

THE ROLE OF INSTITUTIONAL INVESTORS IN FINANCIAL DEVELOPMENT OF EUROPEAN UNION ACCESSION COUNTRIES

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Abstract. *This paper focuses on an important type of market participants in the modern capital markets – the institutional investors. We start with an overview of what is special about institutional investors and how they can contribute to economic development from a theoretical point of view. We then document their past development trends in eight former-socialist European Union Accession Countries (EU-8). Also we will document statistical connection between the development of institutional investors and financial development in mentioned countries.*

We will suggest, from a subjective point of view, the most important steps in the policy in the financial market of the EU-8 countries that stimulate current and potential future institutional investment and financial development.

Key Words: *Institutional investors, financial development, economic growth.*

1. INSTITUTIONAL INVESTORS AND ECONOMIC GROWTH

Institutional investors, like banks, are financial intermediaries that collect funds from saving economic units and channel them to those units that have a deficit to be financed. According to the economic theory the main task of financial intermediaries is to transform primary securities (issued by firms or the government) into indirect securities desired by final investors (issued by households). Thereby securities are transformed in time, in size, and risk. All of these transactions are closely linked to economic development.¹

In 2004 the eight former-socialist European Union accession countries-the Czech, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia- entered the European Union (EU) with the reform of their banking systems mostly completed. Bank restructuring and privatization efforts undertaken during the 1990s have generally resulted in these eight countries (EU-8) now having modern and sound banking systems. Despite

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¹ Levine, R., 1991. *Stock Markets, Growth, and Tax Policy*, Journal of Finance 46 (September), pp. 1445-1465.

these impressive achievements, the challenge of deepening and broadening EU-8 financial systems still remains. Recent population data indicate that the EU-8 represent slightly over 16 percent of the overall EU population after accession, while their banking system assets represent only 1.2 percent of enlarged EU banking system assets (based on 2004 data).²

In these countries the banking system is still in the process of development. Firms have difficulties to finance their restructuring and investment projects. Institutional investors, both domestic and foreign, can mitigate this problem by offering a third source of finance beside bank credits and retained earnings. Even more, institutional investors channel their funds in the most productive use they contribute to the transformation of the whole economy. However, making use of the allocation function of capital markets means that effective price mechanism must be in place. But this was a completely new approach in the former centrally planned economies.

Competition on the supply side of capital can force domestic banks to conduct their business more efficiently. A rising share of securitization can thus give impulses to the restructuring of the banking sector.

Institutional investors have a high preference for liquid assets. They usually have more power than small investors to press for the lowest possible transaction costs thereby boosting liquidity in terms of share turnover in the market.³ This, in turn, can reduce the cost of capital which should make it easier for liquidity-constrained firms to obtain fresh capital infusion. Furthermore, institutional investors are small but important players in corporate governance. As large and diversified investors with strong preference orientation they have the potential and the incentive to press for value-maximizing firm governance. So, institutional investors are in the process of financial development in each country and also provide strong contribution to development of financial sector functions.

On other side the relationship between the development of financial sector functions and economic growth has been studied at the microeconomic and macroeconomic level. In a recent paper, Levine, Loayza and Beck (1999) ask whether the level of financial intermediary development exerts a casual influence on economic growth. Their findings add to a growing literature that supports a positive relationship between financial sector functions and economic growth.

Using data from a sample of 74 developed and developing economies from 1960 to 1995, they find a substantial and significant impact of financial intermediary development on economic growth. "If Argentina had enjoyed the level of financial intermediary development of the average developing country during the 1960 -1995 period, they would have experienced about one percentage point faster real GDP *per capita* growth per annum over this period"⁴

They also find that the three individual components of intermediary development are important. For example, in India, the extent to which intermediaries channeled resources to private sector uses was low. According to their estimates, if India had raised its percentage of finance to the private sector to the average for developing countries, it would have "accelerated real GDP *per capita* growth by 0,6 percentage points per year."⁵

² Based on ECB and national central bank data.

³ Blommestein, J., *The new Financial Landscape and Its Impact on Corporate Governance*, in Mortong Balling et al. (eds.) *Corporate Governance, Financial Markets and Global Governance*, Dordrecht/NL: Kluwer Academic Press. 1998.

