Development Research Group
World Bank

The Role of Non-Bank Financial Intermediaries in Egypt and other MENA countries

Dimitri Vittas

November 1997

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author. They do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

Table of Contents

Introduction 1

Leasing and Factoring 2

Contractual Savings Institutions 4
- **Causes of Underdevelopment** 7
- **Contractual Savings Institutions and the Capital Markets** 9
- **Impact on Capital Market Efficiency** 12

The Insurance Sector 16

Venture Capital Companies and Mutual Funds 18

Recent Developments in Egypt 21
- **The Social Insurance System** 21
- **Private Pension Funds** 24
- **The Insurance Sector** 25
- **The Capital Markets** 25

Policy Implications and Conclusions 26

Tables 30

References 41

This is a slightly revised version of a paper presented at the Conference "Towards an Efficient Financial System in Egypt", organized by the Egyptian Center for Economic Studies in Cairo on February 26 and 27, 1997.

INTRODUCTION[1]

Non-bank financial intermediaries (NBFIs) comprise a mixed bag of institutions. Traditionally, they included all financial institutions that were not classified as commercial banks. But with the assimilation of building societies and other thrift deposit institutions with commercial banks as institutions that accept deposits AND make loans, NBFIs have come to mainly include 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 state of development of the financial system as a whole.[2]

This paper is mainly focused on contractual savings institutions, namely pension funds and life insurance companies, that are by far the most important NBFIs. However, before discussing their role and the determinants of their growth, the paper offers a brief review of the role and growth of leasing and factoring companies. There is also a brief discussion of the insurance sector and venture capital companies and mutual funds. Although the paper offers an overview of developments in selected countries in different regions of the world, a section is devoted to an

---

[1] The comments of Ahmed Galal and other discussants at the conference are gratefully acknowledged with no implication.

[2] The exception is when the development of commercial banks is held back by restrictive regulations. 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).

examinations of the recent growth of NBFIs, and especially of contractual savings institutions and securities markets, in Egypt. The paper concludes with a brief summary of policy implications.

LEASING AND FACTORING

Leasing and factoring companies have experienced significant growth in most countries around the world (Table 1). They enjoy a number of important advantages over traditional bank lending (IFC 1996). 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 their dealings with their 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 thus enjoy important informational 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 much better collection record than commercial banks. Thus, leasing and factoring companies are ideally suited for supporting the financing and growth of small and medium size firms and can play a very important role in those countries where economic and social development is dependent on a thriving SME sector. Leasing companies may also facilitate foreign direct investment as 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.[3] But they can also raise finance from other financial institutions such as pension funds and insurance companies, providing 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, by securitizing their receivables, they have given a boost to asset-backed securitization.

The development of leasing and factoring requires the adoption of 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 Korea in the late 1970s, have supported the establishment and growth of leasing and factoring companies. The sector is today far more developed in Asia, especially East Asia, although significant progress has also been made in Latin America and Eastern Europe. The Arab world appears to be behind in the development of leasing and factoring companies, as in most other areas of the financial sector, although the basic regulatory framework has been established in a number of Arab countries, including Tunisia, Morocco and more recently Egypt and Lebanon.

CONTRACTUAL SAVINGS INSTITUTIONS

As already noted, contractual savings institutions are by far 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.

Countries vary considerably in the relative importance of their contractual savings institutions. We can usefully distinguish three levels of development:

---

[3] This presumes that leasing and factoring companies have a diversified portfolio of creditworthy projects and are well capitalized. However, as highlighted by the recent experience of banks in Japan, Thailand and other East Asian countries, this result would not obtain if the banks use specialized subsidiaries to by-pass strict prudential controls and fail to apply normal prudential standards when they lend to their own leasing and factoring subsidiaries.

* countries where the assets of pension funds and insurance companies correspond to less than 10% of GDP;
* countries where they are over 10% but less than 50%; and
* countries where they exceed 50%, in some cases by a wide margin.

The first group covers most Latin American countries (with the exception of Brazil, Colombia and most notably Chile), all Francophone African countries, and all Eastern European and Asian countries (except the Asian countries listed below).

