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Insurance and Transition Economics: The Insurance Market in Russia

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1. Introduction

The purpose of this paper is to present an analysis of the Russian insurance industry from the perspective of a transition to a market economy and of its integration into the world economy.

First of all we provide a short survey of the impact of insurance on economic development.

The next part describes the recent trends in the Russian insurance market. Life and health insurance are becoming more and more important in Russia as in many countries where in-depth processes of reform aim at transforming social security policy into market-based insurance systems.

In conclusion, the research tries to systematize what one may consider to be the priorities in terms of regulation and a legal framework. The experience of other countries and especially of Eastern European countries is reviewed:

- The importance of insurance in economic development;
- The Russian insurance market;
- Regulation of insurance in a transition context.

2. The importance of insurance in economic development

The importance of insurance in economic development has been recognized since the 1964 UNCTAD declaration: "... a sound national insurance and reinsurance market is an essential characteristic of economic growth."

Nevertheless, research in the field of insurance and economic development has not been extensive. By comparison, research in the field of banking and development is massive.

There are three reasons for this:

- First, insurance and protection are often considered luxuries. The idea is that below a certain level of income, the demand for security is weak;
- Second, banking problems have macro-economic and international consequences, whereas insurance problems tend to be local. When a bank goes bankrupt in a country, it may lead to chain reactions affecting the country's whole economy, and the international banking system and credit chain;

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- Third, economies of developing countries and economies in transition are often characterized by high inflation and it would seem obvious that high inflation is detrimental to the insurance industry.

Warnings by economists against insurance as a tool for development must be criticized. Insurance provides households and firms with security. With security, people are less vulnerable. Their decisions are made over a longer time span. They are able to buy more durable goods and they may organize their decisions according to a longer lifecycle. In the same way, firms are able to plan more investments. Thus, insurance and protection should be viewed as factors favourable to economic development.

The stability of a banking system is highly linked to the robustness of the financial industry in a country. Whereas banks tend to "manage assets", insurance companies "manage liabilities" and the co-existence of a sound and solid insurance sector is a positive factor for the stability of the banking industry.

Also, among the number of causes explaining inflation, two directly have to do with the importance of the insurance sector: the level of public expense and the preference for the presence of economic agents. With a significant insurance sector, the public budget is reduced. Social security benefits can be lowered and the public budget has fewer commitments (coverage of risks on public infrastructures). Furthermore, with a well developed life insurance industry and pension funds, operators' expectations tend to be non-inflationary. They have higher preference for the future.

According to Skipper (1997), four positive effects are of importance in the global contribution of the insurance sector to economic development.

Promotion of financial stability

Insurance stabilizes the financial situation of economic agents. This is particularly important when considering firms. Uninsured losses may cause the failure of many businesses. Stakeholders are unlikely to invest in those businesses where no insurance exists to cover financial losses. Without insurance, leasing operations are impossible or highly difficult, while they represent an important potential for development in transition economies.

The same applies to homeowners. Without insurance coverage, families are forced, in cases of loss, to seek assistance. The risk exposure of families will prevent them from making long-term decisions (housing, durable goods, etc.). It is a well observed fact that when an insurance market does not exist, behaviour tends to produce self-insurance (see St Amour and Vencatachellum, 1997).

It has often been expressed in economic theory that insurance aims to reduce the financial consequences of accidents. Once an insurance system is in place, people will try to avoid paying heavy losses by taking adequate prevention measures. Prevention aims to reduce the probability of accidents. Both insurance and prevention combine to produce more stable and risk-free processes and systems. It has to be added that prevention is more effective when insurance exists. The immediate pay-off of prevention measures is the reduction in insurance premiums.

Subsidies from government programmes

It has been shown (see OECD, 1997) that in OECD countries a positive correlation exists between the importance of the life insurance sector and the reduction of social expenditures.

The recent development of insurance schemes and pension funds to cover old-age benefits is common to Europe, Latin America, Far Eastern countries and Central European countries (see *infra*).

The same scenario is found in the healthcare system where insurance, which complements or replaces social security schemes, permits the reduction of healthcare expenses. The idea is that the insurance market offers better solutions for controlling moral hazard and under certain conditions permits a better allocation of scarce resources.