⁴ Levin, Loayza, Beck 1999, p. 5

⁵ *ibidem* p. 14

Researchers Peter Rousseau and Paul Wachtel explored the relationship between financial structure and economic development with empirical data in United States, the United Kingdom, Canada, Norway and Sweden over the 1870-1929 period. The mentioned period was the one of rapid industrialization, output expansion and growth of non bank financial institutions like insurance companies. A standard measure of the importance of financial intermediaries in financing real activity was the ratio of intermediary assets to annual output. According to their results this ratio triples for the United States and Norway over the sample period, increases by more than 50 percent for the United Kingdom and Sweden, and rises by nearly 50 percent for Canada. The period was also marked by an increasing role for organized market generally.⁶

The importance of the relationship between financial development and economic growth is approved in theoretical and empirical way by Ross Levine and Robert King. They constructed an endogenous growth model in which financial systems evaluate prospective entrepreneurs, mobilize savings to finance the most promising productive-enhancing activities, diversify the risks associated with these innovative activities, and reveal the expected profits from engaging in innovation rather than production of existing goods using existing methods. Those authors created theoretical framework in which better financial systems with developed financial intermediaries improve the probability of successful innovation and thereby accelerate economic growth. Similarly, financial sector distortions reduce the rate of economic growth by reducing the rate of innovation. They also provided empirical support for this view through analysis of 80 countries over the 1960-1989 period. They find support for the core idea advanced in their theoretical approach: "better financial systems stimulate faster productivity growth and growth *per capita* output by funneling society's resources to promising productivity-enhancing endeavors"⁷

From the mentioned researches and growing literatures we can conclude that financial instruments, markets and institutions arise to mitigate financing economic development. Furthermore, financial institutions such institutional investors positively influence saving rates, investment decisions, technological innovation and long-run growth rates. In sum, institutional investors were and still are the central element in transformation process of the EU-8 countries towards viable market economies. In next section we provide the size of institutional sector in EU-8 countries.

2. SIZE OF INSTITUTIONAL SECTOR IN EU-8 COUNTRIES

The development of institutional investors and capital markets should not be viewed in isolation. Rather, when assessing these segments of the financial sectors in the EU-8, it is important to take into account the type and size of institutional investors in both, in the existing member states before accession EU-15 and in EU-8 countries.

We know that institutional investors may be defined as specialized financial institutions which manage savings collectively on behalf of small investors, towards a specific objective in terms of acceptable risk, return-maximization and maturity of claims. Ac-

⁶ Rousseau, P., Wachtel, P. *Financial Intermediation and Economic Performance: Historical Evidence from Five Industrialized Countries*, Journal of Money, Credit and Banking Vol 30, No. 4, 1998. pp. 657-672.

⁷ King, R., Levine, R. *Finance, entrepreneurship and growth*, Journal of Monetary Economics 32, 1993. p.540.

According to this definition in institutional investors we include: insurance companies, mutual and private pension funds. In next subsections we show the level of development of each type of institutional investors.

2.1. Insurance

According to relevant research provided by World Bank⁸ the insurance sector is still in its infancy in most EU-8 countries. "In aggregate, the total assets of the insurance sector, despite rapid growth especially during the last few years, have remained below 10 percent of GDP in EU accession countries during the past seven years, while EU-15 insurance assets as percentage of GDP have increased substantially, and are at around 65 percent".⁹ We can conclude that unless insurance asset growth rates increase sharply, the gap between the EU-8 and the EU-15 will not narrow. This statement is better described by figure 1.

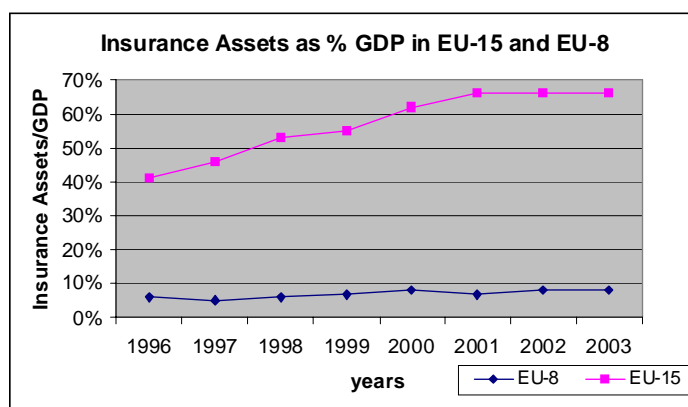


Fig. 1. Insurance Assets as a Percentage of GDP in EU-15 and EU-8 Countries

Source: National insurance associations, OECD Institutional Investor Yearbook, World Bank SIMA database. Total asset data for 2003 are estimated by authors.

