important NBFIs. Before discussing their role and the determinants of their growth, however, the paper offers a brief review of the role and development of leasing and factoring companies. There is also a brief discussion of the insurance sector, and venture capital companies and mutual funds. Although this paper offers an overview of developments in selected countries in different regions of the world, a section is devoted to examining the recent growth of NBFIs in Egypt, especially that of contractual savings institutions and securities markets. The paper concludes by offering policy recommendations for greater openness as the key to growth of the NBFI sector.

[1] The exception is when the development of commercial banks is held back by restrictive regulations. The Republic of Korea is often given as an example of a country where NBFIs have been encouraged to grow at the expense of commercial banks and where by implication the state of development of NBFIs may exaggerate the overall development of the financial system (World Bank 1989).

II. Leasing and Factoring

With a number of important advantages over traditional bank lending, leasing and factoring companies have experienced significant growth in most countries around the world (IFC 1996) (*Table 1, p. 20)*. Leasing companies retain ownership of the leased asset and are able to repossess it more easily in cases of customer default. They can thus overcome the effects of weak collateral and enforcement regulations that hinder commercial bank lending to small and medium-size enterprises. Leasing companies also benefit from the preferential tax treatment conferred on investments in fixed assets and capital equipment. They can apply the accelerated depreciation allowances to profits originating from other business ventures, while sharing some of the tax benefits with lessees. Leasing companies employ specialist staff and follow more focused procedures in dealing with customers. They are often established as joint ventures between equipment manufacturers and financial institutions and thus benefit from the technical support of their founders. They have important information advantages over commercial banks as well as better marketing strategies.

The use of specialized staff and procedures is perhaps the main strength of factoring companies, which usually have a better collection record than that of commercial banks. Thus, leasing and factoring companies are ideally suited for supporting the finance and growth of small and medium-size firms, and they can play an important role in countries where economic and social development is dependent on a thriving small and medium enterprise (SME) sector. Leasing companies may also facilitate foreign direct investment since they are often established as joint ventures with foreign institutions. In this respect, they play an important role in the transfer of financial technology and know-how.

Leasing and factoring companies may also have a beneficial effect on the development of the financial sector. They obtain term finance from commercial banks, allowing them to engage in maturity transformation and earn a higher spread without undue risk.[2] But they can also obtain financing from other financial institutions, such as

[2] This presumes that leasing and factoring companies have a diversified portfolio of credit-worthy projects and are well capitalized. But, as highlighted by the recent experience of banks in Japan, Thailand and other East Asian countries, this result will not be obtained if the banks use specialized subsidiaries to bypass strict prudential controls and fail to apply normal prudential standards when they lend to their own leasing and factoring subsidiaries.

pension funds and insurance companies, which provide profitable outlets for their accumulated financial resources. Leasing companies have stimulated the development of the corporate bond market in many countries by being among the first issuers of medium- to long-term bonds. And more recently, they have given a boost to asset-backed securitization by securing their receivables.

The development of leasing and factoring requires an appropriate enabling regulatory framework, including a clear and supportive tax treatment and an openness to entry of specialized foreign firms that can transfer financial technology and provide links with foreign manufacturers. Many developing countries, starting with the Republic of Korea in the late 1970s, have supported the establishment and growth of leasing and factoring companies. Today, the sector is far more developed in Asia, especially East Asia, although significant progress has also been made in Latin America and Eastern Europe. In the Arab world, a basic regulatory framework has been established in a number of countries including Tunisia, Morocco and, more recently, Egypt and Lebanon, but development of leasing and factoring companies, as with most other areas of the financial sector, appears to be lagging.

III. Contractual Savings Institutions

As already noted, contractual savings institutions are the most important NBFIs. They have the potential to accumulate vast amounts of long-term financial resources and to literally transform the structure and functioning of capital markets. The relative importance of contractual savings institutions varies from country to country, but three levels of national development can be distinguished:

- Countries in which assets of pension funds and insurance companies are less than 10 percent of gross domestic product (GDP);
- Countries with assets over 10 percent but less than 50 percent of GDP; and
- Countries in which assets exceed 50 percent, often by a wide margin.

The first level of development — assets are less than 10 percent of GDP — applies to most Latin American countries (with the exception of Brazil, Colombia and, most notably, Chile), all francophone African countries, and all Eastern European and several Asian countries (except for those listed below).

The second level of development applies to Brazil and Colombia among Latin American countries; some Asian countries including India, Indonesia, Korea, the Philippines and Sri Lanka; all Middle East and North African countries; anglophone Africa; and all continental European countries (except for Scandinavia, the Netherlands and Switzerland). In these countries, assets of pension funds and insurance companies correspond to more than 10 percent, but less than 50 percent of GDP.

