V. THE EXPERIENCE OF CENTRAL AND EAST EUROPEAN COUNTRIES ON FINANCIAL SUPERVISION

by
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The banking and insurance sectors in Central and East European countries operated under strict controls during the planned economy era. At the time, this sector consisted of a central bank, at least one dedicated state-owned commercial bank and one insurance company to meet the needs of its citizen and to carry out state functions, such as the issuing of subsidized loans and the collection of mandatory insurance premiums. Other forms of financial institutions included savings and insurance co-operatives. The banks fell under the supervision of the central bank and the Ministry of Finance, the latter also overseeing insurance enterprises.

This financial structure underwent considerable changes in the 1990s. These changes included new regulations for the introduction of financial and capital markets, the privatisation of commercial banks and insurance companies, the creation of new financial intermediaries, as well as the development of investment and pension funds. A financial supervisory structure of these institutions was created.

There were initial problems in some countries where several commercial banks went bankrupt and incidents of misconduct, such as misuse of investment funds and the occurrence of pyramid schemes, linked to financial markets occurred.. The financial "losses" incurred further eroded any trust in the financial institutions of these countries.

A series of reforms were thus introduced. The establishment of private pension funds (PPF) – or privately managed, non-state pension funds – was part of this reform process, or in some cases the result of reforms in the public finance sector, *i.e.* social security.. It was strongly advocated at the time that it was necessary to establish a single independent PPF supervisor to implement structural pension reforms. Such a supervisor would enforce::

- strict provisions to establish confidence in the pension system;

- pension specific, proactive regulations with a detailed set of rules, such as qualitative rules defined by quantitative measures; and
- centralised solutions to the pension industry to reduce certain costs for members (collection, transparency measures, etc.)

The structure of the supervisory authority differs from one country to the next due to differences in the legal environment, the development of financial markets and financial institutions, the economic background, and past experience of pension arrangements. If we compare the pension reform experiences of two sets of countries, the Czech Republic and Slovenia on the one hand, and Kazakhstan and Russia on the other, we can highlight differences in the new systems. In the first set of countries, the introduction of voluntary private pension funds, combined with parametric pay-as-you-go reforms represents a cautious approach. In the latter set ofcountries, the introduction of mandatory non-state pension funds represents a change of paradigm of the pension system.

The following study will summarise the development of pension reforms in Central and East European countries according to the answers provided to the OECD-INPRS questionnaire.[1] The following countries responded to this questionnaire: Estonia, Bulgaria, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Slovenia, Slovakia, Croatia and also Turkey and Ukraine.

Changes of supervisory agencies

The questionnaire was intended to collect information for the year 2001.It should be noted, however, that a number of changes have occurred or will be introduced to the pension supervisory structure in several countries. Some of these changes will become effective in 2004. These changes are outlined below.

In Lithuania, the Securities Commission (LSC) and Insurance Supervisory Commission (LISC) will cooperate in the new regime. In the Czech Republic, the present Insurance and Pension Supervision Department of the Ministry of Finance will become an independent integrated supervisory organization. Similarly, in Kazakhstan, the Financial Supervision Department of the National Bank of Kazakhstan will become a consolidated financial supervisory organisation. In Slovakia, the Financial Market Agency (FMA) will take over supervision of pension plans. In Hungary, HFSA, the consolidated supervisory body, began operations in 2000, but is subject to change its governance structure. A controlling board will replace the single elected president, who was supported by an advisory council.

The Financial and Capital Market Commission (FCMC) of Latvia began operating in 2001. The Polish integrated supervisory body, KNUiFE, and the Bulgarian consolidated financial market supervisory body, FMC, began operations in 2002 and 2003, respectively. In Estonia, Croatia and Ukraine, the new pension system and/or the supervisory regime began operations in 2002.

Functions and responsibilities

There is a dedicated private pension supervisory organization in most CEE countries. In most cases it is an integrated supervisory structure, the exceptions being in Bulgaria (SISA in 2001, and Croatia (*Hagena*). Pension supervision is regarded as part of the financial market in Estonia (*Finantsinspektsioon, FI*, 2002), Hungary (HFSA), Kazakhstan (Financial Supervision Department of the National Bank, FSD), Latvia (Financial and Capital Market Commission, FCMC, 2001), Turkey (Capital Markets Board, CMB, 2001; Undersecretariat of Treasury, UT), and Ukraine (State Commission for Financial Services Markets Regulation[2], SCFSMR, 2003). In countries where supervision of banks is carried out by a separate organization, *i.e.* the central bank, pension funds can be supervised together with insurance and capital market institutions. This is the case in Bulgaria (FMS, 2003) and Slovakia (FMA, 2004).