The second group covers Brazil and Colombia among Latin American countries, such Asian countries as India, Indonesia, Korea, the Philippines and Sri lanka, all MENA and Anglophone African countries, and all continental European countries (except Scandinavian countries as well as the Netherlands and Switzerland).

The third group covers mainly Anglo-American and Scandinavian countries (i.e. US, Canada, UK, Ireland, Australia, New Zealand, Denmark, Finland, Norway and Sweden) as well as Switzerland and the Netherlands among European countries, Hong Kong, Japan, Malaysia and Singapore among East Asian countries, South Africa and Chile.

Jordan, Morocco and Tunisia among Arab countries bordering on the Mediterranean Sea have total contractual savings in the region of 20% of GDP, while in Egypt the total assets of the social insurance system, private pension funds and insurance companies are nearly 40% of GDP. Despite basing their pension systems on the so-called scaled premium approach,[4] there are important differences among the contractual savings sectors of these four Arab countries.

In Jordan, the assets mostly represent the accumulation of financial resources by the Social Security Corporation. This is financed with a 15% contribution rate 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.

---

[4] A scaled-premium approach sets the contribution rate for a period of 5 or 10 years (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.

Egypt applies a much higher contribution rate of 26% in its social insurance system. Annual flows into the system are very large as both the system and the covered population are very young. However, the benefits of the large annual net inflows have been offset by highly negative real returns earned in the late 1980s and early 1990s.[5]

Morocco and Tunisia have social pension systems with much lower contribution rates and more mature structures. These already face financial pressures with limited accumulated resources. However, both countries operate other social funds with surplus resources, in particular the funds for family allowances.

All four countries have very young populations. Their social security systems may benefit in the medium term from expansion of coverage. However, a sounder basis for their future evolution and greater contribution to financial sector development would be achieved if the systems were based on individual accounts with a more direct link between contributions, investment income, and benefits.

Contractual savings institutions experienced rapid growth in the 1980s in most countries of the third group (Table 2). 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% of GDP in the early 1990s, growing from less than 50% in 1970. Among East Asian countries, Singapore and Malaysia have long had sizable contractual savings sectors, with resources corresponding to between 50% and 70% of GDP, while in the 1980s, following the radical reform of its social security system, the total assets of contractual savings institutions in Chile expanded from less than 1% in 1980 to 30% in 1990 and 52% in 1993. The main factors explaining the high rate of growth in these countries were expansion of coverage and/or high investment returns, especially in the 1980s.

---

[5] Despite imposing an inordinately high contribution rate of 26%, the social insurance system of Egypt succeeded in suffering a reduction in the share of accumulated balances to GDP from 38% in 1988 to 32% in 1993. The culprit for this fall was the negative real rate of return of nearly 12% for most of this period (World Bank 1994). At this rate, the real value of balances declines by 47% in five years and by 78% 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 (see below).

Causes of Underdevelopnent

What accounts for the underdevelopment of contractual savings in different countries? In very poor countries in 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 future long-term needs. Although high-growth poor countries experience a high rate of saving (e.g. China and India in recent years), such saving is usually first placed in bank deposits and other liquid instruments. Reliance on the extended family and other informal support systems, which is more prevalent in poor countries with large rural populations, is another factor.

In middle income countries, the main reasons for the underdevelopment of contractual savings are high inflation and macroeconomic instability, a repressive regulatory framework, and the existence of an unfunded and often badly designed social security system. Each of these factors can have important adverse effects on the development of contractual savings.

High inflation undermines the predictability of operations of pension funds and insurance companies. Although use of indexed instruments may mitigate the problem, indexation mechanisms often break down in highly inflationary countries. 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, the existence of a badly designed and often unfunded social security system may crowd out the development of contractual saving institutions, both by weakening the need for them and by limiting the scope for their expansion through the imposition of high payroll taxes.

