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IMPORTANT FEATURES OF THE SERVICE SECTOR AND TRADE IN SERVICES IN TRANSITION ECONOMIES

FINANCIAL SERVICES IN TRANSITION ECONOMIES

Note by the secretariat

1. The financial sector in countries of central and eastern Europe, the Baltics and the CIS has gone through dramatic changes during the transition period. The original State monobank has been replaced by a two-tier banking system across all countries in the region, and a considerable number of private commercial banks have emerged. The end of the 1980s – 1990s has witnessed the re-emergence of capital markets nourished by the privatization of State-owned enterprises and the inflow of foreign investment. Domestic, and, despite restrictions, foreign insurance companies have become increasingly important players on domestic financial markets.

2. Despite considerable progress, the financial services sector in many transition economies remains underdeveloped, commercial banks and other financial institutions being largely under-capitalized and small by western standards. According to recent research, at the end of the 1990s the aggregate values of bank deposits, outstanding corporate debt and stock market capitalization in relation to gross domestic product (GDP) in transition economies stood on average at 34 per cent, whereas the non-weighted average for OECD countries made up 198 per cent. [1]

[1] “Challenges of Financial System Development in Transition Economies”, Stefan Kawalec and Krzysztof Kluta, p.9.

3. At the end of 1999, the ratio of banking assets to GDP was as high as over 250 per cent in the United Kingdom, almost 200 per cent in Germany and over 160 per cent in France. At the same time, in the Czech Republic this ratio amounted to about 110 per cent, in Poland to 50 per cent and in Russia to less than 35 per cent. [2]

4. The insurance sector seems to be even less developed. In 1999, in transition economies as a whole the "average insurance penetration", measured by total insurance premiums as percentage of GDP, was estimated at 1.7 per cent for non-life and 0.7 per cent for life insurance.[3] In the same year, in western Europe these figures stood at 3.0 per cent and 5.0 per cent, respectively.[4]

5. In terms of financial sector structure in transition economies, one notes that, as compared with developed market economies, banking is by far the most important asset-holder. Bank deposits account for 63 per cent of total assets of the financial sector in countries of central and eastern Europe as compared with 35 per cent in developed countries. At the same time, the stock markets in transition economies are relatively underdeveloped: the ratios of stock market capitalization to the total value of financial sector assets are around 35 per cent in transition countries as compared with 49 in developed economies. There are, however, countries in which the stock market capitalization accounts for 60-80 per cent of the small financial sector (for example Lithuania, Kazakhstan, Kyrgyzstan and the Republic of Moldova, and).[5] In some cases this elevated percentage is the result of under-development of the commercial banking sector caused by a lack of institutional reforms.

6. In many transition countries, especially those of southeast Europe and the CIS, financial services development is still hindered by overall economic instability and high inflation which undermines corporate and personal incomes, and prospects for investment in the real sector. Inconsistencies in legislation and an inadequate regulatory framework, a lack of transparency with respect to property rights enforcement, as well as restrictions on operations of foreign investors, have also contributed to the overall sluggishness of financial services growth.

7. In summary, one notes that over a short period of less than a decade, European transition economies have experienced the emergence of a modern financial sector. Both in terms of size and scope of services rendered this sector still lags behind its counterpart in OECD countries. At the same time, financial sector indicators of more dynamic central and eastern European countries (including the Baltics) are closer to those of developed economies, while most economies of the CIS and southeast Europe are lagging behind their western neighbours in eastern, central and western Europe.

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[2] Ekonomika I hizn', No. 5, February 2001.

[3] "SIGMA", No. 1/2001, Swiss Re, p.3.

[4] Ibid., p. 17.

[5] "Challenges of Financial System Development in Transition Economies"…, p.11.

1. Banking

(a) General trends

8. As was already indicated, after the elimination of the socialist monobank system, during the early transition there was a dramatic increase in the number of banks. In parallel, most transition economies experienced a decline in the state ownership of the banking system as a result of privatization and the penetration of foreign banks.

9. Since the beginning of the 1990s, some transition countries have progressed more than others in developing and strengthening their banking systems. Many are, however, still in the middle or even at the beginning of banking reform.

10. As a result of restructuring programmes, the high share of bad loans characteristic of the beginning of the transition period [6] has gradually declined. At the same time, in the course of market transformations, all transition economies have experienced banking crises or severe distress in their banking sectors resulting in bankruptcies and liquidations of commercial banks, loss of confidence and a rupture of lending to the real sector of the economy.

11. Countries of central and eastern Europe have not experienced hyperinflation during transition, and real values of debt inherited from the past, including bad loans, have been higher than in other transition economies. During the financial crises experienced in the course of transition, the share of non-performing loans in the region ranged from 21 per cent in Hungary to 50-66 per cent in the Czech Republic.[7]

12. At the same time, the stable macro economic environment and government support in central and eastern European countries have contributed to maintaining confidence in their banking systems during financial crises. Governments in these economies have restructured domestic banks having considerable deposits in order to avoid the social costs of their liquidation. As a result, the balance sheets of many banks in central and eastern Europe are still overburdened by non-performing loans.

13. In more general terms, bad loans inherited from the past as well as accumulated during transition, constitute the basis of banking sector instability in many European transition economies.

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[6] In the first half of the 1990s, the ratio of bad loans to total loans in transition economies fluctuated between 15 and 30 per cent. In some countries, though, this percentage was significantly higher. For example, in 1994 it reached 92 per cent in Kyrgyzstan and in 1993, 80 per cent in the former Yugoslav Republic of Macedonia ("Banking Crises in Transition Countries: Fiscal Costs and related Issues", Helena Tang, Edda Zoli and Irina Klytchnikova, p.4).