Pension supervision is partially integrated with capital market supervision in Lithuania (Securities Commission, LSC) and in Slovenia (Securities Market Authority, SMA). Another related market might be insurance. Several countries — Poland, Slovenia (ISA), Lithuania (2004, LISC), Czech Republic — have followed this logic.

Pension supervision can also be divided between agencies. Historically, this is the case where ministries of labour and/or finance (*i.e.* Czech Republic, Slovakia, and Slovenia) have a role in pensions. From a functional perspective, the pension fund model might be regarded as being similar to either investment funds or insurance companies. This will affect the supervisory arrangement, as is the case in Slovenia and Lithuania where two agencies supervise the two types of pension funds. In Turkey the two elements of the pension entity are differentiated in the supervisory process: the pension fund management (company) is overseen by the Treasury, while the pension plan and fund by the CMB. In a similar way, SSMC is involved in supervising investment activities in Ukraine, but SCFSMR has primary role in the supervision and regulation of pension funds.

The dedicated supervisor performs most of the supervisory functions.[3] The Ministry of Finance or Tax Authority is involved in qualification for tax preferences *a posteriori*. Enforcement of collection of mandatory contributions is done by a separate agency in Croatia (called *Regos*, and which collects all state revenues) and in Hungary (Tax Authority). The social security administrator can also be involved in only certain aspects, as is the case in Croatia and Poland. Appointment of a custodian is mandatory in these systems. The Central bank or banking supervision oversees the custodian bank, which might be, in fully consolidated cases, within the same organization.

Registration of members of mandatory funds is done by the supervision in Bulgaria and Hungary; in Croatia, Regos is controlled by the pension supervisory organisation Hagena. In Estonia, the registration is done by a separate organization, the Central Register of Securities. There is a Pension Guarantee Fund in Estonia and Hungary. In Poland, it is part of the KNUiFE.

General public administration procedures regulate information exchange and secrecy rules in the jurisdictions of CEE countries. Where there are market specific rules, explicit co-operation exists in countries where the financial market supervision is not (fully) integrated (Poland, Croatia), or the pension supervision is divided between two agencies (Lithuania). Other forms of co-operation might be established with Tax Authority, Central Bank, or with the Office for Consumers Protection or Competition (*e.g.* Hungary, Ukraine) and the Social Security Administration. Information exchange can also be established through the governance structure: for example, board members in Estonia, Croatia, Poland and Turkey represent related market segments. A similar role can be delegated to advisory councils.

Legal mandates of the supervisor

All CEE supervisory bodies fall under public administration procedures, except the Estonian FI. As a consequence, all relevant resolutions are issued by the same body and can be appealed (Administrative Court in Croatia, Lithuania, Poland, and Turkey) for redress.

Some of the supervisory bodies have regulatory power, as opposed to mere enforcement of a body of laws. It may be part of the general mandate of the parent organisation (central bank, ministry), as is the case in Kazakhstan and Turkey. Or it may be part of special provisions in the private pension or other legislation, as is the case in Croatia, Latvia, Poland and Ukraine. Other supervisors issue non-binding good practice notes and guidelines as part of their policy (Estonia, Hungary and Bulgaria).

Political and institutional independence

The supervisory agencies of the CEE countries in the survey are established as public administration offices by Parliament, in some cases with control by or reporting to the government (Croatia, Hungary, Latvia and Lithuania). In practical terms, this means that the head of supervision is appointed by the Parliament on the proposal of the Prime Minister. In Latvia, the Parliament appoints the Chairperson and Deputy Chairperson based on a joint proposal by the Minister of Finance and the Governor of the Bank of Latvia. The head of supervision reports to Parliament, but there can be a selected minister in the government related to the supervision, usually the Minister of Finance or Labour.[4]

In other jurisdictions, the supervision operates under the direct control of the Government as part of a ministry or as a separate organization. In Bulgaria (SISA), Poland, Slovenia, Turkey (CMB) and Ukraine it is mainly related to the Government or Council of Ministers. Pension and insurance supervision is the responsibility of a specific department of the Ministry of Finance in the Czech Republic, and of the Ministry of Ministry of Economic Affairs (UT) in Turkey.. In Kazakhstan, the Financial Supervision Department is part of the National Bank; deputy governors are appointed by the President and department directors are appointed by the Governor. In Estonia, the Minister of Finance and the President of the Bank of Estonia are office members of the governing body of the FI; other members are appointed by the Government.