Trade and commerce facilitators

Insurance supports trade and commerce by providing liability coverage against any claim for negligence. The reputation and creditworthiness of customers is improved with insurance, permitting banks to offer better credit conditions and allowing international partners to offer normal payment conditions.

Mobilization of savings

The importance of savings in the economic growth process is well known. Insurance and pension funds collect long-term-oriented savings. The recent development of pension-oriented savings instead of, or as a complement to, social security pay-as-you-go systems is a major trend of modern economies.

Personal insurance is everywhere becoming an important industry. Its turnover in developed countries is becoming more and more important. In developing countries and in countries with transition economies, the trend is the same. Ageing is a global concern. The United States and developed countries in Europe were the first to be concerned with ageing. Other areas, such as Far Eastern countries and Central European countries, are now ageing societies. The ageing phenomenon is due to the combination of baby-boomers reaching retirement age, a significant rise in life expectancy, and lower birth rates.

A decisive advantage of insurance and pension-fund solutions is that they permit a rapid and massive accumulation of long-term savings.

Thus the cost of capital is lower, and the owned assets of private firms tend to be higher.

Experiences of transition towards funded systems to cover pensions (insurance, pension funds) are generalized. From an insurance industry point of view, they permit the establishment of mass-market insurance and therefore large and solid insurance companies.

3. The Russian insurance market

The insurance sector during the Soviet period

During the Soviet period, the insurance market was in the hands of two state-owned insurance companies:

- Gosstrakh, which had the monopoly of the domestic insurance market;
- Ingosstrakh, which had the monopoly for international underwriting.

The life insurance sector was important, with long-term, savings-oriented products. Gosstrakh was managing a portfolio of 200 million life insurance policies.

Compulsory insurance, especially in the agricultural sector, was also extensive.

Through their network, Black-Sea & Baltic, Ingosstrakh underwrote import- and exportrelated risks. It is estimated that the ratio of insurance premiums to GDP was around 3 per cent at the end of the 1980s. During the *Perestroïka* period, a certain number of joint-stock insurance companies were created.

The beginning of the transition period

In 1992, a law on insurance was passed and the Office of Insurance Supervision (Nadzor) established. According to the law, insurance companies have to obtain a licence. There are minimal capital requirements. Solvency regulations in life and non-life are in force.

The supervisor, Nadzor, was an independent governmental agency in charge of the general monitoring and the development of the market. Nadzor was also in charge of preparing decrees and regulations concerning the insurance sector.

The medical insurance sector has been profoundly reformed, with Regional Medical Funds now collecting premiums from firms and municipalities and medical insurance firms receiving part of these premiums to contract with healthcare suppliers. Compulsory medical insurance firms and facultative medical insurance firms depend partly on Nadzor control.

The second part of the new Civil Code, passed in 1995, includes provisions for insurance and several elements concerning civil liability.

In 1996, Nadzor was transformed into a Department of the Ministry of Finance.

During the whole period, the emergence of the private sector in financial services, combined with the poor legal framework for insurance, led to a mushrooming market with thousands of newly created companies.

Three different cycles have existed since the 1992 Law (see Figure 1). The first cycle was the "boom" of credit insurance from 1992 to 1994. Hundreds of newly created companies were issuing credit guarantees. These guarantees permitted banks to escape from