For insurance sector in EU-8 is interesting that, according to the Report, approximately two-thirds of total premium revenues were for a range of non-life products (for example, motor vehicles, other transport, property, causality), while life insurance accounted for about one third of total premiums. In existing EU member states, the situation is exactly the opposite, with life insurance premiums dominating non-life premiums by factor of 2 to 1, indicating the much more mature nature of the life insurance industry in the EU-15.

Despite this described situation our opinion is that insurance sector in expected to grow rapidly in all EU-8 over the next three to five years, setting the stage for insurers emerging as important institutional investors in EU-8 financial markets. Growth will be driven by several conventional factors: increase in per capita incomes, provided education, the aging of the population and development of the mortgage markets. Also we have

⁸ Gross, A., and Bakker, M., 2005, *Development of Non-bank Financial Institutions and Capital Markets in European Union Accession Countries*, World Bank Working Paper No 28, Washington D.C.

⁹ Ibidem p. 7.

to be aware that the main constraint to this potential for growth is vulnerability of EU-8 insurers to the enhanced competition in the post-accession environment. Namely, given the large size of EU-15 insurers, they are able to offer low prices to clients in order to gain market share in EU-8 markets. So, this requires that EU-8 insurers move quickly to reduce costs and improve profitability.

One paradoxical situation in insurance sector industry in EU-8 is that a number of very small insurance companies evidenced by continued growth. In EU-15 countries the situation is opposite (figure 2 and 3).

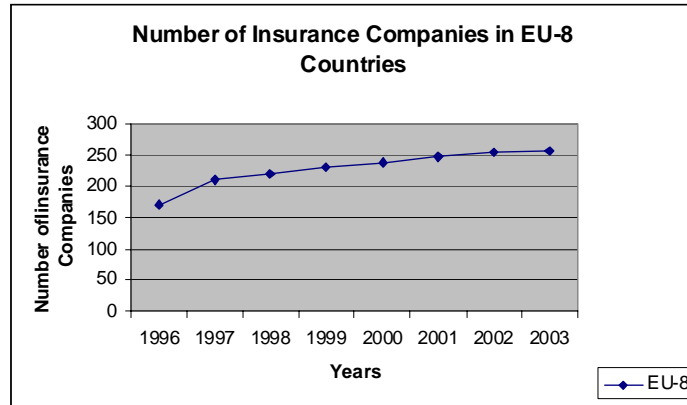


Fig. 2. Number of Insurance Companies in EU-8 Countries
Source: OECD Insurance Statistics Yearbook for each year

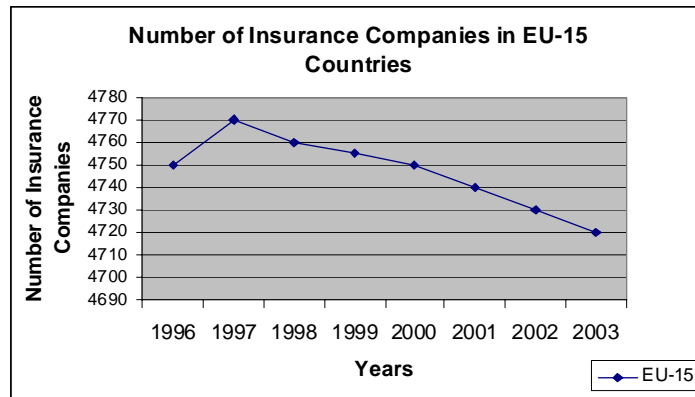


Fig. 3. Number of Insurance Companies in EU-15 Countries
Source: OECD Insurance Statistics Yearbook for each year

2.2. Private Pension Funds

While not all existing EU member states have well developed private pension systems, and despite early efforts in some EU-8 countries to develop such systems, the aggregate level of pension fund assets as percent of GDP is still much higher in the EU-15 than in the EU-8 (Figure 4).