Two models in particular shape the governance structure and decision making procedures. In the first model, the highest decision making body is a committee/board of commissioners or governors with a chairperson. The second model is based on the principle of responsibility being held by one person. An example of the latter is the case where supervision is part of a large organization and the head of pension supervision is the head of a division of that organization.Another example is where an independent supervisory agency is headed by a president.

In Latvia and Lithuania, the supervisory agency is overseen by a decision-making committee or board headed by a chairperson. This board is also the highest executive body comprising all section of the commission. In Poland and Turkey (CMB), leaders of the supervision and delegates of other agencies set up the committee; in Croatia, leaders and delegated experts, and in Slovenia solely delegated experts, comprise the committee. In Estonia, the FI has two boards: the governing body[5] and the management board. The governing board consists of heads and delegates of the Ministry of Finance and the Bank of Estonia, and the management board of heads of sections of the EFI.

The single responsible person model operates in Bulgaria (SISA) and in Hungary. There are consultative councils supporting decision-making in Hungary, Bulgaria, Latvia, Turkey and Ukraine. Market players delegate representatives to the advisory councils in Latvia, Turkey, Ukraine and Hungary in compliance with the relevant law.

In some jurisdictions, there are separate rules for the appointment of the head of the supervisory agency as well as for the deputy head and the directors,[6] or other board members. In Croatia, Hungary, Latvia, Lithuania, and Ukraine the head and deputy head of such agencies are appointed by the same body,. In Kazakhstan, all directors are appointed by the same body. Deputies and directors are appointed by the selected head of supervision in Bulgaria (SISA), Latvia (for the other members), Poland and Slovenia. In Poland, the deputy heads of the supervision are appointed jointly by the Minister of Finance and the Minister of Economy and Labour. In Estonia, the governing body appoints the management board.

The competent person or body should allow for legal requirements for the post of the head of the supervision, with the exception of Kazakhstan. Conditions are similar in every country, that is the competent person should benefit from higher education (the only requirement in Bulgaria and Croatia), management experience and enjoy a good reputation. The term of appointment is fixed between five and six year,with the exception of Estonia (three or four years), Croatia and Ukraine (seven years), and Bulgaria (SISA) where there is no limit to the contractual appointment.

The conditions of removal from office of the head of the supervision are also similar in most CEE countries: (i) end of the term, (ii) resignation, (iii) cases of recall as established in the law, such as conflict of interest, incompetence, violation of rights of the supervised, or other illegal infractions, or (iv) incompetence. The appointing body may initiate the removal in Bulgaria, Kazakhstan, and Latvia. In Croatia and Hungary the decision of Parliament is needed on the initiative of the Government.

Financing

There are two ways to finance the supervisory operations: self-financing using supervisory fees levied on the market or from general tax revenues. Where the organization is part of the government, the latter solution comes from the general setup, like in the Czech Republic and Slovakia (before 2004), Turkey (UT) and Ukraine. Bulgaria, Croatia, Latvia (which will change to full self-financing as of 2007), and Lithuania have started tax financing to avoid placing additional burdens on a small market. Tax financing is/was also characteristic of countries which initially implemented only voluntary pension funds.

Supervisory fees are prescribed in market-specific legislation in the case of integrated supervision. However, as the supervisory agency is a public administration office, its budget must be approved by Parliament. This is done as part of the state budget in Hungary, Poland, Slovenia and Turkey (CMB). In Estonia and Latvia, the governing board approves the annual budget of the supervision.

The budget of the Financial Supervision Department of the National Bank of Kazakhstan comes from the budget of the National Bank of Kazakhstan, which has its own separate budget. There are no supervisory fees in Kazakhstan.

The national auditing office of public spending oversees the financial management of the pension supervision in Estonia, Bulgaria, Croatia, Hungary, Latvia, Poland, Slovenia and Turkey.

