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by Jeffrey B. Miller* and Stefan Petranov**

Introduction

As has been the case in most developing and transition economies, banks in Bulgaria have been the dominant financial institution. Development of other financial institutions, especially private sector institutions, has been very slow during most of the 1990s. Perhaps this was a good thing since laws establishing regulatory agencies did not exist during the early 1990s, and the failure to properly regulate the banking system was an important contributor to the Bulgarian financial crisis of 1996-1997. Since 1997 new laws and changing circumstances have created an environment where a stock exchange with extensive listing has been established, private insurance is more widespread, and private pension systems have begun to emerge.

During the financial crisis several banks failed, depositors lost money and inflation rose dramatically as the lev depreciated sharply. To restore confidence a currency board was established. The establishment of the currency board also signalled that there was a new regime with greater economic discipline.[1] The situation in the banking sector has also improved dramatically. The banks have reduced their exposure to the non-financial sector and the capitalisation of the banks rose to 36.7 per cent in 1998, against the minimum requirement of 10 per cent (OECD, 1999).

Under the currency board regime, banks initially did little additional lending to the non-enterprise sector. Instead they expanded their holdings of cash and government bonds. More recently banks have taken somewhat less conservative positions and have expanded their lending to the non-financial sector and reduced their cash holdings, but credit from the banking system remains very tight and the cost of borrowing high (Caporale, *et.al.*, 2001).

The establishment of the currency board, and the stabilisation that came with it, coincided with the end of the first wave of mass privatisation, While the mass privatisation programme had many distinct features, this first wave was modelled after the Czech programme. Citizens paid a small fee for vouchers which could be used to bid for shares in state-owned enterprises in national auctions (Miller and Petranov, 2000).

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[1] For a general discussion of the currency board and the changes in the economy following its implementation see Miller, 2001

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Once the mass privatisation auctions were concluded, there was increased pressure to develop new capital markets. New regulations were passed and, unlike the Czechs who did not establish a regulatory agency immediately, a Securities and Stock Exchange Commission (SSEC) was created. At about the same time pressures began to build to find better ways to manage the pension system. The value of state pensions had seriously eroded during the early 1990s and the government turned its attention to creating private institutions that could provide additional channels for retirement savings. The increased stability and the lower inflation since the currency board also made it easier for a private insurance market to develop. Another impetus for reform of the insurance industry was extensive "mafia" penetration. By passing new laws and making it more difficult to obtain a license, the government was able to reduce mafia influence.

We then present an overview of recent developments in the capital markets. These markets have had a rocky start with low volume and poor liquidity. The insurance industry, subsequently analysed, has experienced the most growth among non-bank financial sectors but is still relatively small. New pensions systems are beginning to expand and show more rapid growth in the future. In the concluding section we discuss other non-bank financial activities and future prospects for the sector in Bulgaria.

1. Capital Market and Capital Market Institutions

1.1. Laws and Institutions

1.1.1. The Legal Basis for Capital Market Institutions

In June 1995 the Law on Securities, Exchange and Investment Company (LSSEIC) was passed and actions were undertaken to create a regulatory structure and reorganise the capital market. In January 1996, the Securities and Exchange Commission (SSEC) was established and the Central Depository opened in August. In 1995 several exchanges merged and the Bulgarian stock exchange was founded. During the financial crisis confidence in the market eroded and trading ceased in late 1996. In July 1997, following the last auctions in the first wave of mass privatisation, the Sofia stock exchange and the Bulgarian stock exchange merged forming the Bulgaria stock exchange-Sofia (BSE-Sofia) which opened in October 1997. The BSE-Sofia is now the only licensed securities market. The LSSEIC was later amended and then superseded by the Public Offering of Securities Act (POSA) in early 2000. The changes in the new act reflect experience gained during the early years of capital market development and brings Bulgarian law into close alignment with the EU *acquis*. There were also some changes which improved company law. While it is too early to judge what the full impact of these changes will be, there already appears to be improvement in general corporate governance procedures.

1.1.2. Bulgarian Stock Exchange – Sofia

The BSE-Sofia is a joint-stock company. The state has a 37.6 per cent interest, and the remaining shares are owned by financial institutions, i.e. banks, investment intermediaries, financial brokerage houses and insurance companies. The POSA does not allow any non-state shareholders to own more than 5 per cent of the shares. BSE-Sofia is managed by a board of directors which is responsible for the operations of the stock exchange. All decisions as to membership, trade in securities and sanctions against stock exchange members are co-ordinated through an *ad hoc* committee established to meet conditions provided for in the POSA. The committee is a five-member body including representatives of shareholders in the exchange, members of the exchange, stockbrokers and issuers of securities.