Among developed countries, the main factor explaining differences in the state of development of contractual savings has been the existence or not of a social security system 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, fall under this pattern as well as Germany, Belgium and Austria. In addition, the operation of unfunded or partially funded occupational pension plans has been another contributory factor.[6]

---

[6] 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

Contractual Savings Institutions and the Capital Markets

Contractual savings institutions can play a very important role in the development of a country's capital market. This depends on the allocation of their assets, which varies considerably from country to country, reflecting both historical traditions and differences in regulation (Table 3). 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 developed since the mid-1960s in response to the high rates of inflation experienced by the UK economy between 1960 and 1990. But this pattern is also explained by the absence of legally imposed minimum funding requirements and by the use of pension obligations that are quasi-indexed to inflation. Real assets represent a smaller proportion of pension fund assets in the United States and other Anglo-American countries and even smaller ones 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 the result of a traditional emphasis on conservative investment policies. Although pension funds and insurance companies are subject to upper limits on their holdings of equities (as well as overseas securities) and although their managers are seeking either increases in these limits or their complete abolition, restricted investments are well below the specified limits. But a gradual shift of asset allocations of Dutch and Swiss pension funds in favor of equity investments is taking place and this has major implications for the size and liquidity of their respective national markets.

The pattern in other countries is similar to that of continental European countries. Investment rules have generally favored bonds, except for South Africa, where pension funds and life insurance companies have been free to invest in equities. In Singapore, the Central Provident Fund invests over 90% of its funds in specially-issued, nonmarketable and floating rate government securities that earn a modest positive real rate of return. In Malaysia, the funds of the

---

invested in the assets of sponsoring employers. The mobilization of resources should be recorded even if usage is less than optimal.

national provident fund are placed in government bonds, although investments in equities have increased in recent years. In both countries, individual workers are allowed to withdraw funds for investment in housing and an increasingly broader range of approved securities.[7]

In Chile, investments in corporate equities for the privately managed pension funds were less than 20% of total assets in the late 1980s, mainly because of the imposition of tight restrictions on their investment portfolios. 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% of assets in the 1990s while they were also allowed to invest in foreign securities.

In the Arab countries covered in this paper, 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 what happens in 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 paper, in low-interest housing loans, and even in building low-rent housing units. This has depressed investment income, although in recent years 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 Corporation has been forced to place a growing percentage of its new flows into bank deposits,

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

although a new policy may be adopted in the future that emphasizes a more professional approach in 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 to well over 20% in Australia, New Zealand and the United Kingdom and around 60% in Hong Kong.

International diversification may increase portfolio returns, especially if pension funds become too big 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), which may be attributed to the nature of their liabilities, the absence of efficient hedging facilities, and their preference for investing in markets and securities they know better. Nevertheless, international diversification has been growing fast. Most countries, especially those with undiversified economies dominated by a few industries and a few family groups, should allow some foreign investments once a new pension system is well established.

Impact on Capital Market Efficiency

The impact of contractual savings institutions on capital market efficiency depends on their size, their investment policies and their 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). The equity market is very large (in relation to GDP) in the United Kingdom and South Africa where pension funds invest heavily in equities, but it is also very large in Switzerland and Chile, where pension funds invest relatively little in equities. Also, in Malaysia and Singapore, the equity market is very large with high trading volumes even though direct investments by the respective provident funds in equities are either minuscule or nonexistent. Other investors, especially foreign institutional investors,

probably account for the large capitalization of the equity markets, and the large volume of trading, in these two countries.

Levine and Zervos (1995) emphasized the importance of the value of trading as an indicator of market efficiency, low transaction costs and market liquidity. They found that market liquidity is positively and robustly correlated with contemporaneous and future rates of economic growth, capital accumulation, and productivity growth. Recent years have witnessed very big increases in trading volumes in many stock markets around the world as well as growing equity markets, measured in terms of market capitalization in relation to GDP (Tables 5 and 6).

In countries, such as Malaysia and Singapore, the growing internationalization of portfolio investing must clearly be a major factor in the veritable explosion of trading volumes on their equity markets. From 7% of GDP in 1985 (admittedly a recession year with depressed market prices and activity) trading volume exploded to 250% in Malaysia and 150% in Singapore in 1993 (though trading volumes suffered substantial falls in 1994). In contrast, in European countries, in addition to international investors, domestic institutional investors must also have contributed to the growth of trading volumes. This is especially 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 the Dutch and Swedish markets reached in 1993 the level of the UK market in 1990.