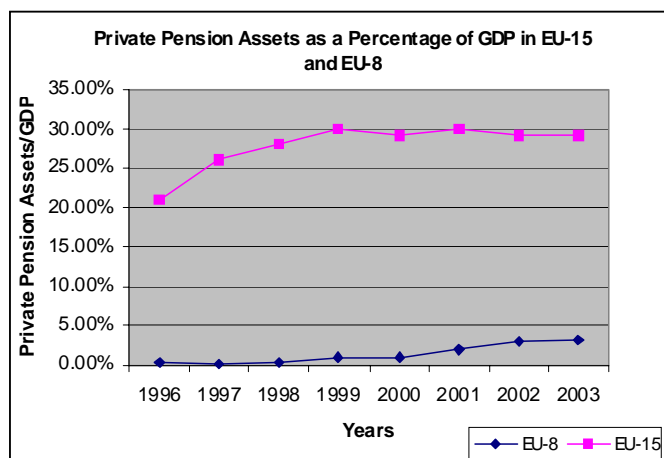


Fig. 4. Private Pension Assets as a Percentage of GDP in EU-15 and EU-8
Source: OECD Insurance Statistics Yearbook for each year

According to World Bank Report¹⁰ Hungary and Poland were the first among the EU-8 countries to initiate privately managed compulsory pension savings schemes, followed later by Estonia and Latvia. In some cases (for example, Hungary and the Czech Republic), sizeable third pillar schemes (private managed voluntary contributions) have been in place for years. Slovakia two years ago started with preparation for introduction of a mandatory pillar, while Lithuania has been debating the pros and cons of a mandatory scheme since early 2002.

Pension assets as percentage of GDP are growing rapidly in most of the EU-8 countries. Growth was driven by the use of tax incentives to attract savings into private pension schemes. For example in Czech Republic employees and self-employed people who join a supplementary pension fund receive a co-payment from the government and in addition may deduct contributions to voluntary pension funds from their taxable income up to a predetermined maximum amount annually, part of supplementary pension fund contributions can be deducted from taxes. Contrary, in Poland, there are no tax incentives to participate in voluntary scheme. There is, however, a tax-advantaged mandatory second pillar and an incentive for companies to create employee pension programs, as employer contributions paid to such programs are tax exempt.

We think that private pension sector in EU-8 countries is expected to grow rapidly in the medium term as a result of the ageing of populations and growing *per capita* income levels. According to these facts we believe that this type of institutional investors have the potential to become important players in EU-8 financial markets.

2.3. Mutual Funds

For this type of institutional investors, despite of the immediate boost given to the industry's development in some accession countries by voucher privatization, their assets as percent of GDP still remain far below levels seen in the EU-15 countries (Figure 5).

¹⁰ World Bank Working Paper No 28, Washington D.C.

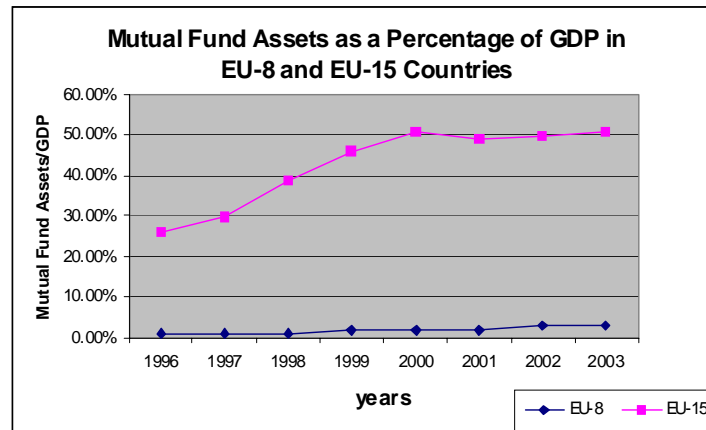


Fig. 5. Mutual Fund Assets as a Percentage of GDP in EU-8 and EU-15 Countries.
Source: Federation Europeane Des Fonds Et Societes D'Investissement (FEFSI).
Various years. Annual Reports. Brussels.

As we noted, voucher privatization kick-started the industry's development by calling for the overnight creation of voucher investment funds (e.g., the Czech Republic, Slovakia, Lithuania). In the initial years of the transition, however, these hastily formed investment funds were only lightly regulated, and this created room for abuse of small shareholder rights. This was a reason of creation of legal and regulatory framework for mutual funds that can ensure investor confidence in line with EU directives. By now, the transition of these early investment funds into properly regulated institutions has been mostly completed.

With appropriate regulation, in the years ahead, the mutual fund industry is expected to continue to grow, although not as rapidly as the private pension industry. By increasing *per capita* income and wealth levels should free up more money for investments by individuals in the type of assets for which mutual funds are the most suitable investment vehicle. We have to note that mutual fund in EU-8 countries will face increasing competition from new private pension funds which are tax-advantaged.