The third level of development includes mainly Anglo-American and Scandinavian countries (the United States, Canada, the United Kingdom, Ireland, Australia, New Zealand, Denmark, Finland, Norway and Sweden); Switzerland and the Netherlands among European countries; Hong Kong, Japan, Malaysia and Singapore among Asian countries; South Africa; and Chile. Contractual savings institutions experienced rapid growth in the 1980s in most countries of the third group (*Table 2, p.20*). In four of these countries (the Netherlands, Switzerland, South Africa and the United Kingdom), the total assets of pension funds and insurance companies exceeded 100 percent of GDP in the early 1990s, growing from less than 50 percent in 1970. Among East Asian countries, Singapore and Malaysia have long had sizable contractual savings sectors with resources corresponding to between 50 percent and 70 percent of GDP respectively, while in Chile, following the radical reform of its social security system, the total assets of contractual savings institutions expanded from less than 1 percent in 1980 to 31 percent in 1990 and 52 percent in 1993. The high rate of growth in these countries is due mainly to expansion of coverage and high investment returns, especially in the 1980s.

Among Arab countries, Jordan, Morocco and Tunisia have total contractual savings of about 20 percent of GDP, while total assets of the Egyptian social insurance system, private pension funds and insurance companies are nearly 40 percent of GDP. Despite basing their pension systems on the so-called scaled-premium approach,[3] there are important differences among the contractual savings sectors of these four Arab countries.

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[3] A scaled-premium approach sets the contribution rate for a five- or ten-year period (the period of equilibrium) at a level that is adequate to cover future benefit payments, after taking into account expected net investment income and demographic factors. The contribution rate is reset at the end of each equilibrium period.

In Jordan, assets mostly represent the accumulation of financial resources by the Social Security Corporation. The corporation is financed by a 15 percent rate of contribution and has benefited both from a low dependency ratio (a small number of beneficiaries compared to the number of contributors) and from a positive, though moderate, real rate of return. As for Egypt, it applies a much higher contribution rate of 26 percent to its social insurance system. Annual flows into the system are large since both the system and the population covered are young. Nevertheless, the benefits of the large annual net inflows have been offset by highly negative real returns earned in the late 1980s and early 1990s.[4] Morocco and Tunisia have social pension systems with much lower contribution rates and more mature structures, but they face financial pressures with limited accumulated resources. Both countries, however, operate other social funds with surplus resources, in particular the funds for family allowances. Given that all four countries — Jordan, Egypt, Morocco, and Tunisia — have young populations, their social security systems may benefit in the medium-term from expanded coverage. A sounder basis for their future evolution and greater contribution to financial sector development, however, would be achieved if the systems were based on individual accounts with a more direct link between contributions, investment income and benefits.

IV. Causes of Underdevelopment

What accounts for the underdevelopment of contractual savings in different countries? In poor countries of Africa, Asia and Latin America, the low level of income and wealth is the most important factor. Poor households cannot afford to put aside large sums of money for their long-term needs. Although some high growth poor countries experience a high rate of savings (as happened, for example, in China and India in recent years), such savings are usually first placed in bank deposits and other liquid instruments. Another factor limiting the development of contractual savings is reliance on the extended family and other informal support systems, which is more prevalent in poor countries with large rural populations.

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[4] Despite an inordinately high contribution rate of 26 percent, Egypt's Social Insurance System suffered a reduction in the share of accumulated balances to GDP from 38 percent in 1988 to 32 percent in 1993. The cause was the negative real rate of return of nearly 12 percent for most of this period (World Bank 1994). At this rate, the real value of balances declined by 47 percent in five years and by 78 percent in 10 years. The real rate of return on social insurance balances improved in recent years. It is now slightly positive in real terms on new and reinvested funds, though the weighted average return on all balances is still slightly below the rate of inflation.

In middle-income countries, the main reasons for the underdevelopment of contractual savings are high inflation and macroeconomic instability, repressive regulatory frameworks, and under-funded, poorly designed social security systems. High inflation undermines the predictability of operating pension funds and insurance companies. Although the use of indexed instruments may mitigate the problem, indexing mechanisms often break down in countries with high inflation. Repressive regulation has a negative impact because it impedes competition, innovation and efficiency and leads to a widespread and mutual mistrust between contractual savings institutions and their customers. Finally, a poorly designed and often poorly funded social security system may crowd out the development of contractual savings institutions both by weakening the need for them and by limiting the scope of their expansion through the imposition of high payroll taxes.

In developed countries, the primary reason for the different levels of development of contractual savings is the existence of a social security system — or lack of it — promising more or less generous pensions and operating on an unfunded, pay-as-you-go basis. The countries of Southern Europe, from Portugal to Turkey, are subject to this pattern as well as Germany, Belgium and Austria. In addition, the operation of unfunded or partially funded occupational pension plans has been another contributing factor.[5]

V. Contractual Savings Institutions and Capital Markets

Contractual savings institutions can play an important role in the development of a country's capital market. This depends on the allocation of assets, which varies considerably from country to country, reflecting both historical traditions and differences in regulation (*Table 3, p. 21*). Real assets, and especially equities, are heavily represented in the portfolios of UK pension funds. This is generally attributed to the equity cult that UK fund managers have led since the mid-1960s in response to the high rates of inflation in the British economy between 1960 and 1990. But this pattern is also explained by the absence of legally imposed minimum-funding requirements and the use of pension obligations that are quasi-indexed to inflation.

[5] A proper accounting of contractual savings in different countries should include any resources accumulated by partially funded schemes, even if these are held in the form of 'book reserves' and are totally invested in the assets of sponsoring employers. The mobilization of resources should be recorded even if usage is less than optimal.