In an effort to guarantee transparency of transactions, equal treatment of traders and strict observance of obligations, the BSE-Sofia has been established as a court of arbitration and a guarantee fund. In principle, the BSE-Sofia stock operates three separate markets, i.e. an official market, a free market and a bond market. In addition, there is also a separate market where state-owned shares are sold as a part of the state's privatisation programme.

The official stock market is subdivided into three segments. The specific listing standards for each segment are given in Table 1.

Table 1 – BSE OFFICIAL MARKET LISTING STANDARDS

	Segment A	Segment B	Segment C
Completed financial years with audited financial statements	At least 3	At least 2	At least 1
Market capitalisation	At least BGL 20 mil.	At least BGL 10 mil.	At least BGL 500 000
Part of the issue owned by minority shareholders (%)	At least 25%	At least 10%	At least 5%
Number of shareholders	At least 400	At least 100	At least 100
Average monthly turnover –number of shares	At least 1000	At least 1000	The issue should consist of min. 50000 shares

Source: Proceedings Rules of the Sofia Stock Exchange.

Municipal and corporate bonds can also be listed on the bond market. The size of bond issue must be at least BGL 1 million[2] and the maturity must be at least 6 months. Issuers of corporate bonds must have completed at least three financial years. In principle, government securities could also be listed on the bond market but are not presently traded. Before they can be listed, the Bulgarian national bank (BNB) which manages

[2] Under the currency board arrangement, the exchange rate is fixed at 1 lev = 1 DEM.

the market in government bonds, would need to amend its regulations. Although the barriers to official market listing are very low, there are still very few market participants. For individuals, trading directly in the market is relatively expensive. Few companies have tried to raise additional capital by issuing new bonds or shares.

The BSE-Sofia is striving to improve its operation by focusing on the trading system and the clearing and settlement system. Efforts are being made to improve its information technology systems and even create a system where remote trades can take place. Nevertheless, declining turnover jeopardises the viability of the stock exchange as an institution. While in 1998 the stock exchange reported a profit, in 1999 it registered losses of BGL 560,000. Losses are expected to be even higher in 2000. These losses raise questions about the future viability of the exchange.

1.1.3. The Securities and Stock Exchange Commission

The Securities and Stock Exchange Commission (SSEC) was established to ensure protection of investors' interests and promote the development of the securities market. The seven officers of the commission are appointed by the council of ministers on the recommendation of the finance minister. Officers serve for 5 years. The commission regulates the issuance of new securities and monitors transactions in securities. It oversees the establishment and operation of stock exchanges, investment intermediaries and investment companies. It also proposes and drafts new legislation. For example, the commission deserves credit for the important role it played in bringing the new Public Offering of Securities Exchanges and Investment Companies Act (POSA) into line with the EU *acquis*.

Licensing and supervision are at the core of the commission's activity. Institutions regulated by the commission are required to submit reports to the commission on a regular basis and notify the commission of important changes. The commission can require the disclosure of information and/or carry out on-site checks. If the commission finds violations or identifies an investor who needs protection, the commission can authorise and impose sanctions and administrative penalties directly.

1.1.4. Central Depository

Under the POSA (as well as previously under the SSEICA), all companies that offer their shares publicly have dematerialised shares, and their shareholder registration books are kept by the Central Depository (CD). The CD is also responsible for the settlement of transactions, i.e. it also acts as a transfer agent. The CD was established as a joint-stock company in August 1996. The company's shareholders include the BNB, the ministry of finance, commercial banks and investment intermediaries. The CD has a five member board of directors. Two members are representatives of the BNB and the ministry of finance. Furthermore, the BNB and the finance ministry can veto decisions of the general meeting of shareholders. All transactions, either on or off the BSE-Sofia, must be recorded by the depository. Since only CD members are authorised to carry out registrations, all transactions must be negotiated via investment intermediaries who are also members of the depository. When transactions occur on the BSE-Sofia, procedures are carried out which guarantee that clearing and settlement occurs within three days.

Where transactions are concluded off the exchange, investment intermediaries are only required to present documentation verifying that the transaction has actually taken place between two individuals. The parties to a transaction are responsible for clearing the transaction.

The establishment of the CD in Bulgaria has greatly facilitated trade and transactions in securities. In other transition economies where shareholder books are kept by the companies themselves, the accuracy of these records have been questioned, further eroding confidence in the markets. There have only been a few controversies regarding shareholder registrations in Bulgaria, and there is confidence that transactions in securities are timely and accurately filed.

1.1.5. Investment Intermediaries

Under the POSA, all transactions on the BSE-Sofia must be concluded by licensed investment intermediaries. Non-bank investment intermediation licenses are issued by the SSEC. When banks obtain their banking licenses from the BNB, they also receive a license as investment intermediaries. However, banks are still required to register with the SSEC as agents carrying out investment intermediation.