[7] Ibid., p. 7.

14. This being said, the adjustment of the banking sector to economic stabilization and a competitive environment has translated into a decreasing number of commercial banking institutions in the region. The number of banks, which discontinued their operations in the 1990s, was the highest in the Baltic States. Of 56 banks operating in Latvia in 1994, 27, or more than half, had stopped their operations by 1999. Over the same period (1994 – 1998), the number of functioning commercial banks in Estonia decreased from 22 to 6 and in Lithuania from 22 to 10 (see table 1).

15. On a smaller scale, a reduction in the number of commercial banks also occurred in the Czech Republic and Hungary, while in Poland this number remained stable.

16. In the CIS region, the scope of the banking sector adjustment has varied from country to country. In some of them, though, the downsizing has been dramatic. As an example, during 1994 – 1998 in Kazakhstan the number of banks plummeted from 184 to 71, and in Georgia from 226 to 43.

17. An important feature of banking in transition economies is the high concentration of assets within large establishments. In Poland, for example, the five largest banks hold almost 47 per cent, and the 15 largest 79 per cent of total banking assets.[8] In the same way, in the Russian Federation, the 50 largest banks control 76.5 per cent of total banking assets. [9] In some countries, the Baltic States for example, these are the foreign-controlled banks, which are among the largest banks dominating the market. [10]

18. Because of its small size and restricted scope of operations, the banking sector in transition economies often lacks the capacity to fully satisfy the financing needs of private enterprises. During 1994-1998, the sum of loans to the private sector was equivalent on average to 27 per cent of GDP in eastern Europe and the Baltics, and to only 9 per cent in the countries of the CIS.[11] In 1999, this sum amounted to 54 per cent of GDP in the Czech Republic, 26 per cent in Estonia, about 23 per cent in Poland and Hungary, 21 per cent in Latvia and 13 per cent in Lithuania. In the same year, loans to the private sector made up about 11 per cent of GDP in the Russian Federation, 9 per cent in the Ukraine and about 6 per cent in Kazakhstan (1998). For comparison, in the 11 countries of the European Union belonging to the "Euro zone", the percentage in question exceeded 100 in the same year. [12]

19. The general level of real interest rates in the region remains higher than those available to private companies in the OECD countries. At the same time, the perceptions of risk, especially in the CIS countries, also remain high, inhibiting commercial bank lending to the economy. According to the recent survey of private bankers in Russia, for example, elevated risk constitutes the major single impediment to

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[8] "Summary Evaluation of the Financial Situation of Polish Banks, first half 2000", National Bank of Poland, p. 8.

[9] "Banking System, overview", Central Bank of the Russian Federation, http://www.cbr.ru/eng/system/overview.html

[10] "Banking Crises in Transition Countries: Fiscal Costs and related Issues…", p. 5 – 6.

[11] See UN/ECE document TRADE/2000/SEM1/2, Important Features of Trade Finance in Transition Economies: Second Half of the 1990s, 20 April 2000.

[12] Calculated from IMF International Financial statistics, March 2001.

bank financing of the “real” (non-financial) sector, the other most important factors being inadequate guarantees of property rights and an insufficient asset base. As a result, according to the Central Bank, commercial bank loans finance only 10 per cent of investment in the “real” sector. [13]

(b) Foreign investment in banking and associated efficiency gains

20. As was already mentioned, (see section V of TRADE/2001/1), foreign providers deliver banking services primarily through foreign direct investment, establishing their commercial presence in a host country under the control of the parent institution.

21. Among countries of central and eastern Europe and the Baltics, Hungary, Latvia, Lithuania and Poland have experienced the most significant penetration of foreign investment in banking (see table 1). At the end of the past decade, in terms of numbers, the share of banks with foreign participation was as high as 67 per cent in Hungary, 56 per cent in Latvia, 50 per cent in Lithuania and 37 per cent in Poland. During 1994-1998, in the Czech Republic and Estonia, the number of such banks did not grow. However, their share in the total number of banks increased to about one-third in each case because of the decrease in the total number of banks in those countries.

Table 1: Number of banks and foreign banks in selected transition economies

	Number of Foreign Banks/ Total Number of banks					**Percent of total**				
	1994	**1995**	**1996**	**1997**	**1998**	**1994**	**1995**	**1996**	**1997**	**1998**
Bulgaria	1/40	3/41	3/42	7/28	…	2.5	7.3	7.1	25.0	…
Czech Republic	12/55	12/55	13/53	14/50	13/45	21.8	21.8	24.5	28.0	28.9
Hungary	17/43	21/42	25/41	30/41	27/40	39.5	50.0	61.0	73.2	67.5
FYR of Macedonia	3/6	3/6	5/22	5/22	5/24	50.0	50.0	22.7	22.7	20.8
Poland	11/82	18/81	25/81	29/83	31/83	13.4	22.2	30.9	34.9	37.3
Estonia	1/22	4/18	3/15	3/12	2/6	4.5	22.2	20.0	25.0	33.3
Latvia	…/56	11/42	14/35	15/32	15/27	…	26.2	40.0	46.9	55.6
Lithuania	0/22	0/12	3/12	4/11	5/10	0.0	0.0	25.0	36.4	50.0
Georgia	1/226	3/101	6/61	8/53	9/43	0.4	3.0	9.8	15.1	20.9
Kazakhstan	8/184	8/130	9/101	22/82	20/71	4.3	6.2	8.9	26.8	28.2
Kyrgyzstan	3/18	3/18	3/18	3/20	6/23	16.7	16.7	16.7	15.0	26.1
Ukraine	1/228	1/230	6/229	12/227	…	0.4	0.4	2.6	5.3	…

Source: “TANG , H et. al. "Banking Crises in Transition Countries Fiscal Costs and Related Issues”, p. 5 – 6.