Chile and South Africa continued 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 all three countries. Among Arab countries, Jordan has a reasonably high level of trading activity. The stock exchanges of the other 3 countries are still at an early stage of development, although considerable progress has been made in very 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 the traditional investment banks, that 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 have been a major contributing factor to the advent of 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). More recently, institutional investors have become more actively involved in monitoring corporate performance and exerting direct and indirect pressure for better and more effective structures of corporate governance.[8]

The role of pension funds and insurance companies in the capital markets has also come under criticism for allegedly causing greater market volatility, adopting a short-termist attitude on investments, and neglecting the financing needs of smaller firms. Because they trade more actively, institutional investors increase the liquidity of markets and lower volatility. However, their proneness to herding behavior exposes markets to sudden changes of sentiment that may cause abrupt fluctuations in prices. The evidence on short-termism is also somewhat mixed and not particularly strong. Moreover, recent developments underscore 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 specialist institutions such as banks as well as leasing, factoring and venture capital companies.

---

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

THE INSURANCE SECTOR

The insurance sector comprises life and nonlife (also known as casualty and property) insurance companies. Their development varies considerably across countries (Table 7). It 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. Nonlife insurance companies generate a relatively smaller amount of financial assets deriving from the reserves they set aside to cover future claims.

Income and wealth, macrofinancial stability, and the regulatory framework are the main determinants of insurance business as they are 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 and low premiums. Motor insurance produces large technical losses, which force insurance companies to scrutinize claims and delay their settlement. In many cases, large court awards complicate matters as claimants prefer to go to court rather than accept reasonable settlements by insurance companies. A climate of mistrust has evolved over time 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, 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 retention of risks, but it also implies that the domestic market does not develop the capacity to price and retain risks locally. However, 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 countries around the world, including East Asia, Latin America and Eastern Europe, insurance business has experienced considerable growth. In the Arab world insurance business has stagnated and has suffered declines in relation to GDP. In large part, this may be attributed to the underdevelopment of life insurance. Whereas in many countries around the

world the share of life premiums in total premiums has been growing fast, reaching or exceeding 60%, it has hovered around 20% or less in Arab countries (Table 8).

The development of life insurance is often affected by the existence of a credible social security system and/or the offer of well funded company pensions based on defined benefit plans. But in countries where the security of social pensions is in doubt, life insurance business may benefit as workers seek alternative means for security their old age financial needs. For instance, life insurance has been growing very fast in France where both social security and company pensions are unfunded.

But life insurance business also receives a great boost in countries that rely on defined contribution pension plans since workers purchase annuity products when they retire. The rapid growth of life insurance business 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. This is needed to protect workers and their families from the financial consequences of serious accidents and death before reaching retirement.

In Arab countries, cultural and religious factors may also explain the underdevelopment of life insurance. However, the repressive regulatory environment, lack of competition and product innovation, and the prevailing mistrust of insurance companies have probably been of greater significance. After all, life insurance represents nearly 50% of total premiums in Malaysia, where life business corresponds to 2.30% of GDP against 0.16% in Egypt and 0.12% in Tunisia.

VENTURE CAPITAL COMPANIES AND MUTUAL FUNDS

These two types of institutions are the latest additions to NBFIs, although they have existed in one form or another for a long time. Their role has become more important in recent years as a result of the growth of pension funds and other contractual savings institutions.

Venture capital companies (VCCs) specialize in financing small firms and new ventures. Increasingly, they become involved in financing infrastructure and other major projects that governments delegate to the private sector for more efficient construction and management. The main characteristics of VCCs is that they offer both equity and debt finance and take a more

active and specialist interest in the management of the ventures they support. Their approach is described not as "hands-off" as with traditional commercial banking, but rather as "hands-on" but with "gloves-off". VCCs expect sizable losses on some projects but operate on the principle that a few successful ventures will cover most losses and will leave a substantial profit to compensate their founders for the risks assumed.