To trade on the BSE-Sofia an intermediary must become a member of the exchange, and establish trading posts manned by stockbrokers certified by the SSEC. The SSEC also reviews the capital adequacy, liquidity, and managerial competence of investment intermediaries. The commission issues two types of licenses: partial licenses allowing intermediaries to render brokering services and full licenses also allowing intermediaries to deal on their own account and underwrite new issues. By mid-2000, there were 101 licensed investment intermediaries of which 29 were commercial banks. For such a small and shrinking market, this is a large number. Seven or eight large investment intermediaries control between 55 – 65 per cent of the BSE-Sofia turnover and the twenty most active intermediaries account for about 80 per cent. Given this situation, investment intermediaries have opted for reducing operating costs and have turned to trading off-the-exchange instruments like compensatory notes.[3] Both these activities are transient. The first signs of downsizing are already at hand. In 1998 the more active investment intermediaries employed three or four stockbrokers. By 2000 most companies had only one broker and in many cases companies shared the same broker to reduce staff costs.

Table 2 shows how the situation has changed. While the number of intermediaries has been increasing slowly, many intermediaries are not members of the BSE-Sofia and do not have trading posts. These firms do not attach great importance to on-the-exchange business and are mostly involved in outside activities like trading in compensatory notes.

[3] Compensatory notes are notes created as part of the restitution process. These notes have been given to previous owners of property that could not be physically returned. The notes can only be used to bid in privatisation auctions, but they can be transferred.

Table 2 – NUMBER OF INVESTMENT INTERMEDIARIES (INCLUDING COMMERCIAL BANKS)

	31.12.1998	30.06.1999	31.12.1999	31.06.2000
Licensed by SSC	78	92	97	101
Deregistered by SSC		1		2
Members of BSE-Sofia	61	73	76	78

Source: Public Register of SSC

1.1.6. Investment Companies

An important part of the mass privatisation programme was the participation of privatisation funds. These funds collected vouchers from citizens and then used these vouchers to bid for firms in the privatisation auctions. After the first round of the mass privatisation programme concluded, these funds became investment companies. Later, however, these companies were required to declare themselves holding companies or continue their status as investment companies. Holding companies can make loans to companies in which they hold 25 per cent or more of the shares.[4] Investment companies are intended to have more diversified portfolios and are not permitted to hold more than 10 per cent of the shares in any one company. All but four of the original privatisation funds became holding companies.[5] Unfortunately no special legislation was passed to regulate these holding companies so, even though they are really financial institutions, they are operating under the general commercial code.

Currently, there are only five registered investment companies. Four are closed-end companies and only one, *Zlaten Lev*, is an open-end fund. It is also the largest investment company accounting for about 90 per cent of the assets and net profit of all investment companies over the 1998 – 1999 period. Total assets of these funds was BGL 26.8 million in 1998, but has fallen to BGL 11.8 million as prices of shares on the stock market have declined.

1.2. General Conditions of the Capital Market

In spite of establishing extensive market institutions and regulatory agencies, trading has been so light that it threatens the viability of the market and raises important issues regarding the mass privatisation programme upon which the capital markets were built.

Stocks, as measured by the Warburg 30 Index of the largest market capitalisation stocks, performed most successfully in the initial period. The index was set to 100 in

[4] In the present environment where the banks are providing little credit and interest rates on loans are high, these loans can benefit both the holding companies and the companies in their portfolios. The loans provide liquidity to the companies, and the holding companies which often have representatives on the board that can evaluate the risk.

[5] One company, Zlatin Lev, split into two parts. One part is a holding company and the other continues to be an investment company.

December 1997. The index reached its high in May 1998 at 165 but fell to 67 in late-2000. Other market indicators have followed a similar trend. For instance, total market capitalisation (see Table 3) peaked in the 2nd quarter of 1998 at BGL 3 billion but has fallen to BGL 1 billion.

Market activity has also fallen over the 1999 – 2000 period. The number of listed companies has declined and activity has diminished. While figures are not available for the most recent period, new changes in the law permit firms that were privatised during the mass privatisation programme to become private (i.e. not publicly traded.) This should reduce the number of traded firms by, perhaps, several hundred.

Large block trades are an important percentage of overall turnover. During the early months of 1998 there were a large number of block trades. This is because leading up to the voucher auctions, agreements were reached between privatisation funds and between foreign investors and privatisation funds to purchase shares in the auctions. Transfers of these shares were executed through block trades in early 1998 (Miller and Petranov, 2000).