[13] Ekonomika i Zhizn’, No. 5, February 2001.

22. The penetration of foreign banks is smaller but also important in a number of CIS countries. At the end of the 1990s, in Kazakhstan, Georgia and Kyrgyzstan their share in the total number of banking institutions ranged from 21 to 28 per cent. In the Ukraine, the number of banks with foreign investment increased from 1 in 1994 to 12 in 1997; their share in the total number of banking institutions though remained small amounting to about 5 per cent.

23. In some transition economies aspiring to quickly accede to the European Union and relaxing restrictions on the presence of foreign banks, the latter has become strategically important. In Hungary, for example, the foreign investors' share of banks' assets increased from 15 – 20 per cent in the early 1990s to about 60 per cent at the end of that decade. The indicated share in assets enables banks with majority foreign participation to control over 80 per cent of the sector's assets. [14] In 2000, in Estonia the foreign share in the banking sector's paid-in capital increased to 69.9 per cent. [15] In Poland, the foreign share of banks' assets at the end of the 1990s was as high as 36 per cent. This participation permitted control of 53 per cent of the banking sector's assets attesting to a spectacular rise from 2 per cent in 1994.

24. The Czech Republic, another candidate for EU membership, has been slower in bank privatization and restructuring than other central European countries. However, the sale of controlling stakes of banks to foreigners in the course of privatization after the insolvency crisis of 1996 - 1997 reportedly brought foreign participation in the banking sector assets to around 54 per cent.[16]

25. The inflow of foreign capital in the banking sector depends largely on the progress of legal and regulatory reforms, aimed at establishing national treatment and fair competition for foreign and domestic bankers. In countries of central Europe these reforms have been conditioned by the objectives of EU accession and have been tailored to meet the accession requirements. At the same time, foreign investors are equally attracted by the sustainable growth of the host economy, confidence in, and health of the financial sector, and improved prospects for lending to the "real" economy. In most of the transition economies not belonging to central and eastern Europe, the indicated regulatory and economic conditions are not yet in place or sufficiently developed for attracting FDI to the banking sector.

26. Recent empirical research has shown a number of advantages that the host economy might reap from an inflow of foreign investment to the banking sector. In particular, a number of studies have concluded that as opposed to foreign banks operating in developed economies, banks with foreign participation operating in emerging markets have been more efficient than their domestic rivals in terms of both costs and profits. [17]

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[14] "International Capital Markets; Developments, Prospects and Key Policy Issues", by a staff team led by D. Mathieson and G. J. Schinasi, IMF 2000, p. 208-209.

[15] "Credit Institutions in the Republic of Latvia", Bank of Latvia, http://www.bank.lv/Kred/English/text10.html

[16] "International Capital Markets; Developments, Prospects and Key Policy Issues…", p. 208-209 and 153.

[17] See for example Berger et. al. (1999), Claessens et. al. (1998), Kiraly et. al. (1999), Tamirisa (2000).

27. In transition economies, foreign banks' affiliates tend to have higher profits than their domestic competitors. As shown in table 2, during 1996-1998, banks with foreign participation in the Czech Republic, Hungary and Poland enjoyed a return on equity averaging 19 per cent, while all banks (including those with foreign participation) suffered losses equivalent to 5 per cent of equity. Foreign-controlled banks also had lower costs and a smaller percentage of problem loans than the banking sector in these three countries taken as a whole. These differentials in the efficiency indicators attest to a direct contribution of foreign-controlled banks to the economic efficiency of the host economy.

Table 2: Bank performance indicators in selected central and eastern European economies, 1996-1998 average (per cent)

	Return on Equity		**Cost-to-Income Ratio**		**Problem Loans/ Total Loans**	
	Foreign Banks	Domestic Banks	Foreign Banks	Domestic Banks	Foreign Banks	Domestic Banks
Czech Republic	14.4	-1.6	70.9	40.5	18.8	28.5
Hungary	16.1	-26.0	62.4	113.0	10.6	15.1
Poland	24.1	-0.1	50.9	59.9	11.1	9.2
Total	19.3	-5.0	59.9	62.1	13.7	17.1

Source: IMF (2000), "International Capital Markets; Developments, Prospects and Key Policy Issues", p. 166.

28. It is also important to note that the entry of foreign investment in banking has important indirect efficiency spill-over effects in the host economy. Under competitive pressure from new entrants (or even under a threat of such entry) domestic banks make efforts to streamline their operations and improve their corporate governance. This reduces the cost of borrowing for domestic corporate and private customers, and improves the investment climate in the economy. In addition, the rotation of personnel trained by foreign banking affiliates facilitates the transfer of know-how and spill-over of international best practices into the domestic banking sector.

29. To summarize, one can note that during the transition period, countries of central and eastern Europe, the Baltics and the CIS have achieved considerable progress in restructuring the inherited financial systems and the development of indigenous private banking services. The latter grow particularly fast in countries of central and eastern Europe aspiring to join the European Union in the near future; this growth is much slower in the other European transition countries, particularly in those which have not yet reached economic and/or political stabilization.

30. The variety of situations in various groups of countries is also reflected in the scale of foreign investor penetration into the banking sector. Countries of central and eastern Europe have both achieved sustainable economic growth and liberalized their regulations, which have resulted in a massive inflow of

foreign direct investment in banking. While the data available are insufficient, one would assume that such an inflow has not yet materialized in the transition economies of the CIS and southeast Europe.