Table VI.1. Supervisory structures in EEC countries

2001/2002	Pension funds			Supervision			Comments*
	Funds	Members	Assets (10 00USD)	Entity/ -ies	Employees	Budget (10 00USD)	
Bulgaria	9	591 558	112 057	separate	43	299	Single supervisor in 2001 and without voluntary funds
Croatia	6	1 038 827	751	separate	40	3 770	PF data September 2003; Budget of 2002
Czech Republic	14	24 730	2 793,744	integrated	20	N/A	Pension and insurance supervisors
Estonia	19	1 290	19 346	integrated	70	4 255	
Hungary	110	3 407 000	4 193 123	integrated	541	33 918	All financial sector employees
Kazakhstan	16	5 000 000	N/A	integrated	165	2 212	Financial Supervisory Department 2003
Latvia	4	17 359	55 207	integrated	88	3 590	All financial sector employees

2001/2002	Pension funds			Supervision			Comments*
	Funds	Members	Assets (10 00USD)	Entity/ -ies	Employees	Budget (10 00USD)	
Lithuania	N/A	-	0	integrated	41	954	From 2004 supervision shared by LSC and LISC
Poland	17	11 060 000	9 913 072	integrated	209	7 672	After merger, without voluntary funds; 2003
Slovenia	9	81 000	158 127	integrated	25	1 587	All funds; supervision ISA other entity: SMA
Turkey	72	24 842	4 419	integrated	450+21	N/A	31.12.2003; supervision shared by CMB and UT
Ukraine	47	31 000	3 080	integrated	170	640	31.12.2003

Transparency

The objective of transparency and — in support of this objective — detailed reporting regulations were included in the pension reforms of the CEE countries. As a good practice, all supervisory bodies have a stated mission statement.

To be consistent with the market, the supervisory body prepares quarterly and annual reports from pension fund data. These are based on statistics and research of the market, and published on the website, a common practice throughout the region. The supervisors prepare an annual report to the controlling body as well. In Estonia, pension fund data is part of the investment fund information contained in the government's yearbook.

Other examples of disclosure policies include the publishing of the resolutions of the supervisor on investigated cases (in Hungary), or the decisions of the governing body (Estonia, Latvia) in the official government paper and on the Internet. Regular press conferences are also a widespread practice (as in Bulgaria, Hungary, Slovenia, and Turkey)

Table VI.2 Disclosure policies in the EEC supervisory agencies

Bulgaria	FSC: http://www.fsc.bg
Croatia	HAGENA: http://www.hagena.hr
Czech Republic	http://www.mfcr.cz
Estonia	http://www.fi.ee/
Hungary	HFSA: http://www.pszaf.hu
Kazakhstan	http://www.nationalbank.kz
Latvia	FCMC: http://www.fktk.lv
Lithuania	LSC: http://www.vpk.lt - LISC: http://www.vdpt.lt
Poland	I&PFSC: http://www.knuife.gov.pl
Slovenia	SMA: http://www.a-tvp.si - ISA: http://www.a-zn.si
Turkey	Treasury: http://www.hazine.gov.tr - CMB: http://www.spk.gov.tr
Slovakia	FMA: http://www.uft.sk
Ukraine	www.dfp.gov.ua

Human Resources

Employees of the supervisory agencies have civil servant status in the countries studied, with the exception of Croatia and Estonia where labour laws are applied. Migration between public and private sector employment is not restricted, nor specially regulated for pension fund professionals. A general rule applies to civil servants in Lithuania; according to this rule, personnel leaving a supervisory agency must wait one year before accepting employment with a company they oversawI This is also the case in Croatia and Turkey (UT) which have similar market specific legislation. Other restrictions imposed try to prevent the misuse of insider information[Latvia and Turkey (CMB)].

Heads of supervision agencies enjoy independence in defining their remuneration policy and in establishing a corporate culture for the agency, with the exception of Croatia and Ukraine where government regulations place a certain number of constraints. In most cases, the salaries of supervisory employees are comparable with the market, with the exceptions of Bulgaria, Croatia, Turkey (UT) and Ukraine. Nevertheless, it should be noted that migration between the public and private sectors is rare because of the narrow income gap between the two sectors and/or the relatively short experience of new agencies.

Pension supervisory staff come primarily from the public administration and its predecessor organizations, especially where integrated supervisory agencies are concerned. A second important source of recruitment is the education sector, both academics and graduates.

Supervisors consider continued education as an important element in developing this new financial sector. There are internal training programs, but the most frequently mentioned form is participation in international conferences, seminars and study tours. Aid from the United States, both direct and via agent organizations, the World Bank and the European Commission have supported and implemented training programs linked to pension reform.