What is interesting is that after a lull, block trades are again an important part of overall turnover in the market. Block trades, although they are recorded as taking place on the exchange, are not normal trades. These are agreements negotiated off the exchange and reflect attempts by large shareholders to gain more concentrated ownership positions. A better gauge of the liquidity of the BSE-Sofia auction market is the number of non-block market transactions and the turnover. As Table 3 shows, liquidity has fallen dramatically, based on both of these measures. Transactions in the first two quarters of 2000 were occurring at about half the rate they were in 1998. Turnover has fallen from a high of BGL 52 million in the 2nd quarter of 1998 to only BGL 6 million in the 2nd quarter of 2000. In spite of the high cost of borrowing from banks, the capital market has provided only a limited alternative. Investment banking has not really developed. There were only two offerings of corporate bonds and no primary issues of stocks. It is difficult to discern whether the lack of investment banking is due to lack of interest in new issues or inadequately trained investment bankers.[6] Why have the capital markets developed so slowly?[7] There are several factors. Some are external factors like the 1998 crisis in Russia and the subsequent withdrawal of international investors from risky emerging markets. Other problems are internal, however. The core of the problems lies with the very genesis of the Bulgarian capital market which *de facto* evolved from mass privatisation. Over one thousand companies initially traded on BSE-Sofia were part of the mass privatisation programme. Unlike companies in the West that come to the capital market to acquire new financing, these companies were registered as public companies in a purely administrative way without having any economic motivation to become publicly traded companies.[8]

[6] For a discussion of the issues surrounding the development of securities markets see Vitas (1998).

[7] For a comparison between the capital market performance in other transition economies, see Johnson and Shleifer (1999), Pohl, *et.al.*, (1995), World Bank (1999) and OECD (1998).

[8] For further details on the impact of the genesis of the capital market on its future development, see Petranov and Miller (1999).

Table 3 – INDICATORS OF TRADE ON BSE-SOFIA

	Q1 98'	Q2 98'	Q3 98'	Q4 98'	Q1 99'	Q2 99'	Q3 99'	Q4 99'	Q1 2000	Q2 2000
Official Market										
No. Companies	1	4	10	19	25	NA	NA	NA	NA	NA
No. Shares	246,938	443,514	911,759	1,364,894	545,976	610,795	264,832	927,633	466,947	3,905,715
No. Transactions	193	166	1,269	1,753	2,047	1,807	808	1,222	1,150	1,340
Turnover (BGL)	5,241,800	8,694,800	3,406,700	2,714,800	1,440,900	7,588,949	645,344	1,566,437	876,662	1,504,570
Market Capitalisation (BGL)	17,494,100	48,102,900	182,417,100	243,401,200	268,532,100	268,186,891	242,108,223	219,126,830	255,559,586	325,032,137
Free Market										
No. Companies	322	983	983	979	844					
No. Shares	1,625,542	5,776,357	4,236,416	2,703,567	1,286,802	623,995	478,991	2,804,411	809,800	1,266,464
No. Transactions	277	4,903	6,376	4,141	3,982	2,711	935	1,757	1,494	1,463
Turnover (BGL)	16,518,700	43,329,300	39,259,100	33,623,800	11,335,700	4,151,907	2,793,960	14,455,675	6,554,944	4,781,870
Market Capitalisation (BGL)	1,823,671,300	3,094,227,700	1,654,719,700	1,092,452,600	1,451,865,500	1,323,718,661	1,203,427,392	1,154,208,586	1,151,869,366	1,011,835,726
Subtotal										
No. Shares	1,872,480	6,219,871	5,148,175	4,068,461	1,832,778	1,234,790	743,823	3,732,044	1,276,747	5,172,179
No. Transactions	470	5,069	7,645	5,894	6,029	4,518	1,743	2,979	2,644	2,803
Turnover (BGL)	21,760,500	52,024,100	42,665,800	36,338,600	12,776,600	11,740,856	3,439,304	16,022,112	7,431,606	6,286,440
Block Trading										
No. Shares	6,629,337	1,941,955	0	335,566	4,331,355	1,821,252	1,602,972	2,847,762	2,645,397	5,816,728
No. Transactions	318	117	0	8	51	42	14	46	46	40
Turnover (BGL)	53,738,300	5,231,700	0	1,836,600	38,149,100	16,767,354	3,725,966	15,923,187	14,818,227	7,896,064
Bond Market										
No. Companies	0	0	0	0	0	0	1	1	1	1
No. Bonds	0	0	0	0	0	0	3,235	1,007	20	1
No. Transactions	0	0	0	0	0	0	23	12	1	1
Turnover (BGL)	0	0	0	0	0	0	220,401	251,762	5,289	269
Total										
No. Shares	8,501,817	8,161,826	5,148,175	4,404,027	6,164,133	3,056,042	2,350,030	6,580,813	3,922,164	10,988,908
No. Transactions	788	5,186	7,645	5,902	6,080	4,560	1,780	3,037	2,691	2,844
Turnover (BGL)	75,498,800	57,255,800	42,665,800	38,175,200	50,925,700	28,508,210	7,385,671	32,197,061	22,255,122	14,182,773