VCCs play an instrumental role in the provision of high tech finance in the United States and in supporting the emergence of large numbers of new ventures in such areas as computing and electronics, biotechnology, etc. Their successful operation requires an enabling regulatory framework and an environment that is conducive to private sector initiatives. Access to long-term financial resources and an active market allowing the disposal of stakes and exit from individual companies once the latter are well established are also essential.

Mutual funds investing in equities or bonds have been developed over time as means for conferring to small individual investors the benefits of professional fund management and efficient risk diversification. Their number has proliferated in recent years, especially in the financial systems of high income countries. There are now mutual funds specializing by sector or by country or region as well as mutual funds following active investment management policies or passive ones using published indices of various types of securities.

The proliferation of specialized mutual funds has allowed their use by pension funds and other institutional investors for their 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, are also 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 for dealing with small firms and new ventures, both in selecting promising projects and in monitoring their performance. Participating in venture capital funds, that may also be listed on the stock exchange and may thus be easy to dispose, is an effective alternative that is 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. The latter usually offers higher returns than publicly listed and traded equity and is also gaining in popularity among institutional investors in America, Europe and Asia.

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

RECENT DEVELOPMENTS IN EGYPT[9]

The NBFI sector in Egypt is poised to make a significant contribution to economic development following recent policy changes.[10] First, enabling legislation for the creation of leasing companies and mutual funds has been enacted. 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.

The Social Insurance System (SIS)

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% of the workforce, although this is because farmers are only required to

---

[9] This section draws extensively on a chapter prepared by Albert Martinez of the World Bank for the latest economic report (country economic memorandum or CEM) on Egypt.

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

make a nominal contribution of 1 Egyptian pound against which they receive a minimum pension of 45 Egyptian pounds.

The system dependency ratio is high at 38% despite the young age of the Egyptian population and the young age of the system. This is due in part to the inclusion of spouses, children and other relatives among surviving dependents. Excluding children and other relatives, the system dependency ratio falls to 28%. This is still double the demographic old age dependency ratio and is explained by the low retirement age for women and the young age of surviving spouses.

The SIS is financed from employer and employee contributions, from government transfers, and from investment income earned on its very large 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% is assessed for old age, disability and survivorship pensions, but the contribution rate for other benefits varies from 5% to 15%.

Revenues from payroll contributions declined from 5.1% of GDP in fiscal 1986 to 3.5% in fiscal 1995 (Table 9). This is probably explained by the ceiling that is imposed on covered wages. Government transfers include a 1% formal contribution plus transfers to cover the ad hoc inflation adjustments for basic pensions. Revenues from government transfers grew from 1.2% of GDP in fiscal 1986 to 1.5% in fiscal 1995, although they were around 1% for most of the intervening years. Investment income (net of operating expenses) rose from the equivalent of 2% of GDP in 1986 to 2.8% in 1995. Its share of total SIS revenues increased from 24% in fiscal 1986 to 36% in fiscal 1995. This 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% of GDP in 1986. This fell to 2% 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. But the cost rate of pensions reversed to 2.5% of GDP in 1995. This left an annual surplus of

5.3% of GDP, up from 4.6% in 1990 but down from 5.8% in 1986. The total balances of SIS fell from 38% in fiscal 1986 to 33% in fiscal 1995, with a low point of 29% of GDP in 1992.

As already noted above, this decline has been caused by the highly negative real returns earned by SIS for most of the 1980s. While inflation averaged 18%, SIS balances received a nominal rate of interest of 5% to 6%. Had the balances earned a zero real rate of interest, they would have been 60% higher at the end of 1995 and would thus have amounted to well over 50% 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 economic plan. Starting July 1992, the NIB raised the ate of interest on incremental social security funds (i.e. new funds plus reinvested balances) to 13% in nominal terms. This rate is higher than the current bank term deposit rate of 12% but lower than the 17% paid on NIB investment certificates. It is also higher than inflation which averaged 10% in the period 1992-96.