31. While the perceptions of "acceptable" levels of foreign penetration in the domestic economy in general and in the banking sector, in particular, may differ, empirical studies suggest that this sector might yield important efficiency gains through enhanced foreign penetration. In order to take full advantage of these potential benefits, policy-makers in the CIS and southeast Europe should consider without prejudice the experience accumulated in this area by countries of central and eastern Europe.

2. Insurance

(a) General trends

32. During the 1990s, the insurance industry in transition economies developed at relatively high rates, although from negligible (if not non-existent) initial levels. [18] At constant prices, during 1993 – 1999 the average growth rate of non-life insurance premiums was 7.6 per cent, while the respective rate for life-insurance amounted to 17.4 per cent (see table 3). [19] Both figures compare favourably with the growth rates of insurance in developed market economies: over the same period, average yearly premium growth for non-life and life insurance in the European Union did not exceed 2 and 10 per cent, respectively.

33. The dynamism of the insurance sector has been fuelled by regulatory changes in a number of transition economies, in particular, the introduction of a compulsory third party liability insurance for motor vehicles and a growing demand for private accident and health insurance. In several countries, life insurance growth has been triggered by the introduction of tax allowances for pension savings.

34. The growth of insurance nevertheless has not been stable throughout the region. Especially in the Baltic States, southeast Europe and Russia, financial and economic crises, abrupt changes in taxation, as well as, in some cases, political turmoil, have caused the volume of operations to rise and fall.

35. In most countries of the region, the insurance sector still finds itself at an initial stage of development. In 1999, the aggregated insurance premium volume in transition economies was USD 10.4 for non-life insurance and USD 4.6 bn for life insurance as compared with respectively USD 269 bn and

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[18] Statistics used in this section were complied by the Swiss Reinsurance Company on the basis of data provided by national supervisory authorities and insurance associations.

[19] Depending on the nature of its products, insurance is generally sub-divided into life- and non-life insurance. Life insurance is an activity where policyholder makes regular payments to an insurer for which the insurer guarantees to provide an agreed sum, or an annuity, at a given date, or earlier if the policyholder dies beforehand. The sum may be fixed or reflect the income earned from investment of premiums. Policyholders expect the benefits received to exceed the premiums paid until the policy is due, and therefore the life insurance can be seen as a form of saving. Non-life insurance protects the health of individuals, as well as the property of individuals and institutions against unexpected losses, for example accidents, sickness, fire, etc (see System of National Accounts 1993, Annex IV).

Table 3: Insurance sector indicators in selected transition economies

Country/Region	Life Insurance						Non-Life Insurance					
	Premiums			Growth rates (constant prices)			Premiums			Growth rates (constant prices)		
	USD mn	per capita (USD)	per cent of GDP	1993 - 1999	1998	1999	USD mn	per capita (USD)	per cent of GDP	1993 - 1999	1998	1999
Central and eastern Europe												
Czech Republic	576	56.0	1.08	10.2	7.4	29.3	1231	119.6	2.32	9.6	3.6	4.1
Hungary	507	50.1	1.04	16	22.6	21.6	748	74.0	1.55	1.5	3.3	4.6
Poland	1484	38.4	0.96	16.4	18.2	21.6	3041	78.6	1.97	11.5	6.5	7.9
Slovakia	207	38.3	1.05	17.5	28.8	19.3	366	67.8	1.86	7	13.3	-7.5
Slovenia	159	80.3	0.81	26.2	8.7	12.1	567	285.7	2.88	5.1	4.7	0.1
Baltic States												
Estonia	15	10.2	0.29	14.7	48.7	2	74	50.7	1.43	15.1	1.5	2.4
Latvia	18	7.5	0.29	-1.2	-6.1	34.6	145	58.9	2.32	24.1	30	3.3
Lithuania	18	5.0	0.17	-5.5	9.9	9.7	84	22.5	0.78	24.5	61	0.5
SETE7												
Albania	0.03	0.0	0	-65.5	-95.5	60.6	12.5	3.3	0.34	-7.3	8.7	19.8
Bosnia-Herzegovina	7	1.8	0.15	…	…	…	102	27.8	2.31	41.9	22.1	27.9
Bulgaria	15	1.8	0.12	-19.4	17.1	6.8	154	18.7	1.25	4.3	15.3	35.7
Croatia	96	21.4	0.48	22.5	36.2	12	513	114.0	2.54	-3.7	5.6	1.1
Macedonia, F.Y.R. of	1	0.6	0.04	2.9	5.7	-8.8	111	50.7	3.23	-0.6	-1.3	1.5
Romania	34	1.5	0.1	8.4	55.2	77.1	246	11.0	0.79	14.8	6.7	29.7
Yugoslavia	1	0.1	0	-7.2	-25.7	-20.3	200	18.7	0.23	3.9	0.9	-9
CIS												
Belarus	1	0.1	0.01	-29.1	-32.5	-31	56	5.5	0.52	22.7	17.8	61.3
Kazakhstan	5	0.3	0.03	2.2	-25.2	24.4	44	2.6	0.28	75.9	28.5	24.4
Moldova, Rep. of	1	0.2	0.06	-39.4	-86.2	-48.8	9	2.2	0.81	6.1	21.1	-24.7
Russian Federation	1439	9.8	0.78	16.5	20.3	54.3	2476	16.9	1.34	7.1	-18.6	11.2
Ukraine	6	0.1	0.02	-51	-37.5	-51.5	276	5.5	0.9	8.8	80.4	21.3
Total	**4591**	**33.2**	**0.89**	**17.4**	**17.2**	**32.1**	**10419**	**66.3**	**1.74**	**7.6**	**-0.3**	**7.4**
Memorandum items:												
EU 15	434065	1136.0	5.03	9.6	5.8	17.7	268666	669.9	2.97	1.6	-0.3	1.7
Selected EU Candidate Countries [1)]	3033	44.9	0.97	15.9	17.4	22.9	6655	96.0	1.98	10	7.2	6.5