Real assets represent a smaller proportion of pension fund assets in the United States and other Anglo-American countries and an even smaller proportion in continental European countries.

In continental Europe, pension funds, as well as life insurance companies, place the largest part of their assets in government, corporate and mortgage bonds and in long-term loans. This is partly the result of investment regulations and partly due to a traditional emphasis on conservative investment policies. Although pension funds and insurance companies are subject to upper limits on their equity holdings (as well as overseas securities), and although their managers are seeking either to increase these limits or abolish them all together, restricted investments are well below the specified limits. A gradual shift of assets is taking place, however, among Dutch and Swiss pension funds in favor of equity investments. This has major implications for the size and liquidity of their respective national markets.

The pattern of asset allocation in other countries is similar to that of continental European countries. Investment rules have generally favored bonds, except in South Africa, where pension funds and life insurance companies have been free to invest in equities. In Singapore, the Central Provident Fund invests more than 90 percent of its funds in specially issued, nonmarketable and floating-rate government securities that earn a modest, positive real rate of return. In Malaysia, although investments in equities have increased in recent years, the assets of the National Provident Fund are placed in government bonds. In both countries, individual workers are allowed to withdraw funds for investment in housing and an increasingly broader range of approved securities.[6]

In Chile, investments in corporate equities for the privately managed pension funds were less than 20 percent of total assets in the late 1980s, mainly because of tight restrictions on their investment portfolios. As a result, the pension funds invested heavily in government, mortgage and corporate bonds as well as bank deposits (Vittas 1995b). The gradual relaxation of investment rules has allowed the Chilean pension funds to invest more in equities. The limit on equities has been raised to 30 percent of assets in the 1990s and investment in foreign securities was permitted.

[6] These allocations are not included in the reported statistics.

In the Arab countries addressed here, investment allocations have been subject to direct government influence with the notable exception of Jordan, where any such influence has been indirect. In Egypt, most of the vast resources of the social security system are handed over to the National Investment Bank which invests in public projects. This is similar to Malaysia, but with the important difference that in Malaysia the rate of return credited to individual accounts has been positive in real terms. In Tunisia and Morocco, contractual savings institutions have been required to invest in low-yielding government bonds and low-interest housing loans, and even in building low-rent housing units. This has depressed investment income. In recent years, however, investment rules have been substantially relaxed and new investment flows are now placed in assets yielding market rates of return. In Jordan, the Social Security Corporation has enjoyed greater freedom from government interference, but investments have been constrained by the highly conservative policies of the corporation and by the shortage of attractive investment opportunities. Increasingly, the Social Security Corporation has been forced to place a growing percentage of its new flows into bank deposits, but a new policy may be adopted in the future to emphasize a more professional approach to asset allocation and even manager-selection practices.

In most countries around the world, investments in foreign assets have been constrained by regulations — either foreign exchange controls or unnecessarily tight prudential controls. Following the removal of exchange controls and the relaxation of investment rules, pension funds in several countries have built up substantial holdings of foreign equities and bonds, reaching well over 20 percent in Australia, New Zealand and the United Kingdom and around 60 percent in Hong Kong.

International diversification may increase portfolio returns, especially if pension funds become too large for the local markets. But a more general result is a reduction in investment risk, stemming from the less-than-perfect covariance of returns in different national markets. Contractual savings institutions in most countries tend to display a strong 'home bias' (Reisen 1996). This can be attributed to the nature of their liabilities, the absence of efficient hedging facilities, and the preference for investing in well known markets and securities. Nevertheless, international diversification has been growing rapidly. Most countries, especially those with undiversified economies dominated by a handful of industries and a few powerful

family groups, should allow foreign investment once new pension systems are well established.

VI. Impact on Capital Market Efficiency

The impact of contractual savings institutions on capital market efficiency depends on the magnitude of savings, investment policies and management practices. From a quantitative point of view, there is a certain correlation between the size of contractual savings and the development of equity markets, but the pattern is far from clear *(Table 4, p. 21)*. The equity market is large in relation to GDP in the United Kingdom and South Africa, where pension funds invest heavily in equities, but it is also large in Switzerland and Chile, where pension funds invest relatively little in equities. In Malaysia and Singapore, the equity market is large, with high trading volumes, even though direct investment in equities by the respective provident funds is either minuscule or nonexistent. Other investors, especially foreign institutional investors, account for the large capitalization of the equity markets and the large volume of trading in these two countries.

Levine and Zervos (1995) emphasize the value of trading as an indicator of market efficiency, low transaction costs and market liquidity. They find that market liquidity is positively and robustly correlated with contemporaneous and future rates of economic growth, capital accumulation and productivity growth. In recent years, there have been large increases in the volume of trading on stock markets around the world, as well as growing equity markets, as measured in terms of market capitalization in relation to GDP (*Tables 5 and 6, p. 22*).