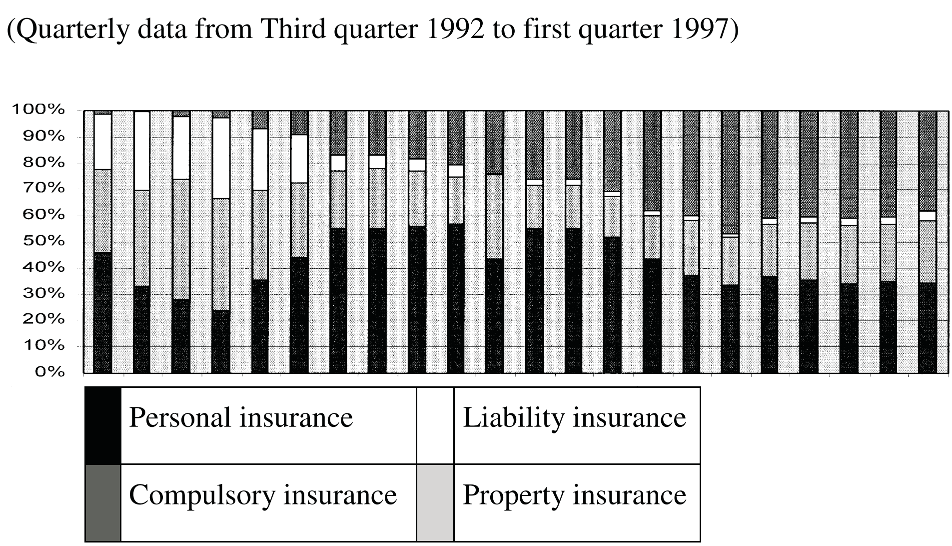

Figure 1: Structure of the insurance turnover in Russia (1992–1997)

the constraint of solvency ratio regulations. Endangering the new and non-mature financial system, these operations have been forbidden and no longer exist today.

The second cycle was the "boom" of life insurance as a fiscal instrument from 1994 to 1998. It was possible to avoid part of social taxes on salaries if the salary was transformed into short-term (three-month) life policies (savings products). Changes in the taxation regime have diminished the attractiveness of these products.

The third cycle, from the rouble crisis of 1998 to the present, consists in the consolidation of the biggest insurance companies. The market is more concentrated than before the crisis. One of the most important consequences of the rouble crisis has been a higher concentration of insurance companies in Moscow and the Moscow region. Moscow now represents more than two-thirds of the total premiums collected (the figure was 45 per cent before the crisis). As a result, insurance is absent or has disappeared from entire regions in the Russian Federation (see Figure 2).

In addition to Moscow's regional predominance linked to the rouble crisis, the concentration of insurance is explained by a poor distribution system. Insurance markets need skilled and specialized distribution networks, whose role is essential as they directly contribute to the turnover of insurance companies and to the quality of their portfolio. Specific

Region of Russia 1997/2000	Number of companies (1997)	Share of premium (%) (1997)	Share of premium (%) (2000)	Share of payments (%)
Moscow City	651	45.14	74.00	39.5
St Petersburg	119	5.20	2.60	7.15
Tyumen			2.80	
Kemerovo	50	5.18		6.71
Samara	50	4.91	1.90	6.82
Moscow region	66	2.52	2.50	2.60
Ekaterinburg	86	2.08		1.82
Tatarstan	36	1.30		0.95

Figure 2: Regional breakdown of the insurance market

legislation on brokers' and agents' professional skills is necessary and exists in several transition countries.

The apparition of compulsory third-party liability (TPL) in Russia will develop the insurance market. Already today, several compulsory insurance plans are defined in the country's Insurance Law and Civil Code. These obligations concern the professional liability of certain economic sectors (transportation, nuclear industry) or personal insurance of certain groups among the population (military, customs).

The reliability and the sustainability of the market are poor. The market is highly volatile and the list of top ten companies varies from one quarter to the next.

The amount of total premiums collected in 1997 was 34 billion new roubles (US$5.8 billion). The rouble crisis in 1998 provoked a severe depression of the insurance market with a total premium of US$3 billion in 1998 and US$3.7 billion in 1999. In 2000, the insurance market collected a total premium of US$6.1 billion (see Figure 3). Data is divided between compulsory and voluntary insurance. Compulsory insurance includes personal insurance (medical, life) and professional liability. Voluntary property insurance is mainly sold to firms where voluntary personal insurance consists in supplementary covers in medical insurance.

The non-life insurance market

The non-life insurance market in Russia mainly consists of property insurance. The development of this sector is slow. Commercial and industrial firms do not have a sufficient

2000	Premiums RUR billion	Premiums US$ billion	% of the total
Total:	171	6.1	100
Compulsory	*30.4*	*1.08*	
Voluntary	*140.6*	*5.02*	
Life and personal	60.8	2.17	35.50
Non life:	79,8	2.85	64.90
Property	*38.2*	*1.36*	
Liability	*6.6*	*0.23*	

Figure 3: Turnover of the Russian insurance industry in 2000

financial basis to cover risks on their assets. They are not authorized to deduct insurance premiums from their benefits up to an amount equivalent to 3 per cent of their turnover (1 per cent for life insurance premium and 2 per cent for non-life). This is extremely low in comparison with their needs.

In the absence of a complete civil-liability regime, liability insurance is weak and limited to certain sectors where certain obligations of insurance exist (such as passenger liability).