Mutual funds are not tax-advantaged because there is little economic rationale for providing tax incentives to mutual funds investors, it may be conducive to growth of mutual funds to develop tax integration systems that avoid the double taxation of dividends and capital gains. We emphasize that any changes in taxation system should be carefully thought through before being implemented to avoid undue asset shift which may negatively impact asset allocations.

3. INSTITUTIONAL INVESTORS AND FINANCIAL DEVELOPMENT IN EIGHT EU ACCESSION COUNTRIES

For research phenomena of financial development we will use measurement provided by Goldsmith till 1969¹¹ in his researches about connection between financial and eco-

¹¹ Goldsmith, R., W. 1969. *Financial structure and Development*, Yale University Press, New Haven.

conomic development. These measures, after they are accepted by contemporary economists, Ross Levine and Robert King¹², are also doing with same connection. That is the value of financial assets of financial intermediaries in terms of GDP. The level of overall financial development is measured by level of total financial sector assets in terms of GDP. For analyzed countries, data about financial development from 1996 till 2003 are presented in table number 1.

Table 1. Elements of financial development in mill US\$

Elements of financial development (in mill US\$)	Year							
	1996	1997	1998	1999	2000	2001	2002	2003
Institutional Investors Assets-Ins Inv	20,898	21,037	26,529	28,990	34,759	41,978	55,549	70,713
Total Financial Sector Assets -TFSA	261,061	282,462	330,206	333,861	357,794	391,708	463,037	540,258
GDP	290,499	306,700	326,104	320,904	317,082	356,435	396,536	435,494
Ins Inv / GDP u %	7.19%	6.86%	8.14%	9.03%	10.96%	11.78%	14.01%	16.23%
TFSA /GDP u %	89.87%	92.10%	101.26%	104.04%	112.84%	109.90%	116.77%	124.06%

Source: calculated by different statistical publications

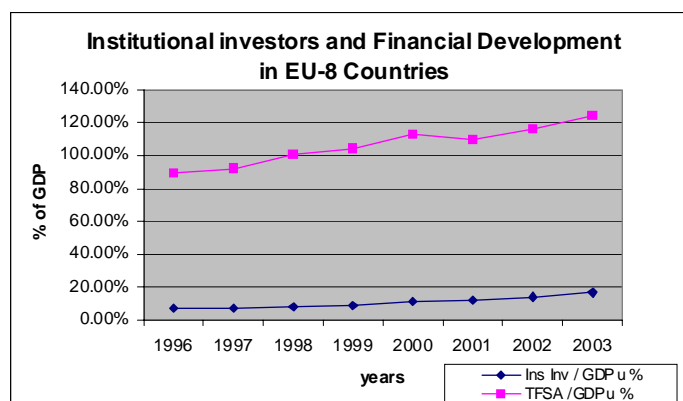


Fig. 6. Institutional investors and Financial Development in EU-8 Countries

Source: Table 1.

Contribution of institutional investors to financial development in EU-8 countries is presented in figure 6. From this figure it is more than obvious that development of institutional investors has the same trend as overall financial development in EU-8 countries.

¹² King, R. and Levine, R. 1993. *Finance, entrepreneurship and growth*. Journal of Monetary Economics 32, pp. 513-542.

4. CRITERIA FOR INSTITUTIONAL INVESTMENT

As we noted in this paper, financial development is very important for economic growth. Also we provided data that institutional investors contributed to financial development but unfortunately, not enough. Because of the importance of institutional investment in EU-8 countries from abroad and to get a more detailed picture of accession European countries we present in the following the results of a survey which was conducted among the most active group of investors: European and American institutional investors.¹³ In this survey participants were mainly portfolio managers and analysts: actually, people that make the investment decisions.

The survey differentiated between macro and microeconomic criteria as well as criteria regarding financial markets. The respondents were asked to state what criteria they use for their investment decisions in Central and eastern European equity. The research was focused on equity investment because institutional investors have put a much heavier weight on equity in their portfolio and according to World Bank equity capital at the beginning of 21st century was a major source of finance in other emerging markets.¹⁴ The respondents ranked in the criteria by relevance for their actual decisions. results of survey presented in table 2.