In countries such as Malaysia and Singapore, the growing internationalization of portfolio investing clearly must have been a major factor in the veritable explosion of trading volumes on their equity markets. From 7 percent of GDP in 1985 (admittedly a recession year with depressed market prices and activity), trading volume exploded to 250 percent of GDP in Malaysia in 1993 and 150 percent in Singapore (though their trading volumes suffered substantial falls in 1994). In Europe, domestic institutional investors, in addition to international investors, also contributed to the growth of trading volumes. This is especially true in those countries where contractual savings institutions are in the process of redefining their investment policies in favor of equity holdings. Swiss trading volume was much higher than those of the US and UK

markets in 1993, while in 1993 the Dutch and Swedish markets reached the 1990 level of the UK market. Chile and South Africa continue to have subdued levels of equity trading, probably because of continuing restrictions on foreign portfolio investment. The low level of equity trading in Chile and South Africa is also attributed to the 'buy and hold' strategy of pension funds, although market liquidity has increased in both countries. Among Arab countries, Jordan has a reasonably high level of trading activity. The stock exchanges in Egypt, Tunisia and Morocco are still at an early stage of development, but considerable progress has been made in recent years.

Contractual savings institutions have the potential to act as catalysts for the modernization of securities markets, the development of efficient trading and settlement systems, the adoption of modern accounting and auditing standards and the promotion of information disclosure. In the United States, the growing market power of pension funds and insurance companies has undermined the dominance of corporate bond markets by traditional investment banks, which long after the passing of the Glass-Steagall Act in the 1930s, continued to operate effectively as a cartel, with rigid hierarchical structures in syndicated issues. Institutional investors were the primary impetus to competitive bidding for corporate issues, the abolition of minimum commissions on equity trading, and the restructuring of stock exchanges (Chernow 1990). The hedging needs of US corporate pension funds, operating under strict minimum-funding requirements, have been instrumental in stimulating the development of immunization techniques and new products, such as zero-coupon bonds and collateralized mortgage obligations, as well as index options and futures (Bodie 1990, Davis 1995). Recently, institutional investors have become actively involved in monitoring corporate performance and exerting direct and indirect pressure for better and more effective structures of corporate governance.[7]

Pension funds and insurance companies in capital markets have also come under criticism for allegedly causing greater market volatility, adopting a short-term approach to investments, and neglecting the financing needs of smaller firms. Because international investors trade more actively, they increase the liquidity of markets and lower volatility. Their common herding behavior, however, exposes markets to

[7] For an excellent survey of corporate governance issues with extensive coverage of some highly publicized failures, see Monks and Minow (1995).

sudden changes of sentiment that may cause abrupt price fluctuations. The evidence of this short-term approach is also somewhat mixed and not particularly strong. Recent developments show the growing involvement of pension funds and insurance companies in corporate governance issues and suggest an increasing concern for the long-term performance of the corporate sector. Nevertheless, fund managers are themselves subject to short-term performance evaluations and are therefore forced to pay close attention to short-term prospects. With regard to financing smaller firms, contractual savings institutions need to rely on other specialized institutions, such as banks, as well as leasing, factoring and venture capital companies.

VII. The Insurance Sector

The insurance sector is comprised of life and non-life insurance companies, also known as casualty and property insurance. Their development varies considerably across countries *(Table 7, p. 23)*. This sector has been influenced by the same factors that determine the growth of contractual savings institutions. In fact, life insurance companies are a main component of contractual savings because they offer whole life and endowment insurance policies as well as a growing variety of annuity products. Non-life insurance companies generate relatively smaller financial assets from the reserves they set aside to cover future claims.

Income and wealth, macrofinancial stability and the regulatory framework are the main determinants of the insurance sector, as they are determinants of contractual savings more generally. In many developing countries, including most Arab countries, the main line of insurance business is compulsory motor insurance, which is often subject to regulated, low premiums. Motor insurance yields large technical losses, which force insurance companies to scrutinize claims and delay their settlements. In many cases, large court awards complicate matters since claimants prefer to go to court rather than accept reasonable settlements from insurance companies. A climate of mistrust has developed between insurance companies and their clients. This has had adverse effects not only on motor insurance but also on the development of other personal lines of coverage including household and life insurance.

In many developing countries, large industrial and commercial risks are reinsured with international reinsurance companies. This protects the domestic market from excessive risk, but it also implies that the domestic market has not developed the

capacity to price and retain risks locally. Nevertheless, in countries where local retention has been enforced and where the reinsurance business has been declared a state monopoly, the financial and insurance results have been disastrous.

In most areas of the world, including East Asia, Latin America and Eastern Europe, the insurance sector has experienced considerable growth. Conversely in the Arab world, the insurance sector has stagnated and suffered declines in relation to GDP. This decline may be attributed, in large part, to the underdevelopment of the life insurance market. In many countries around the world, the share of life premiums among total premiums has been growing rapidly, reaching or exceeding 60 percent, while it has only hovered around 20 percent or less in Arab countries (*Table 8, p. 23*).