Although the rate of interest is now positive in real terms, it should be noted that this is paid only on incremental funds. According to NIB data, the new deposits from SIS amounted to 23.4 billion Egyptian pounds or 35% of the total balances of SIS of 67 billion pounds. Assuming that the remaining 65% earns on average 5.5% yields a weighted rate of interest on all balances of slightly over 8%, 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, while the weighted average rate of interest will gradually reach 13%.

Yet despite these improvements, the fact remains that the balances of SIS are not used efficiently and provide little direct support to the development of the capital markets and the promotion of the private sector. A fundamental but gradual reform of the pension system is essential. This could involve first the conversion of the system from a defined benefit into a defined contribution scheme, followed by a privatization of its investment function (with the possibility to invest in corporate equities and bonds) and the an option to employees to contract 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 actuarial position of most of the 500 or so private pension funds that operate in Egypt and offer defined benefit pensions but without full funding. The number of these funds has been increasing very rapidly from 330 in 1991 to over 500 in 1995. They cover nearly half a million workers, up from 200,000 in 1991 and their total reserves amount to 3.3 billion pounds, up from 1.4 billion in 1991. A majority of these funds are established by employees of public sector entities with only about 10% set up by private sector enterprises. The reserves are invested in bank deposits (48%) and government bonds (42%). 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 the insurance sector. A new insurance law was enacted in 1995 and a new set of regulations was adopted in June 1996. These brought the regulatory framework in line with the prevailing approach in Europe. This emphasizes solvency monitoring and prudential regulations and leaves premium setting 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 control collectively over 90% of the market. However, a new emphasis on competition and innovation is likely to result in privatizations as well as in opening the domestic market to foreign competition.

The Capital Markets

Various measures have been taken to revitalize the capital markets, with special emphasis on the market for corporate equities. New legislation--the Capital Markets Law-- was passed in 1992 and executive regulations issued in 1993. These sought to strengthen the Capital Market Authority (CMA), reorganize and modernize the stock exchanges, including the establishment of new trading, clearing and settlement systems, and improve information disclosure. The creation

of mutual funds has been authorized and 15 licensed mutual funds have been created as of June 1996.

The development of the stock market has been stimulated by the spate of privatizations, the increase in the number of listed companies, and the inflow of foreign capital, both for direct and portfolio investment purposes. Market capitalization reached 20% of GDP in 1996, up from 10% in 1993, while trading activity amounted to 3.4% of GDP, up from 0.2% in 1993.[11]

POLICY IMPLICATIONS AND CONCLUSIONS

The main conclusion from the preceding analysis is that NBFIs complement the services provided by banking institutions and also represent a countervailing force to their dominant role, forcing them to be more competitive and efficient. NBFIs provide a strong stimulus to the development of the 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 mostly deal with financial professionals or, at worst, businessmen and entrepreneurs, the main precondition for their creation and growth is enactment of an enabling regulatory framework, including a clear and supportive tax treatment. Openness to foreign participation to ensure availability of the specialist skills and transfer of financial technology and know-how would also be very helpful. 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.

The promotion of pension funds, insurance companies and mutual funds requires more fundamental changes and presupposes the existence of a more robust and elaborate regulatory and supervisory framework. In particular, the establishment of private pension funds may also depend on the implementation of more basic and systemic social security reform. Systemic pension

---

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

reform is difficult to implement because it has many and far-reaching economic, financial, political and social implications. However, many countries around the world, especially in Latin America and Eastern Europe (as well as most OECD countries) are forced to take action 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 take measures to reform and enhance the efficiency of 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 underlying covered populations 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 act as disincentives for systemic pension reform for governments that are faced with more pressing problems. Despite these difficulties, Arab countries would be well advised to start a gradual reform of their social security and pension systems. This is both in order to avoid the problems facing European countries when demographic aging raises the cost of defined benefit schemes and in order to reap the beneficial effects of capital market development.