Source: BSE-Sofia

Another important reason for the slow development of the capital market is that the government has failed to take important steps to help the markets expand. While the new laws like POSA should improve market conditions, it is important that efforts be made to ensure that the law is effectively enforced. This is particularly important if good corporate governance is going to be supported and shareholders' rights protected. The government could provide further support for the market if new laws were passed that provided equal tax treatment of all institutional investors. It should also be possible to adjust the law so that government securities can be traded on the BSE-Sofia.[9]

Another problem that must be faced is off-the-exchange transactions. Under present law all transactions in shares of companies that participated in the mass privatisation programme have to take place on the stock exchange. This restriction was an attempt to seek better price integrity and market transparency. Even block trades that are negotiated off the exchange must be registered on the exchange. The only transactions that are allowed to take place off the exchange are swaps and dealings between individuals. In spite of these restrictions between January 1998 and June 1999, the number of shares traded OTE exceeded BSE–Sofia trading by 33.9 per cent. Several other transition economies have been successful in creating viable capital markets. Bulgaria has passed good legislation and established appropriate institutions to promote its capital market. Some big issues remain, however. It is important that the government take a more active role in promoting the market by ensuring that the new laws are enforced and shareholder rights are protected. It can also help broaden the market by completing the sale of important companies like the telecommunications company.

2. Insurance

Before 1997 there was weak regulation of the insurance industry and few requirements to promote transparency. There were questions about whether insurance companies' capital came from legitimate sources and a number of powerful insurers were mafia-like businesses which often resorted to strongarm tactics. In 1997 and 1998, the insurance sector in Bulgaria was thoroughly restructured when the Insurance Act was substantially amended. Stricter requirements on insurers were imposed and the National Insurance Council (reporting to the Council of Ministers) and the Insurance Supervision Directorate (under the Ministry of Finance) were created to regulate the industry.

The highest regulatory body is the National Insurance Council. The Council has seven members with representatives from the Minister of Finance, the Minister of Justice, and the Minister of the Interior, and the CEO of the Insurance Supervision Directorate. The council is chaired by the Finance Minister. It is responsible for licensing, authorisation of mergers and divestitures, and bringing insolvency/bankruptcy proceedings. The Insurance Supervision Directorate is responsible for daily regulatory matters. The CEO is appointed by the Prime Minister on the recommendation

[9] For further information on the possible economic policy measures of the government that may promote capital market development, see Petranov and Miller (1999).

of the National Insurance Council. The Insurance Supervision Directorate monitors the overall activity of insurance companies and insurance brokers. It issues permits to insurers to undertake certain actions. These include sale of insurance portfolios when an insurer is undergoing liquidation; control over products offered and insurance premiums charged. The directorate also authorises the promotion of new insurance products, determines the minimum premium amount on compulsory insurance and approves the annual reinsurance programmes of insurers. It may also undertake certain administrative measures to stabilise the financial condition of insurance companies.

Since the beginning of 1998 the National Insurance Council has instituted new licensing procedures for insurance companies and mutual insurance societies to bring insurers into compliance with the 1997 amendments to the Insurance Act. The majority of companies in the sector have failed to meet the new stricter requirements. Eighty-seven insurance and reinsurance companies and mutual insurance societies (out of a total of 112 companies registered to date) have lost their licenses. Seventeen new joint-stock property insurance companies and another six life insurance companies and four mutual insurance societies were licensed in 1998. Table 4 shows how the structure of the sector has changed over the 1997-1999 period. The sector is highly concentrated. In 1999 the State Insurance Institute – General Insurance, the largest property insurance company, accounted for nearly 30 per cent of the market. The market share of the four largest companies amounted to 70.2 per cent. The concentration of life insurance companies was even higher. In 1999, the State Insurance Institute – SII accounted for 62.4 per cent of the market while the market share of the four largest insurance companies was 91.7 per cent. Both the Herfindahl index and the four firm concentration ratio provide evidence that the sector is becoming more competitive, but the level of concentration remains high.

Table 4 – STRUCTURE OF THE INSURANCE SECTOR

	General Insurance			Life Insurance		
	1997	1998	1999	1997	1998	1999
Number of insurance companies*	n.a.	17	18	n.a.	10	12
State-owned	3	4	3	2	2	1
Private	n.a.	13	15	n.a.	8	11
O/w foreign companies**	0	3	6	0	0	3
O/w mutual insurance societies	n.a.	0	0	n.a.	4	5
Herfindahl index***	0.458	0.421	0.384	0.774	0.756	0.658
Four-Firm Concentration ratio (%)***	84.1	76.4	70.2	97.2	94.1	91.8

*In 1997, the number of insurers (joint stock companies and mutual insurance societies) totalled 112. Data, however, were not reliable enough to treat them in separate groups.