The development of a life insurance system is often affected by the existence of a credible social security system and/or well-funded company pensions based on defined-benefit plans. But in countries where the security of social pensions is in doubt, the life insurance business may benefit if workers seek alternative means for financial security in their old age. For instance, life insurance has been growing rapidly in France, where both social security and company pensions are unfunded. But the life insurance business also receives a great boost in countries that rely on defined-contribution pension plans, because workers purchase annuity products when they retire. Rapid growth of the life insurance sector in Chile is attributed to the pension reform program that was implemented in the early 1980s. The life insurance sector also benefited from the compulsory purchase of term life and disability insurance. These types of insurance are needed to protect workers and their families from the financial consequences of serious accidents and death before reaching retirement.

Cultural and religious factors may explain the underdevelopment of the life insurance sector in Arab countries; however, the repressive regulatory environment, the lack of competition and product innovation, and the prevailing mistrust of insurance companies have probably been more significant factors. Life insurance represents nearly 50 percent of total premiums in Malaysia, which corresponds to 2.3 percent of GDP, as opposed to 0.16 percent in Egypt and 0.12 percent in Tunisia.

VIII. Venture Capital Companies and Mutual Funds

Venture capital companies (VCCs) and mutual funds are the latest additions to NBFIs, although they have existed in one form or another for quite awhile. They have become

more important in recent years due to the growth of pension funds and other contractual savings institutions. VCCs specialize in financing small firms and new ventures. Increasingly, VCCs are financing infrastructure works and other major projects that governments delegate to the private sector for more efficient construction and management. The primary characteristics of VCCs are that they offer both equity and debt finance and take a more hands-on approach to managing the ventures they support. VCCs expect sizable losses on some projects but operate on the principle that a few successful ventures will cover most losses and will generate a substantial profit to compensate their founders for the risks assumed. VCCs play an instrumental role in financing high-tech projects in the United States and supporting the emergence of numerous ventures including projects in computing, electronics and biotechnology. Successful operation of VCCs requires an enabling regulatory framework and an environment conducive to private sector initiatives. It is also essential for them to have access to long-term financial resources and an active market that allows for disposal of stakes and exit from individual companies once they are well established.

Mutual funds investing in equities or bonds have been developed as a means of conferring to small individual investors the benefits of professional fund management and efficient risk diversification. The number of mutual funds has grown rapidly in recent years, especially in the financial system of high-income countries. There are now mutual funds specializing in certain sectors, countries or regions, as well as mutual funds following active or passive investment management policies using published indexes of various types of securities. The proliferation of specialized mutual funds has allowed pension funds and other institutional investors to use this form of asset allocation, provided a reduced management fee can be negotiated. Pension funds and other institutional investors clearly lack the specialist skills needed to invest in particular economic sectors or in particular regions or countries. Using well-established and successful mutual funds is an economically viable and efficient alternative.

Mutual funds, in the form of venture capital funds, have also been established by successful venture capitalists. Such funds have also become an important outlet for the financial resources controlled by pension funds and other institutional investors. Institutional investors often lack the skills to deal with small firms and new ventures, both in terms of selecting promising projects and monitoring their performance.

Participating in venture capital funds, that may also be listed on the stock exchange and thus may be easily disposed of, is an effective alternative gaining popularity around the world. Such funds or investment trusts may also be used for financing infrastructure projects, real estate development and other forms of private equity. Private equity usually offers higher returns than publicly listed and traded equity and is also gaining popularity among institutional investors in America, Europe and Asia.

Venture capital companies and mutual funds are not particularly advanced in the Arab world, although the legal foundations for their creation and growth have been established in Egypt, Morocco, Tunisia and Jordan. The prospects for these types of NBFIs are promising in the region, especially if sound macrofinancial policies continue to be pursued and the countries concerned are able to successfully reform their contractual savings sectors, particularly their social security and pension systems.

IX. Recent Developments in Egypt

The NBFI sector in Egypt is poised to make a significant contribution to economic development following recent policy changes.[8] First, enabling legislation has been enacted for the creation of leasing companies and mutual funds. Second, the privatization program has been pursued with renewed vigor. Third, the modernization of the securities markets has reached a critical stage. Fourth, the reform of the insurance industry has continued to progress with a revised regulatory framework and greater emphasis on competition and innovation. And, fifth, the financial performance of the Social Insurance System (SIS) has been improved with the rise of interest rates paid on new and reinvested balances. [9]

The Social Insurance System

The SIS is by far the most important component of the NBFI sector in Egypt. It provides pension benefits and insurance against disability, death and loss of earnings due to unemployment or illness. It covers 83 percent of the workforce, in part because farmers are only required to make a nominal contribution of LE1 against which they receive a minimum pension of LE45. The dependency ratio is high at 38 percent

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[8] For a review of the financial sector of Egypt before the recent policy reforms, see World Bank (1993).

[9] This section draws extensively on a chapter in the latest economic report — Country Economic Memorandum (CEM) — on Egypt. Prepared by Albert Martinez of the World Bank.

despite the young median age of the Egyptian population and the relatively new system. In part, this is due to the inclusion of spouses, children and other relatives among surviving dependents. Excluding children and other relatives, the system's dependency ratio falls to 28 percent. This is still double the demographic old age dependency ratio and is due to the early retirement age for women and the young age of surviving spouses.