As a first step in the direction of reform, Arab countries would do well to convert their defined benefit schemes into defined contribution ones, while keeping a centralized public system in place as well as centralized fund management. Once this step 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 of similar or improved conditions. In addition, their 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 or from general tax revenues or a combination of the two, or they could offer to make up any shortfall in the pension obtained from a worker's retirement savings.

This gradualist approach would avoid the immense regulatory burden that would be entailed in a full and immediate privatization of the pension system. However, with or without a

gradualist approach, it is important to emphasize that an efficient and stable financial system presupposes satisfaction of the following three basic conditions (Honohan and Vittas 1996). First, existence of operationally autonomous central banks, able to set interest rates and credit conditions with a view to protecting the value of the currency and the stability of the financial system. Second, presence of autonomous commercial banks (and other financial institutions) that operate as profit centers and are not captive of 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, attainment of a legal and administrative framework that is conducive to the well functioning and enforceability of financial contracts. Inherent in the second condition mentioned above is openness to the international markets and foreign presence that is essential for the transfer of skills and technologies. Such openness is in many respects far more important for the more specialist functions performed by NBFIs.

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
Korea	13	16	23
Indonesia	6	9	14
Colombia	1	6	21
Hungary	..	8	18
Venezuela	12	8	15

Source: IFC (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
UK	43	46	97	145
US	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 the funds invested directly by individual workers in housing and other approved assets. Although Singapore is a high income country, it is classified in this paper with developing countries because of the historical interest of its performance.

Source: Davis (1995) and national central banks.

Table 3

Asset Allocation of Pension Funds in Selected Countries, 1990

(% of assets)

	Real Assets	(Of which Equities)	Debt Instruments
Netherlands	31	(20)	69
Sweden	..	(..)	..
Switzerland	33	(16)	67
UK	72	(63)	28
US	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 the direct investments 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
UK	145	123	45
US	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
UK	37.1	63.6	79.9	123.3
US	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
UK	6.6	13.3	26.2	45.3
US	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
UK	7.11	9.67	11.43
US	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
UK	59.8	64.5	63.9
US	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
(% of GDP)

	Contributions	Transfers	Investment Income	Total
Fiscal 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)

	Contributions	Transfers	Investment Income	Total
Fiscal 1986	61	15	24	100
1990	54	14	32	100
1995	45	19	36	100

Source: Ministry of Social Affairs and World Bank

References

Bodie, Zvi. 1990. "Pensions and Financial Innovation", **Financial Management**, 19:11-22.

Chernow, Ron. 1990. **The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance.** New York: Simon & Schuster Inc.

Davis, E. Philip. 1995. **Pension Funds: Retirement-Income Security and Capital Markets - An International Perspective.** Oxford: Clarendon Press.

Honohan Patrick and Dimitri Vittas. 1996. **Bank Regulation and the Network Paradigm: Policy Implications for Developing and Transition Economies.** Policy Research Working Paper 1631. World Bank.

IFC. 1996. **Leasing in Emerging Markets.** Lessons of Experience Series, No. 3. , International Finance Corporation: Washington DC.

Levine, Ross and Sara Zervos. 1995. **Stock Markets, Banks, and Economic Growth.** World Bank. Processed.

Monks, Robert A.G. and Nell Minow. 1995. **Corporate Governance.** Cambridge, Ma: Basil Blackwell Inc.

Reisen, Helmut. 1996. **Liberalizing Foreign Investments by Pension Funds: Positive and Normative Aspects.** OECD Development Center. Paris. Processed.

Vittas, Dimitri. 1995a. **Pension Funds and Capital Markets.** World Bank. Processed.

Vittas, Dimitri. 1995b. **Strengths and Weaknesses of the Chilean Pension System.** World Bank. Processed.

Vittas, Dimitri. 1995c. **Sequencing Social Security, Pension, and Insurance Reform.** Policy Research Working Paper 1551. World Bank.

World Bank. 1989. **Financial Systems and Development.** World Development Report 1989. New York: Oxford University Press.

World Bank. 1993. **Egypt: Financial Policy for for Adjustment and Growth.** World Bank Report No. 10790-EGT.

World Bank. 1994. **Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth.** New York: Oxford University Press.