**Insurance companies with foreign shareholders owning over 50% of their capital.

***1997 estimates draw upon the market shares of the insurers licensed to operate in compliance with the amendments to the Insurance Act.

Source: Annual Report of the Insurance Supervision Directorate; Authors' Calculations

Table 5 – TOTAL INCOME FROM PREMIUMS FOR THE INSURANCE SECTOR IN BULGARIA (MILLIONS OF BGL)

	1997	1998	1999
General Insurance	147.3	204.5	278.1
Life Insurance	17.5	28.3	31.6
Shareholding companies	17.5	27.6	30.9
Co-operatives	0.0	0.7	0.7
Total	164.8	232.8	309.7

Source: Annual Report of the Insurance Supervision Directorate

Currently, the largest companies in both segments of the insurance market are state-owned. There are two other state-owned insurance companies, and another company, the Municipal Insurance Company is indirectly controlled by the Sofia municipality. The remaining companies are private, although there is an indirect state interest in some companies like Bulstrad PLC which was privatised. The gradual increase in the number of new private companies, the privatisation of state-owned companies, and the entry into the Bulgarian market of well-established foreign insurance companies are positive signs that the insurance industry will continue to grow. During the period 1997-1999, general insurance generated 90 per cent of premium income (Table 5). Total income from premiums in both segments, i.e. general insurance and life insurance, reported a robust growth of nearly 88 per cent over two years.

Despite its impressive growth the sector remains relatively small. Total income from insurance premiums was only 1.27 per cent and 1.18 per cent of GDP in 1997 and 1998 respectively. This is far below the 2.9 per cent in the Czech Republic of 2.9 per cent (1995). Greece at 1.6 per cent has the smallest insurance sector in the EU (See Table 6 for further comparisons).

Under the Insurance Act, all insurance companies must comply with a number of restrictions on their investment policy. Insurers are allowed to invest insurance reserves only in certain instruments like government securities, real estate, and municipal bonds. Furthermore, the structure of the various investment categories within total insurance reserves is also subject to regulation. Holdings of bank deposits and government securities should be at least 50 per cent, and there are limitations on holdings. For instance, the relative share of real estate cannot exceed 10 per cent of the total; the share of municipal bonds cannot exceed 5 per cent, and the share of corporate securities cannot exceed 30 per cent. Because the sector has been expanding, total assets and total insurance reserves have grown quickly, increasing by 51.8 and 23.0 per cent over only two years. The insurance business as whole is profitable, although some smaller companies have experienced losses in certain years (See Table 8).

Presently, insurance companies are pursuing very conservative investment strategies. Very few financial instruments meet their investment needs. The poor liquidity of most shares on the stock exchange has discouraged insurers from actively

Table 6 – INSURANCE INDUSTRY INDICATORS – PENETRATION AND DENSITY

	in % of	Premiums per capita (USD)		Premiums (in % of GDP)	
	GDP	Non-life	Life	Non-life	Life
Belgium	6.80	909	711	3.82	2.98
Cyprus	4.29	228	257	2.01	2.28
Denmark	6.22	782	1,221	2.43	3.79
Finland	7.77	442	1,368	1.90	5.87
France	9.25	693	1,511	2.91	6.34
Greece	1.74	101	100	0.87	0.87
Holland	9.41	959	1,233	4.12	5.29
Ireland	8.37	622	1,092	3.04	5.33
Italy	4.17	454	376	2.28	1.89
Norway	4.56	805	783	2.31	2.25
Poland	2.74	69	27	1.97	0.77
Portugal	5.42	295	262	2.87	2.55
Russia	1.41	34	10	1.10	0.31
Switzerland	11.94	1,297	2,993	3.61	8.33
Slovakia	2.59	67	26	1.87	0.72
Slovenia	3.73	269	72s	2.94	0.79
Spain	5.38	385	341	2.85	2.53
United Kingdome	11.21	731	1,721	3.34	7.87
Sweden	4.71	591	625	2.29	2.42
Czech Republic	2.89	107	39	2.12	0.77
Germany	6.53	973	694	3.81	2.72
Hungary	2.33	69	34	1.56	0.77
Austria	5.36	853	517	3.34	2.02
EU-15	7.33	679	908	3.14	4.19
USA	8.49	1,404	1,167	4.64	3.85

Source: Sigma Journal, 3/99, OECD

participating in the capital market. Furthermore, they do not have the expertise, information and experience to invest in risky assets. As a result, they tend to invest their reserves almost exclusively in bank deposits and medium- and long-term government securities (See Table 8). In 1999, general insurance companies held over 52 per cent of their reserves in bank deposits and invested more than 40 per cent in government securities. Life insurance companies placed 75 per cent of their reserves in government securities and 15 per cent in bank deposits. There is very low risk in such a strategy, but also very low returns on their investments.