The Egyptian SIS is financed by employer and employee contributions, from government transfers and from investment income earned on its considerable balances. Contribution rates vary depending on the type of wage (basic or variable) and the type of employer (private sector enterprises, public sector enterprises or government offices). A total contribution rate of 26 percent is assessed for old age, disability and survivorship pensions, but the contribution rate for other benefits varies from 5 percent to 15 percent. Revenues from payroll contributions declined from 5.1 percent of GDP in 1986 to 3.5 percent in 1995 (*Table 9, p. 24*). This decline is partially due to the ceiling imposed on covered wages. Government transfers include a 1 percent formal contribution plus transfers to cover the ad hoc inflation adjustments for basic pensions. Revenues from government transfers grew from 1.2 percent of GDP in 1986 to 1.5 percent in 1995, although they were around 1 percent for most of the intervening years. Investment income (net of operating expenses) rose from 2 percent of GDP in 1986 to 2.8 percent in 1995. Its share of total SIS revenues increased from 24 percent in 1986 to 36 percent in 1995. This increase reflects the growing accumulated balances of SIS and the increased rate of interest paid on them in recent years.

The cost of pension benefits amounted to 2.5 percent of GDP in 1986. This fell to 2 percent in 1990 as a result of the adverse impact of inflation on the real value of pensions — especially the variable wage pensions that did not benefit from the ad hoc adjustments conferred on basic wage pensions. In 1995, the cost rate of pensions rose again to 2.5 percent of GDP. This left an annual surplus of 5.3 percent of GDP, up from 4.6 percent in 1990 but down from 5.8 percent in 1986. Total SIS balances fell from 38 percent in 1986 to 33 percent in 1995, reaching a low of 29 percent of GDP in 1992. This decline was caused by the highly negative real returns on SIS balances for most of the 1980s. While inflation averaged 18 percent, SIS received a nominal rate of interest of 5 percent to 6 percent. Had the balances earned a zero real interest rate, they

would have been 60 percent higher at the end of 1995 and would have amounted to well over 50 percent of GDP.

The balances of SIS are invested with the National Investment Bank (NIB), which finances public projects and public enterprises in accordance with the prevailing economic plan. Starting July 1992, the NIB raised the rate of interest on incremental social security funds (i.e., new funds plus reinvested balances) to 13 percent in nominal terms. This rate is higher than the current bank term deposit rate of 12 percent but lower than the 17 percent paid on NIB investment certificates. It is also higher than inflation which averaged 10 percent in the period 1992 to 1996. Although the rate of interest is now positive in real terms, it should be noted that interest is paid only on incremental funds. According to NIB data, the new deposits from SIS amounted to LE23.4 billion or 35 percent of SIS's total balance of LE67 billion. Assuming that the remaining 65 percent earns 5.5 percent on average, the weighted rate of interest on the total balance of LE67 billion is slightly over 8 percent, which is still below the rate of inflation and thus negative in real terms. Nevertheless, the current situation represents a major improvement over the 1980s, and the weighted average rate of interest should gradually reach 13 percent.

Despite these improvements, the fact remains that the SIS balances are not used efficiently and provide little direct support to the development of the capital markets and the promotion of the private sector. To this end, a fundamental but gradual reform of the pension system is essential. Reform could involve first converting the system from a defined-benefit to a defined-contribution scheme. This would be followed by privatizing its investment function (with the possibility of investing in corporate equities and bonds) and giving participants the option of contracting out to approved schemes operated by employers or by specialized financial institutions.

Private Pension Funds

The need to improve the pension system is heightened by the weak position of most of Egypt's 500 private pension funds that offer defined-benefit pensions but without full funding. The number of these funds has increased rapidly from 330 in 1991 to more than 500 funds in 1995. Pension funds cover nearly half a million workers, up from 200,000 in 1991, and their total reserves amount to LE3.3 billion, as opposed to

LE1.4 billion in 1991. The majority of these funds are established by employees of public sector entities and only about 10 percent are set up by private sector enterprises. Almost 48 percent of the reserves are invested in bank deposits and 42 percent in government bonds. Thus the private pension funds also make little direct contribution to the financing of the private sector and the development of the capital markets.

The Insurance Sector

Regulatory and institutional changes are also occurring in Egypt's insurance sector. A new insurance law was enacted in 1995 and a new set of regulations was adopted in June 1996. These changes brought the regulatory framework in line with the prevailing approach in Europe, emphasizing solvency monitoring and prudential regulation and leaving the setting of premiums to the interplay of market forces. Except for motor vehicle and fire insurance, which will be deregulated in 1999, premiums in all other lines have been liberalized and price control has been replaced with price reporting.

There are now 10 insurance companies operating in Egypt. The sector is dominated by the large state-owned companies which collectively control over 90 percent of the market. A new emphasis on competition and innovation, however, is likely to result in privatization, as well as the opening of the domestic market to foreign competition.

Capital Markets

Various measures have been taken in Egypt to revitalize capital markets, with special emphasis on the market for corporate equities. New legislation — the Capital Markets Law — was passed in 1992 and executive regulations were issued in 1993. These are designed to strengthen the Capital Market Authority (CMA), improve information disclosure, and reorganize and modernize the stock exchanges, and establish new trading, clearing and settlement systems. The creation of mutual funds has been authorized and 15 licensed mutual funds were created as of June 1996.