1) Selected EU Candidate countries include: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania. Slovakia and Slovenia

Source: Swiss Re, "Sigma", N°. 1/2001, p.12 and 33

USD 434 bn in the European Union countries. Seven countries accounted for 90 per cent of the USD 15.2 bn combined (life- and non-life) premium volume: Poland, Russia, Czech Republic, Hungary, Slovenia, Croatia and Slovakia. Remaining countries had only USD 1.8 bn or 11.5 per cent of the regional total.[20]

36. Recently, insurance penetration (measured as the percentage of insurance premiums to GDP) has risen in almost every transitional economy. At the same time, at the end of the past decade, its economic weight was still significantly lower than in more affluent countries of western Europe. In 1999, the total insurance premium volume as a percentage of GDP in transition economies was equivalent to 55 per cent of the average western European level for non-life insurance and to only 14 per cent for life insurance, the latter being particularly dependant on general income levels.

37. Insurance premiums per capita tell even more about the gaps in the levels of this sector's development in different country groups. In 1999, insurance premiums per capita in transition economies amounted to only 10 percent of the EU level for non-life and to just 3 per cent for life insurance.

38. Within transition economies, at the end of the 1990s, insurance penetration was higher than average among the central and Eastern European countries (Czech Republic, Hungary, Poland, Slovenia and Slovakia) which had a ratio of insurance premiums to GDP of over 2.0 per cent for non-life and almost 1.0 per cent for life, amounting to respectively two thirds and 19 per cent of the EU level. In per capita terms, however, the comparison with the EU was much less advantageous: on the same date, premiums per capita of those countries did not exceed 15 per cent and 4 per cent of the European Union levels for non-life and life insurance, respectively.

39. This being said, in the non-life insurance sub-sector, more advanced transition economies already show a higher weight of insurance to GDP than some of the European Union's southern Member States. At the same time, growth in life insurance in countries of central and eastern Europe has been encouraged by the stabilized macro economic environment and tax incentives introduced to promote individual private pension plans. Life insurance premiums account for a third of total premiums in the countries of central and eastern Europe. This is the highest proportion as compared with that in any grouping of transition economies; however, it is still substantially lower than in European Union countries where life insurance contributes 62 per cent of all premiums.

40. During 1993 – 1999, the Baltic countries benefited from opening their markets to foreign investment in insurance and enjoyed a steady growth in non-life insurance. In contrast, life insurance developed slowly, especially in Latvia and Lithuania, where the industry suffered from a lack of government support. In the late 1990s, life-insurance growth accelerated due to newly introduced tax allowances for long-term life insurance.[21] At the same time, growth of non-life insurance fell back in

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[20] "SIGMA", No. 1/2001, Swiss Re, p. 3, 12.

[21] Ibid., p.12-14

1999 in the aftermath of the 1998 financial crisis. As a result of these contradictory developments, in 1999 the weight of insurance in the Baltic States' GDP was slightly lower than the transition economies' average for non-life, and more than three times lower than the average for life insurance. Premiums per capita amounted to 70 per cent of the average for transition economies in non-life and to about 23 per cent in life insurance.

41. Within the CIS region, the Russian Federation is the dominant market for insurance services. In 1999, it accounted for almost 90 per cent of the aggregated CIS insurance premiums, while the second largest market of Ukraine had less than 7 per cent. In the same year, Russia had insurance premiums in non-life insurance with a value equivalent to three-quarters of transition economies' average. In the other CIS countries for which data are available, this indicator did not exceed one half of the average.

42. The situation was even more diversified in the sub-sector of life insurance. In 1999 its weight in the Russian GDP exceeded 85 per cent of the transition economies' average and, according to the opinions of experts, the development of life insurance in the Russian Federation should be attributed to the recently enacted changes in tax regulations favouring contractual savings and private insurance savings schemes. At the same time, the volume of insurance premiums and their ratio to GDP recorded at the end of the previous decade attest to a virtual non-existence of life insurance.

43. In terms of premiums per capita, in 1999 the Russian insurance sector had indicators significantly inferior to the transition economies' average (respectively 25 per cent of the average for non-life and 30 per cent for life insurance sub-sectors). In the other CIS countries, for which data are available, these percentages were even lower.

44. Levels of insurance penetration are also quite diverse in the countries of southeast Europe. In 1999, the non-life insurance sub-sector premiums in the former Yugoslav Republic of Macedonia and Croatia as a percentage of GDP were significantly higher than the transition economies' average, while in Albania and Yugoslavia the respective levels did not exceed one fifth of that average. These disparities are even more pronounced in life insurance: in the same year, Croatia had a level of penetration of about 54 per cent of the transition economies' average, while in the other countries of the region, the respective indicators did not exceed 15 per cent of the average.

45. Along the same lines, with the exception of Croatia and F.Y.R. of Macedonia, countries of south-east Europe had low levels of insurance premiums per capita. In Albania, Bulgaria, Bosnia-Herzegovina, Romania and Yugoslavia this indicator did not exceed 40 per cent of the transition economies' average for non-life insurance and in life insurance 5 per cent.