Table 7 – MACROECONOMIC AND INSURANCE SECTOR INDICATORS

	1997	1998	1999
GDP (current prices, millions BGL)	17,055.2	21,577.0	22,776.0
Gross Income from Premiums (millions BGL)	164.8	232.8	309.8
Insurance Penetration (%)	0.97	1.08	1.36
Population (thous.)	8,283.2	8,230.3	8,190.8
Insurance Density (BGL)	19.9	28.2	37.82
Labour Force (thous.)	4,749.5	4,749.7	4,752.8
No. of Individuals with Life Insurance Policies (thous.)	-	1374.1	1,688.9
Relative Share of Individuals with Life Policies as Labour Force (%)	-	28.9	35.5

Source: National Statistical Institute; Annual Report of the Insurance Supervision Directorate

Table 8 – NET PROFIT, TOTAL ASSETS AND RESERVES OF THE INSURANCE SECTOR (MILLION BGL)

	General Insurance			Life Insurance		
	1997	1998	1999	1997	1998	1999
Net Profit	0.31	3.09	5.96	0.28	0.54	0.88
Total Assets	165.0	261.4	355.9	194.0	178.2	188.3
Total Reserves	39.6	86.4	103.2	108.5	86.8	79.0
Distribution of Reserves (%)						
Government Securities	3.7	13.5	40.7	53.2	56.9	75.6
Real Estate	-	8.6	5.18	0.7	1.7	8.0
Municipal Bonds	0.0	0.0	0.09	0.0	0.0	0.2
Corporate Securities	-	1.2	1.94	0.2	3.5	0.3
Bank Deposits	96.3	76.7	52.08	45.6	37.8	15.7
Loans Against Life Insurance	0.0	0.0	0.0	0.3	0.1	0.1

Source: Insurance Supervision Directorate, Annual Report

3. Pension and Health Insurance Funds

The first private pension funds were established as early as the beginning of 1994. They started operating without any specific legal framework or regulation, drawing upon the general provisions of the Commerce Act. In early 1999 there were 30 registered pension funds, but in practice only a few of them are currently operating. Mid-1999 saw the adoption of the Additional Voluntary Pension Insurance Act (AVPIA). This new act provided a legal basis for the social security system in Bulgaria. The system has three pillars. The first pillar encompasses the existing system of mandatory pension insurance as a state provided "pay-as-you-go" system. The second pillar provides additional pension insurance for certain professions with high risk jobs. Employers are required to make insurance contributions to special funds. The third pillar embraces the whole system of additional voluntary insurance. This third pillar includes defined contribution pension insurance purchased by individuals on the free market from licensed pension insurance companies.

The new act also provides for state regulation and control of pension insurance companies and pension funds and the establishment of a State Agency for Insurance Supervision under the Council of Ministers. The agency is authorised to license and regulate companies selling pension insurance. The agency is a legal entity funded by the government with annual appropriations. The Council of Ministers is responsible for appointing the chairman of the agency and determining the number of staff. The new law also establishes a Council for Additional Voluntary Insurance. The council has seven members representing various ministries and the Securities and Stock Exchanges Commission. The council is assisted by a representative of the Association of Companies for Additional Pension Insurance who performs advisory functions. The Council is chaired and convened by the Minister of Labour and Social Policy on a regular basis. It makes decisions regarding licensing and authorises the merger or divestiture decisions of companies.

Under the new law, the State Agency for Insurance Supervision began licensing pension insurance companies. Out of thirty original pension insurance companies only seven were able to meet the new, stricter requirements and were granted licenses to establish and manage pension funds. It is estimated that the licensed pension insurance funds in Bulgaria manage BGL 50 million obtained from contributions from about 500,000 people. Under AVPIA, pension funds are required to meet specific requirements and comply with a number of restrictions in implementing their investment policy. Investments are limited to certain instruments. Pension funds must invest at least 50 per cent of their assets in government securities or bank deposits. No more than 10 per cent of the assets can be invested in real estate and mortgages and no more than 5 per cent of the assets in other instruments. Investment diversification is also subject to a number of restrictions stemming from the need to minimise investment risk. Pension insurance companies are allowed to invest up to 10 per cent of their own assets abroad.

A special feature of the Bulgarian system is that licensed pension insurance companies can also accept pension premiums in the form of investment bonds obtained as vouchers in the second wave of the mass privatisation programme. However, most companies privatised so far in the second wave of the privatisation programme are in dire financial straits or stand slim chances of recovery so their shares have been very illiquid. For this reason the investment bonds are considered unattractive for pension funds. Indeed there are real potential problems here for the pension funds. If many premiums are paid in investment bonds, the assets of pension funds will then consist of highly illiquid securities. At the same time, pension funds must make regular pension payments. This mismatch between the assets and liabilities could destabilise the funds.