The development of the Egyptian stock market has been stimulated by the spate of privatization, the increase in listed companies, and the inflow of foreign capital, both for direct and portfolio investment purposes. Market capitalization reached 20 percent of GDP in 1996, up from 10 percent in 1993, while trading activity amounted to

3.4 percent of GDP, up from 0.2 percent in 1993.[10]

X. Policy Implications and Conclusions

The main conclusion of this analysis is that NBFIs complement the services provided by banking institutions and also represent a countervailing force to the banks' dominant role, forcing them to be more competitive and efficient. NBFIs provide a strong stimulus to the development of capital markets, generating large amounts of long-term financial resources and creating new sources of supply and demand for marketable securities.

For leasing, factoring and venture capital companies, which deal primarily with finance professionals or businesspeople and entrepreneurs, an enabling regulatory framework, including a clear and supportive tax treatment, is essential for growth. Openness to foreign participation which ensures availability of specialist skills and transfer of financial technology and know-how is also necessary. If such companies provide loans to consumers, or obtain funds from nonprofessional investors, they should be subject to the same consumer and investor protection regulations as other financial institutions.

Promoting pension funds, insurance companies and mutual funds presupposes a robust and elaborate regulatory and supervisory framework and often requires fundamental changes. In particular, establishing private pension funds may depend on more basic and systemic social security reform; however, systemic pension reform is difficult to implement because it has far-reaching economic, financial, political and social implications. Nevertheless, many countries around the world, especially in Latin America and Eastern Europe, as well as most member countries of the Organization for Economic Cooperation and Development, however, are forced to restructure and downsize their unfunded or partially funded social security systems and create more room for mandatory or voluntary private pension funds. At the same time, most countries willingly take measures to reform and enhance the efficiency of

[10] Similar developments were observed in several other developing countries, reflecting the growing importance of equity markets. Among Arab countries, total market capitalization reached 25 percent of GDP in Morocco and 20 percent in Tunisia in 1996. In contrast, market capitalization, and especially trading activity, fell sharply in Jordan, where in 1996 they reached 64 percent and 4.2 percent of GDP, respectively down from 87 percent and 25 percent in 1993.

their insurance sectors, since systemic pension reform cannot succeed without a sound, innovative and competitive insurance sector (Vittas 1995c).

Most Arab countries have partially funded, defined-benefit social security systems. These still generate surpluses, because both the systems and the populations covered are young. Moreover, the relative underdevelopment of the financial system and the absence of a long tradition of private pension funds and professional fund management are disincentives for systemic pension reform when governments are faced with more pressing problems. Despite these difficulties, Arab countries would be well advised to begin a gradual reform of their social security and pension systems. This will help them avoid the problems currently facing European countries when demographic aging raises the cost of defined-benefit schemes and will help to reap the benefits of capital market development.

As a first step in the direction of reform, Arab countries should convert their defined-benefit schemes into defined-contribution arrangements, while keeping a centralized public system with centralized fund management in place. Once this is completed, the authorities should consider allowing private firms and individual workers to contract out of the public system, provided they join a new scheme with similar or improved conditions. In addition, centralized agencies could start delegating the investment management function to authorized private asset managers. To ensure that retiring workers receive a minimum pension from their retirement savings, the authorities could offer a public pension financed from payroll taxes, general tax revenues, or a combination of the two, or they could offer compensation for any shortfall in the pension obtained from a worker's retirement savings. This gradualist approach would avoid the immense regulatory burden entailed in a full and immediate privatization of the pension system.

With or without a gradual approach, it is important to emphasize that an efficient and stable financial system requires the following three basic conditions (Honohan and Vittas 1996). First, operationally autonomous central banks, capable of setting interest rates and credit conditions with a view to protecting the value of the currency and the stability of the financial system, are essential. Second, it is necessary for a country to have autonomous commercial banks and other financial institutions that operate as profit centers and are not captive to their borrowers or the government. This would imply that not only the financial system but also industry and commerce are

largely in private hands. Third, a legal and administrative framework conducive to the sound functioning and enforceability of financial contracts is essential for reforming the pension system. Inherent to autonomous commercial banking is openness to international markets and a foreign presence essential for the transfer of skills and technologies. Such openness is the lynchpin for all specialist functions performed by nonbank financial institutions.

Table 1. Leasing in Selected Countries (% of private investment)

	1988	1990	1993
United States	32	32	32
United Kingdom	20	20	19
Australia	33	25	20
Spain	26	28	18
Sweden	27	15	20
Ireland	19	28	43
Portugal	10	10	24
Republic of Korea	13	16	23
Indonesia	6	9	14
Colombia	1	6	21
Hungary	..	8	18
Venezuela	12	8	15

Source: International Finance Corporation (1996).

Table 2. Pension Fund and Life Insurance Assets in Selected Countries (% of GDP)

	1970	1980	1990	1993
Netherlands	45	63	110	124
Sweden	42	51	60	76
Switzerland	51	70	105	130
United Kingdom	43	46	97	145
United States	40	46	74	90
Chile	..	1	31	52
Malaysia*	18	21	51	58
Singapore*	17	41	68	68
South Africa	40	47	81	121
Egypt	..	39	34	36
Jordan	..	10	17	19
Morocco	..	..	12	18
Tunisia	..	..	10	12

* The data do not include funds invested directly by individual workers in housing and other approved assets. Singapore is a high-income country, but it is classified here with developing countries because of the historical interest of its performance.
Source: Davis (1995) and the respective national central banks.