Organisation

Supervisory agencies are organised in such a way that the main departments — legal, supervisory, corporate services and administration — are separate. On-site and off-site supervision is differentiated mainly in cases of consolidated supervision, especially if the structure is defined according to functional (as opposed to institutional) lines. In cases of mandatory systems and systems linked to investment funds, off-site supervision send in daily asset reporting (on-line).

Specialized pension supervisors [Bulgaria (SISA), Croatia, and Ukraine] are organised according to their functions. In the new Bulgarian FSC, the Social Insurance Supervision Division operates under a dedicated Deputy Chairman and the units follow risk management functions.

Many consolidated supervisory agencies have functional divisions in Kazakhstan, Latvia, Lithuania, and Turkey (CMB). In Ukraine these division are sectoral. The organizational structure of the HFSA follows the matrix principle. The main structure is developed according to functions — supervisory and legal directorates — but the departments are organized according to the financial sectors. Moreover, the sectoral chief counsellors incorporate a horizontal flow of information according to the financial sectors. Until 2004, KNUiFE (Poland) was organized by function, except for the (voluntary) Employee Pension Programs Department. This has changed to a mixed sectoral/cross sectoral structure. Estonian FSA has sectoral divisions, but the legal services are cross-sectoral.

Employees come from different fields and professions – particularly actuaries – with a large variance from one country to the next. The main differentiating factors are the level and way of integration, and the status of the insurance sector.

Table VI.3. Employment in EEC supervisory entities

	Total Number of employees	Front-line Superisory activities[1]	Supervisory support functions[2]	Corporate Services[3]	Number of actuaries	Number of Lawyers
Separated agencies						
Bulgaria – SISA	43	23	6	12	3	4
Croatia	40	15	3	7	0	8
Integrated agencies						
Bulgaria - FSC	29	7	13	N/A	5	5
Estonia – FI	70	52	4	8	0	8
Hungary – HFSA	541	325	42	172	11	110
Kazakhstan	165	132	33	N/A	0	53
Latvia – FCMC	88	50	12	26	1	13
Lithuania – LSC	41	21	10	10	0	4
Poland – KNUiFE	208	101	35	70	4	46
Slovenia - ISA	25	19	3	3	4	4
Turkey – CMB	450	180	45	225	0	25
Turkey - UT	74	7	21	N/A	3	1
Ukraine	170	94	39	31	0	29

1. For example, on-site and off-site supervision, licensing, enforcement, intervention and termination.
2. For example, statistics, studies, legal and economic analysis.
3. For example, administration, human resources, budget.

Conclusions

The newly established agencies are based on integrated supervision and, recently, some stand-alone institutions have been merged into integrated supervisions. In their conclusions, respondent supervisors of integrated set-ups commend the synergies and other advantages of consolidated supervision.

The CEE supervisors deem the pension supervision legislation adequate — save minor past and planned amendments, and the overly complex supervisory and regulatory framework in Slovenia. Similarly, they are responsible for their financial resources, except for central budget-financed entities in Croatia and Ukraine.

As a whole, the questionnaire did not reveal serious deficiencies in the supervisory framework of the examined countries. However, it did make clear that there are several plans and actual developments of supervisory structures throughout the region.

There are noticeable tendencies in the functional structure of the supervisory agencies to provide for risk-based supervision. This might be a result of the consolidated approach, but it does not solve certain problems related to the mandatory and defined contribution features of the private pension systems.

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NOTES

1. See Annex II.2 of Chapter 2.

2. In Ukraine, capital markets are overseen by the State Securities and Stock Market Commission (SSMC)

3. Questionnaire 1.3: a) Licensing/registration, b) Qualification for tax benefits, c) Compliance to governance rules, d) Contributions and regularity of payment, e) Membership and portability (enrolment process, transfers and compliance), f) Benefits eligibility conditions and access to plans, g) Investments, asset allocation, performance, minimum capital and reserves, h) Custodian procedures, i) Financial, actuarial and accounting methods, j) Administrative cost, fees and marketing, k) Disclosure procedures referring to members and beneficiaries, potential members and accounts, l) Merger and liquidation process

4. The exact composition and names of posts may change in each country. Other board members and parliamentary committees may also be involved.

5. Also called supervisory board.

6. Here, heads of sections.

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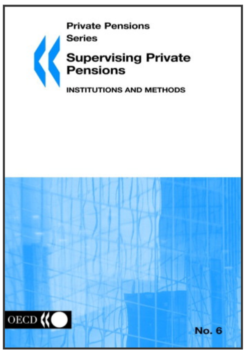

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