Table 2. Most Important Criteria for Portfolio Investment Decisions

Classification	Criteria
Macroeconomic	<ul style="list-style-type: none"> • Stability of legal system 82% • Stability of financial system 80% • Stability of political system 77% • Currency stability 68% • Clear tax legislation 62% • General economic situation 62% • Strictness of bankruptcy laws 57%
Micrepeconomic	<ul style="list-style-type: none"> • Managerial qualification 93% • Growth of particular sector 84% • Productivity of the investment target 82% • Skill level of employees of the investment target 63% • Personal contacts with management 63% • Level of taxation of the investment target 52%
Financial Markets	<ul style="list-style-type: none"> • Liquidity of individual stocks 96% • Legislation and enforcement law 82% • Controls on capital flow 80% • Presence of strategic investors 53% • Listing at a foreign exchange 51%

Source: Köke, J., 1999. Institutional Investment in Central and Eastern Europe: Investment Criteria of Western portfolio Managers, ZEW Discussion Paper No. 99-37, Centre for European Economic Research, Mannheim. NOTE: Average degree of importance on a scale of 0-100%.

¹³ Köke, J., 1999. Institutional Investment in Central and Eastern Europe: Investment Criteria of Western portfolio Managers, ZEW Discussion Paper No. 99-37, Centre for European Economic Research, Mannheim.

¹⁴ World Bank 1997. Private capital Flows to Developing Countries: The road of financial integration NY: Oxford University Press p.157.

Table 2 presents the ranking of criteria which is used by western institutional investors who are specialists in the Central European capital markets. From this table it is obvious that portfolio investors check a whole spectrum of criteria before they buy assets in a Central European country. Liquidity of the individual stock has the highest degree of importance (receives 96%, on a scale of 0-100%). Managerial qualification is also central (93%) as well as the stability of the legal (82%) and financial system (80%).

In EU accession countries economic environment was changing rapidly and competent decisions regarding the allocation of capital and labor were needed. That was a reason why, on microeconomic side, institutional investors looked for highly qualified management teams.

Liquidity of the individual stock is by far the dominant selection criterion. Institutional investors have a high preference for liquid assets because they want to be able to adapt quickly to changing economic conditions. At the same time, they demand clear and fair legislation, in particular no discrimination of foreign investors.

5. CONCLUSION

Investment by institutional investors has been increasing considerably over the last two decades in mature capital markets. The large investors in terms of absolute size of total assets and also their relative importance in comparison with private or governmental shareholders are rising. Although the individual share held by an investment fund, an insurance company or a pension fund is small, the combined power of these institutional investors is potentially large.

While the EU-8 have made substantial progress in reforming their financial systems over the past decade, the challenge of deepening and broadening overall levels of intermediation in EU-8 financial markets still remains. Contribution to financial development is provided by institutional investors.

According to criteria for institutional investment presented in previous section, the policy makers in EU-8 countries, if they want to ensure a more rapid conversion of institutional assets towards levels of development seen in existing member states, will have to be very proactive in undertaking further financial reforms. The key policy challenges include: completing insurance privatization, undertaking further reform of pension systems, strengthening creditor rights, improving corporate governance and strengthening consumer protection. These steps are necessary because institutional investors are an important force in EU-8 capital markets. Both by active investment and by pressure for change in financial system regulation, they contribute to the further financial development and economic growth.

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ULOGA INSTITUCIONALNIH INVESTITORA U FINANSIJSKOM RAVOJU NOVOPRIKLJUČENIH ČLANICA EVROPSKE UNIJE

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Ovaj rad je posvećen posebnoj vrsti učesnika na finansijskim tržištima u savremenim tržišnim privredama- institucionalnim investitorima. Svoju analizu započinjemo sagledavanjem karakteristika institucionalnih investitora i njihovog doprinosa privrednom rastu, sa teorijske tačke gledišta. Zatim ćemo prezentovati razvoj ovih posrednika u osam bivših socijalističkih zemalja, a danas članicama Evropske unije i dokazati statističu vezu između razvoja institucionalnih investitora i finansijskog razvoja.

Prezentovaćemo, sa subjektivnog stanovišta, najznačajnije korake za kreatore ekonomske politike u novopriključenim članicama Evropske unije na polju razvoja finansijskih tržišta, kako bi se stimulisao aktuelni i budući razvoj institucionalnih investitora i finansijskog sektora.

Ključne reči: *Institucionalni investitori, finansijski razvoj, privredni rast.*