Table 3. Asset Allocation of Pension Funds in Selected Countries, 1990 (% of assets)

	Real Assets	(real assets as equities)	Debt Instruments
Netherlands	31	(20)	69
Sweden	..	(..)	..
Switzerland	33	(16)	67
United Kingdom	72	(63)	28
United States	46	(46)	54
Chile	20	(20)	80
Malaysia*	2	(2)	98
Singapore*	2	(2)	98
South Africa	60	(55)	40
Egypt**	5	(..)	95
Jordan**	25	(15)	75
Morocco**	15	(..)	85
Tunisia**	15	(..)	85

* Does not include direct investment in housing and approved securities by individual workers.
** Rough estimates.
Source: Davis (1995); Vittas (1995a).

Table 4. Contractual Savings and Equity Markets in Selected Countries, 1993 (% of GDP)

	Contractual Savings	Equity Market	Value Traded Equities
Netherlands	124	61	23
Sweden	76	62	25
Switzerland	130	117	72
United Kingdom	145	123	45
United States	90	82	55
Chile	52	104	7
Malaysia	58	365	255
Singapore	68	240	147
South Africa	121	153	12
Egypt	36	8	0.2
Jordan	19	85	24

Morocco	18	9	1.6
Tunisia	12	7	0.3

Source: Tables 2, 5 and 6.

Table 5. Equity Markets in Selected Countries (% of GDP)

	1980	1985	1990	1993
Netherlands	18.6	38.7	39.2	61.4
Sweden	10.6	32.8	38.6	61.8
Switzerland	44.4	82.0	66.0	117.2
United Kingdom	37.1	63.6	79.9	123.3
United States	45.7	57.6	56.0	82.4
Chile	..	13.9	59.6	103.6
Malaysia	..	50.7	113.4	365.1
Singapore	..	60.1	90.4	239.5
South Africa	123.9	115.1	127.6	152.5
Egypt	..	4.9	5.0	9.7
Jordan	..	44.7	49.8	87.3
Morocco	..	1.9	3.7	9.9
Tunisia	..	6.8	4.3	6.5

Source: International Finance Corporation.

Table 6. Value of Equity Trading in Selected Countries (% of GDP)

	1980	1985	1990	1993
Netherlands	3.0	11.0	13.2	22.7
Sweden	1.4	8.4	6.6	25.1
Switzerland	..	..	28.9	72.4
United Kingdom	6.6	13.3	26.2	45.3
United States	15.1	24.7	32.9	55.3
Chile	..	0.4	2.8	6.5
Malaysia	..	7.2	25.4	254.7
Singapore	..	7.6	53.5	147.3
South Africa	6.6	5.8	7.6	11.5
Egypt	..	0.3	0.2	0.2
Jordan	..	3.2	10.1	24.6
Morocco	..	0.1	0.2	1.9
Tunisia	..	0.1	0.1	0.3

Source: International Finance Corporation.

Table 7. Life and Non-Life Insurance Premiums in Selected Countries (% of GDP)

	1985	1990	1994
Netherlands	5.60	8.08	8.80
Sweden	4.72	4.83	6.40
Switzerland	7.07	8.03	9.74
United Kingdom	7.11	9.67	11.43
United States	7.52	8.89	8.57
Chile	2.16	2.97	3.30
Malaysia	2.79	3.09	4.65
Singapore	2.40	3.20	4.22
South Africa	7.22	10.60	12.77
Egypt	1.00	0.89	0.79
Jordan	..	..	..
Morocco	1.84	1.92	2.65
Tunisia	1.63	1.51	1.71

Source: Sigma, Swiss Reinsurance.

Table 8. Share of Life Insurance in Total Insurance Premiums in Selected Countries
(% of total premiums)

	1985	1990	1994
Netherlands	46.6	51.7	51.3
Sweden	57.1	52.0	54.8
Switzerland	53.3	55.9	61.5
United Kingdom	59.8	64.5	63.9
United States	37.9	42.6	42.4
Chile	52.4	59.6	59.1
Malaysia	41.9	44.3	49.5
Singapore	39.5	56.3	64.7
South Africa	76.8	80.0	80.8
Egypt	18.0	18.0	20.3
Jordan	..	..	..
Morocco	18.1	19.3	21.1
Tunisia	5.2	8.6	7.0

Source: Sigma, Swiss Reinsurance.

Table 9. Revenues of the Social Insurance System of Egypt

Year	Contributions	Transfers income	Investment income	Total
(% of GDP)				
1986	5.1	1.2	2.0	8.3
1990	3.6	0.9	2.1	6.6
1995	3.5	1.5	2.8	7.8
(% of total revenues)				
1986	61	15	24	100
1990	54	14	32	100
1995	45	19	36	100

Source: Ministry of Social Affairs and World Bank.

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