For this reason, no licensed pension insurance company has openly encouraged pension contributions in investment bonds.[10]

Pension funds should play an important role as the financial system develops. Because contributions to the "second pillar" pension funds are mandatory, they should grow rapidly. At present, however, they are facing some technical start-up problems. These problems should be overcome in the near future. Health insurance, as provided for by the Health Insurance Act, and the pension insurance system have similar structures. Besides the mandatory health insurance system implemented by the state, there will also be funds for supplementary health insurance. Companies providing supplementary health insurance must be licensed by the State Agency for Insurance Supervision. Currently, there are no licensed health insurance funds as the licensing procedure needs further clarification.

4. Other Financial Services

Other financial institutions that are commonly found in countries with more developed financial markets have not made serious inroads in Bulgaria. In part this is due to the breadth of activities in Bulgaria's universal banks. For example, the development of mortgage banks, investment banks, savings banks, savings and loan associations, finance companies, leasing companies and public financial agencies is very limited.

At present only four commercial banks extend housing loans backed by real estate as collateral. This activity may expand, however, with the passage of the new Mortgage Bonds Act which details the rules for underwriting and trade in mortgage bonds. A new local market for these bonds opened in October 2000. The expectation is that banks will be able to attract additional resources by underwriting mortgage bonds, thus giving rise to bond trading. This in turn will foster supply and lead to the expansion of the housing loan market. Until recently the State Savings Bank (SSB) functioned as a savings bank. In 1999, its legal status was changed into a commercial bank broadening the scope of its loan transactions and banking products offered. Currently, there is no pure savings bank operating in Bulgaria although the SSB has the largest branch network and customer base and still orients its business towards consumer loans. The ongoing restructuring will present a number of challenges for the SSB since its lacks expertise in risk evaluation and still has a reputation of poor customer service. Other financial institutions include two institutions set up under the PHARE Programme to provide financial support to the agricultural sector[11] and the Encouragement Bank. Established in 1999 by the government, the Encouragement Bank enjoys a special status and is suppose to provide financing for small- and medium-sized businesses. After a little more than a year of unsuccessful operation, the Small- and Medium-Sized Enterprises

[10] In the second wave of the mass privatisation programme using investment bonds as pension payments was suppose to support the mass privatisation programme. The programme so far has been very small and has had little effect on overall privatisation efforts.

[11] There is also the State Fund Agriculture which is currently providing financial support to agricultural producers under different programs has been recently accredited as the single paying agency in Bulgaria to manage EU SAPARD funds.

Act under which the bank was established was amended by parliament. The amendments have provided for the removal of restrictions on the bank's lending operations.[12]

5. Conclusions

The establishment of the currency board in 1997 was a real watershed for the financial markets in Bulgaria. During the early years of transition, Bulgaria created a banking system that had many institutional features that resembled banking systems in western market economies, but it did not function as a western banking system. Inadequate controls over the money supply and poor regulation were important factors in bringing about the financial crisis in 1996-7. The currency board changed this. Banks now are more highly capitalised. The problem is no longer too many bad loans, but rather very tight credit. In this atmosphere there should be room for other financial institutions to compete.

There are also some lessons from the early bank experience when considering the present state of non-bank financial institutions. Establishing appropriate institutions is a good first step, but it is crucial that they function appropriately. Since 1997, real progress has been made in creating the appropriate legal and regulatory framework for the expansion of non-bank financial activities. While these steps are important, it is equally important that these new laws be enforced. Furthermore, regulatory organisations must find the right balance between enforcement that builds confidence in these new financial sectors, and regulation that stifles growth. As yet, the insurance sector is the only sector that has seen significant expansion, but pension funds should begin to grow. The development of the capital market is less certain, but the expansion of the insurance and pension sectors should assist the development of the capital markets by providing a new demand for shares. An important question, however, is whether this will be enough to create sufficient liquidity in the capital market. If it does not, serious consideration should be given to closing the local market and organising or participating in a larger regional effort.[13]

At this point in time, the non-bank financial institutions are too small to provide significant competition to the banks, which continue to maintain a wide spread between deposit and lending rates.[14] If these non-bank institutions are able to gain public confidence and expand, this could create more competition for the banks and provide more financial resources to the real sector. This could improve the prospects for better economic growth.

[12] All state-owned banks but Commercial Bank Biochim have been privatised. Many analysts argue that the Encouragement Bank was established by the government to again gain control of a commercial bank.

[13] If Bulgarian companies are traded on foreign or regional markets rather than local markets, it is still important that company law is enforced so that potential investors have confidence that their rights will be protected.

[14] An important unanswered question is whether this spread arises from inherent risks or limited competition in the financial sector.

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