46. In summary, in the second half of the 1990s, the insurance sector in transition economies has developed at a relatively high speed although it witnessed setbacks in a number of countries. In spite of this growth, at the end of the past decade the level of the insurance development in the region was considerably lower than that in countries of western Europe. This concerned, in particular, the life insurance sub-sector, and the gap was particularly pronounced in terms of per capita indicators.

47. Within the group of transition economies, countries of central and eastern Europe can be singled out as more advanced, especially regarding non-life insurance. These are followed by the Baltic States, Croatia, F.Y.R. of Macedonia and Russia. Other countries of south-east Europe and the CIS have a way to go to catch up with the more advanced transition economies, let alone the countries of western Europe.

(b) Market structure and foreign investment

48. At the end of the 1990s, the number of insurance companies operating in the majority of transition economies did not exceed 30 or 40 (see table 4). This was the case of European countries outside of the CIS; and the situation was similar in the smaller countries of the CIS, where the number of insurance operators ranged between 1 and 60. In contrast, the Russian Federation and Ukraine had considerably higher numbers of insurance companies present on the market. In Russia there were as many as 384 companies in non-life and 1,261 companies in life insurance sub-sectors. The respective figures for the Ukraine were over 30 and 260.

49. In 1999, within the group of transition economies, the insurance companies of central and eastern Europe enjoyed the highest premium volumes per company. In the non-life insurance sector (where companies in transition economies are bigger than in life insurance), the volume of insurance premiums was more than USD 100 mn per company in Poland, about USD 60 mn in the Czech Republic and around USD 45 mn in Hungary and Slovenia.

50. In the Baltics and countries of southeast Europe the volume of yearly premiums per company was much smaller, ranging between USD 10 and 30 mn. Finally, in the CIS region, the volume of premiums per company were the lowest of all, ranging between USD 7 and 9 mn (although in Kazakhstan this indicator was about USD 15 mn).

51. This situation where there are a large number of companies each having a small turnover impedes insurance operators from reaping the benefits of economies of scale and lowering insurance costs for their business clients and households. To remedy this, many transition economies, in the CIS and southeast Europe regions in particular, face the task of restructuring the insurance sector, an objective that is hardly achievable without liberalizing market access and attracting FDI from abroad.

Table 4: Insurance market structure in selected transition economies, 1999

Country/region	Number of Companies		Market Share of Top three Insurers		Market Share of Foreign Insurers		Premiums per Company (millions of USD)	
	Life	Non-Life	Life	Non-Life	Life	Non-Life	Life	Non-Life
Central and eastern Europe								
Czech Republic	39	21	78.6	82.9	37.1	54.4	14.77	58.62
Hungary	16	17	77.8	67.6	91.5	89.5	31.69	44.00
Poland	32	30	73.2	86.5	78.4	98.5	46.38	101.37
Slovakia	21	19	77.1	71.7	32.9	51.7	9.86	19.26
Slovenia	11	12	86.5	83.4	1.5	17.2	14.45	47.25
Baltic States								
Estonia	10	6	55.2	74.8	86.6	97.0	1.50	12.33
Latvia	19	8	41.7	68.5	46.4	31.2	0.95	18.13
Lithuania	27	8	63.7	97.8	68.4	98.0	0.67	10.50
SETE7								
Albania	3	1	100.0	100.0	0.0	0.0	0.01	12.50
Bosnia and Herzegovina	26	7	42.9	80.3	…	…	0.27	14.57
Bulgaria	19	7	60.1	87.6	23.1	10.8	0.79	22.00
Croatia	22	17	76.0	59.0	11.4	39.5	4.36	30.18
Macedonia, F.Y.R. of	4	1	99.5	100.0	94.0	100.0	0.25	111.00
Romania	48	14	57.0	85.5	31.0	71.2	0.71	17.57
Yugoslavia	50	8	75.4	…	…	…	0.02	25.00
CIS								
Armenia	25	1	…	…	…	…	…	…
Azerbaijan	44	4	56.9	…	…	…	…	…
Belarus	54	8	55.2	…	…	…	0.02	7.00
Georgia	20	3	50.1	…	…	…	…	…
Kazakhstan	60	3	29.0	…	…	…	0.08	14.67
Kyrgyzstan	17	…	…	…	…	…	…	…
Moldova, Rep. of	35	6	60.4	93.6	44.5	90.0	…	…
Russian Federatrion	1261	384	24.2	40.9	10.2	11.8	1.14	6.45
Tajikistan	11	0	…	…	…	…	…	…
Turkmenistan	7	1	99.8	…	…	…	…	…
Ukraine	260	>30	19.3	…	…	…	0.02	9.20
Uzbekistan	28	…	…	…	…	…	…	…

Source: Swiss Re, “Sigma”, N°. 1/2001, p.34

52. While the average scale of insurance operations in the countries of central and eastern Europe is small, the concentration of operations within the largest companies is relatively high. In 1999, the market share of the top three insurance providers in the Czech Republic, Hungary, Poland, Slovakia and

Slovenia ranged between 70 and 85 per cent, their having the lowest dispersion as compared with other transition economies.

53. These concentration rates are considerably higher than those in the leading countries of Europe. As a comparison, in the second half of the 1990s, the share of the leading five insurance companies did not exceed 40 per cent in Germany, the United Kingdom and Italy, and 50 per cent in France.[22] At the same time, the market segments which the largest companies account for in transition economies represent only fractions of the insurance markets controlled by their counterparts in developed market economies.[23]

54. In 1999, the concentration rates in insurance were somewhat more diversified in the Baltic States and countries of southeast Europe. In the former region, the top three insurers held the market shares ranging from 42 per cent in Latvia's life insurance to 98 per cent in the Lithuanian non-life insurance. In southeast European countries, the three largest insurance companies accounted for 43 per cent of the life-insurance market in Bosnia and Herzegovina, and around 60 per cent in Bulgaria and Romania. On the other side of the spectrum, there were Albania and the former Yugoslav Republic of Macedonia, in which the top three operators held 100 per cent of both life and non-life insurance markets.

55. Concentration rates of between 50 and 60 per cent were characteristic of life insurance in several smaller countries of the CIS (Azerbaijan , Belarus, Georgia and the Republic of Moldova,). In contrast, in larger countries of this grouping - Kazakhstan, the Russian Federation and Ukraine, - the insurance market was more fragmented. There, the concentration rates in 1999 were the lowest of all the transition economies ranging between 20 and 30 per cent in life insurance. While for the majority of CIS countries the data for non-life insurance are not available, in Russia in 1999 the top three companies collected 41 per cent of premiums in this sub-sector.

56. The inflow of foreign investment in insurance has been particularly important in countries of central and eastern Europe and the Baltics, which lifted restrictions on the operations of foreign insurers during the 1990s. At the end of last decade, the share of foreign-controlled companies in the total volume of premiums was the highest in Poland, Estonia, Lithuania and Hungary where it ranged between 80 and 98 per cent.

57. In 1999, outside of central and eastern Europe, the weight of foreign investors, measured by their share of premiums, peaked in the former Yugoslav Republic of Macedonia (90 – 100 per cent) and Republic of Moldova (90 per cent in non-life insurance), while in the other transition economies the penetration rates of foreign-controlled insurance companies were generally lower. In the mid-ranking

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[22] Byuro Ekonomicheskogo Analiza. Tendentsii i perspektivy razvitiya strakhovaniya v Rossii (Trends and Perspectives of Insurance in Russia), Moskva, 1999 (in Russian), p. 10.

[23] In 1999, the three largest insurance companies in Poland had combined premium volumes of USD 3.5 bn. In the same year, the volume of premiums collected by Allianz (Germany) exceeded USD 50 bn, Generali (Italy) USD 35 bn, and AIG (U.S.) USD 30 bn (company reports).

group of countries (Czech Republic, Slovakia, Latvia, Croatia (non-life) and Romania), the shares of foreign insurers varied between 30 and 60 per cent, and in Bulgaria, Slovenia and the Russian Federation foreign participation accounted for between 2 and 17 per cent of the market.

58. To summarize, one can note that despite recent accelerated growth, European transition economies have relatively small insurance markets. In countries of central and eastern Europe, and also in some countries of southeast Europe these markets are serviced by a small number of companies, with the bulk of operations being effected by a few leading firms. In the larger countries of the CIS, the insurance market is more fragmented with the number of operators running into hundreds and concentration ratios significantly lower than in the economies of central and eastern Europe. In both cases you find a large number of small firms with relatively small operations that risk being under-capitalized and do not benefit from any economies of scale.

59. The penetration of foreign investment and the weight of foreign insurers is generally higher in countries of central and eastern, and southeast Europe. At the same time, it is not necessarily the highest in countries seeking to accede to the European Union in the near future. While national policies *via-à-vis* foreign investors in the insurance sector differ, one would suggest that the opening of transition countries' insurance markets could contribute to their efficiency at a national level and to a smoother integration into the European and world insurance markets.

3. Transborder leasing

60. Transborder leasing is a form of medium-term trade and investment finance, which gives both the lessor and the lessee certain advantages over purchases on credit. In a leasing arrangement, the lessee buys the right to use the product against a rental fee to the lessor, who owns the product. The advantages of leasing for local companies stem from the fact that leasing enables them to acquire an asset without immediate investment and pay for it out of operational profit. In its turn, the lessor expands its presence on markets with considerable sales potential. The existing demand for secondhand leased equipment in transition economies creates an additional guarantee of investment return for western lessors. That is why this financing technique is of particular relevance for countries overcoming the transitional slump and requiring a higher than usual amount of investment.

61. According to Leaseurope, which unites leasing companies from 30 countries, including the Czech Republic, Estonia, Hungary, Poland, Russia, Slovakia and Slovenia, leasing operations in Europe have been steadily growing. From 1977-1993, the annual value of leased equipment grew almost ten-fold. During 1993-1999, the value of newly leased equipment increased by over 10 per cent a year, reaching in 1999 EUR 131.7 billion.

62. In the 1990s, leasing services also enjoyed buoyant growth in the countries of central and eastern Europe. The total volume of new leased equipment financing in Hungary, Poland, the Czech Republic, Slovakia, and Slovenia rose from EUR 1.1 billion in 1993 to EUR 4.2 billion in 1997 and EUR 5.8 bn in 1999 (including Estonia in the last year). Over the indicated period, the growth of leasing operations in

the mentioned economies in transition was higher than the average growth rates in Europe and, as a result, their share of the value of new leases of equipment in Europe increased from 1.6 per cent in 1993 to 4.4 per cent in 1999.[24]

63. Statistical research shows that the high growth rates of leasing in Europe during the 1980s were related to the high rates of investment and overall economic growth. From 1984 – 1997, Portugal and Ireland, for example, which economically were lagging behind more advanced European countries, had leasing growth rates significantly higher than the European average.[25] This confirms the idea that leasing is of particular importance to economies at the stage of rapid catching-up growth, when corporate savings cannot match the much larger investment requirements. From this standpoint, the opening of the EU to selected eastern European countries might create an important additional stimulus for investment and potential for lease financing.

64. During the second half of 1990s, the ratio of leased equipment value to investment in machinery and equipment in European countries on average fluctuated between 13 - 14 per cent. At the same time, these percentages were as high as 25 – 27 per cent for such countries as the United Kingdom and Ireland. In some of the transition economies, primarily those which have advanced the most in creating market economy institutions, leasing also makes up a considerable share of investment finance. In the mid-nineties, for example, leased equipment in the Czech Republic and Hungary, accounted for 19-20 per cent of total fixed capital investment.[26]

65. In other European transition economies, however, leasing in general and cross-border leasing, in particular, is undersized as compared with developed market economies. At the end of the 1990s, the share of leased equipment in total investment in the Russian Federation did not exceed 3 per cent[27], while in the other former Soviet Union member-countries this ratio was less than one per cent.

66. Because of elevated risk, financial leasing deals in many transition economies are short-term and do not fully explore their potential as a form of investment finance. The trend toward shortening lease contracts has become particularly pronounced after the 1998 financial crisis that hit the economies of the CIS.

67. It is important to emphasize that regardless of the lessor's origin (domestic or foreign), most of the leased equipment in transition economies comes from abroad. International and cross-border leasing is reported to be most developed in the sectors of transport equipment (ships, aircrafts and lorries), construction, computers and office equipment, polygraphic, medical, food-processing, packaging equipment and agricultural machinery.

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[24] Calculated from Leaseurope Association, Annual Report 1997 and Annual Report 2000 as presented on the Leaseurope WWW site (www.leaseurope.org).

[25] Christof Beuselinck. The Economic Impact of Leasing. Draft Working Paper. Ghent University, April 2000, p. 4 - 5.

[26] UN/ECE doc. TRADE/R. 641, p. 19.

[27] Ekonomika i zhizn', No. 26 June 1998.

68. In statistical terms, in European countries, leased equipment is generally composed of motor cars and other road vehicles (about 50 per cent) machinery and industrial equipment (25 per cent) and computers and business machines (12 – 13 per cent). In the countries of central and eastern Europe, the types and use destinations of leased equipment (production or consumption) vary. In Hungary, the Czech Republic, Slovenia and Slovakia leasing is primarily used for acquisition of motor cars and other road transport vehicles to be used both for productive purposes and consumption. In some of these countries, Hungary and Slovenia in particular, the use of leasing for private consumption has developed quickly; the weight of this use category in 1998-1999 being significantly higher than the European average.

69. In contrast, in Poland and Estonia leasing is used mostly for production purposes. At the end of the 1990s, the weight of industrial machinery and equipment in these countries' lease contracts (33 and 25 per cent) was higher than the European average. On the same date, in terms of leased equipment destinations, industry and construction, and private sector service providers accounted respectively for almost 35 and over 50 per cent of leased equipment in Poland; in Estonia, over 60 per cent of leased equipment found use in agriculture, forestry and fishing.

70. While the data for all the CIS countries is not available, one notes that the use of leasing for investment purposes is also characteristic of the Russian Federation: at the end of the 1990s, over 40 per cent of leased equipment was used in industry and construction, and about 25 per cent in agriculture and communication, each.[28]

71. Impediments to the use of leasing lie in the legislative, regulatory and tax areas and are often common to other internationally traded services. These include:

a) the absence of legal acts clearly defining the lessors' and lessees' rights;

b) non-transparent, cumbersome and lengthy procedures for contract enforcement in cases of default;

c) excessive taxation liable to abrupt changes.

d) the lack of or inadequate financial guarantees from prospective lessees.

72. The first three obstacles should be remedied through the overall upgrading of legal and tax systems, and law enforcement. The last one is linked, in addition, to the poor financial condition of local enterprises and is overcome by leasing companies through innovative business models involving sub-leasing and risk sharing.

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28 Ibid.

73. Payments of leasing obligations can be secured through additional guarantees from various commercial, or municipal or regional government entities as well as through pledges of other assets (e.g. real estate). The use of international sub-leasing permits allows the lessee to be offered competitive financial terms (owing to cost of capital differentials between developed and transition economies). At the same time sub-leasing facilitates the monitoring of leased equipment use and the collection of payments.

74. In spite of sometimes cumbersome legal procedures for contract enforcement, in those countries where the lessor maintains ownership of the leased goods, leasing often allows goods to be more easily "confiscated"/re-claimed in the case of non-payment than under other financing arrangements. For example, when financing is done on a loan basis with the goods belonging to the borrower, but used as collateral, in most transition economies it can take two to seven years to confiscate the goods for non-payment. As a result, financial institutions are highly reluctant to issue loans for equipment, especially to SMEs, and leasing offers a valid financing option to these companies. Given the overall low financial leverage available to industry and enterprise in transition economies, as opposed to in developed market economies, this is important.

75. Therefore, we would recommend that Governments adopt leasing-friendly legislation, encourage competitive financing of local leasing companies and support the development of local expertise and promotion through professional leasing associations

76. To summarize, one can note that in countries of central and eastern Europe cross-border leasing has become an important means of trade and investment finance; and the accession to the European Union might increase opportunities for this business service. In countries of the CIS, leasing has not yet acquired a similar economic importance. The strict enforcement of property rights, and those stemming from leasing contracts, in particular, would improve the overall environment. Leasing friendly legislation, competitive financing for local leasing companies and the development of local expertise would also support the development of leasing as a financing alternative for enterprises. At the same time, better economic prospects might contribute to reducing the risk perceptions of lessors and facilitate the use of leasing models, tailored to the conditions of countries in question.

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