The personal and life insurance market

The life insurance market is basic due to inflation and the lack of financial instruments. Lately, the market has mostly been driven by the group life sector with very short-term products presenting fiscal advantages.

The newly created pension funds system is a direct alternative to life assurance. In 1998, the Duma adopted a new law on pension funds aimed at improving the system.

Non-state pension funds	1996	1997
Total assets (bln current roubles)	542	3490
Population covered (in thousands)	220	1545

Even though the life sector constitutes an important part of individual insurance, the market is weak and poorly developed. Global uncertainty, the attractiveness of short-term financial assets and holdings in cash in foreign currencies (still representing a volume of US$30billion) explain the difficulties in launching the market.

However, potentials for growth exist. The savings-to-income ratio of the population is very high in Russia and the progressive standardization of financial markets would permit a new generation of life insurance policies.

It should be pointed out that several foreign life insurance companies have offered directly within Russia offshore life covers in foreign currencies. Russian law forbids these operations and no data exist to estimate the size of this market.

Medical insurance constitutes the most important part of compulsory insurance. The Ministry of Health estimates that 125 million Russian citizens are insured for their medical expenses.

The reinsurance market

Local reinsurance capacities are very low and prevent Russian insurance companies from underwriting high risk without reinsurance abroad. An unofficial estimate is that 80 per cent of the premiums are reinsured abroad. Foreign international reinsurance companies only have branch offices in Russia. Most reinsurance contracts are based abroad. Remedies to enhance reinsurance capacities are not forthcoming. If the creation of a national reinsurance company has been envisaged, the risk of a poorly efficient monopolistic system has prevented such a solution until now. Some companies are actually experimenting with the exchange of reinsurance coverage. Russian risks located in Russia are reinsured abroad and the Russian reinsurance company keeps a certain share of the risks. Russian risks located abroad are reinsured abroad with a certain share of the risks reinsured in Russia.

4. Regulation of insurance in a transition context and Russian insurance structures

The first aim of insurance regulation is to protect the insured. Insured individuals and firms are considered incapable of estimating the solvency of an insurance company. This is especially the case in life insurance, where contracts are long-term and where the actuarial and financial techniques require specialized analysis. Another fundamental reason in favour of insurance regulation lies in the existence of mandatory insurance. As public authorities organize compulsory insurance programmes, it seems normal that they oversee the solvency of insurance companies.

Apart from consumer protection, an insurance market requires regulation in order to reach an equilibrium price. Research in information theory has formally demonstrated the necessity of regulation to limit moral-hazard and adverse-selection phenomena. In other words, the pooling of risks in the absence of regulation is difficult or impossible.

Insurance regulation exists at three levels:

- Legal frameworks, in most CIS and Eastern countries, of laws which principally:
  - establish a supervisor;
  - fix the principles of licensing and the creation of insurance companies;
  - define the categories of insurable risks and the general conditions of insurance contracts;
  - define major liability principles;
  - fix prudential and solvency rules; and
  - fix specific insurance tax systems;
- Regulations and administrative decisions, to verify that the insurance supervisor is competent in organizing market competition and in precisely defining accounting standards, reporting rules, prudential constraint and so on:
  - in numerous countries, the supervisors fix insurance rates;
- Jurisprudence and court decisions: court decisions are essential, as they define the extent of liability rules and permit insurers to forecast their financial exposures.

ARIA, association of all insurers of Russia

Professional insurance associations are also active producers of regulation as they serve to solve conflicts between insurance companies and establish compensation rules. In Russia, the Association has 160 member companies, representing not less than 80 per cent of the total premium of the Russian market; all the important Russian insurance companies are members of ARIA. ARIA is undoubtedly representative of the insurance industry in Russia. The competence of the professional insurance association is a major factor in the transition of the insurance market. The role of the professional association is to organize working groups to develop methodologies and good-practice guidelines, as well as prudential and prevention standards. The association must also promote compensation and agreements between companies. The association has an important role in representing the profession with regard to third parties: healthcare centres and similar organizations.

Insurance supervisory body

The supervisory authorities are either part of the Ministry of Finance, as in Russia, or independent governmental bodies, as in, for example, the Baltic countries, Hungary, Georgia and Poland. The supervisory body can be financed by the state budget (Russia), by insurance companies (the Baltic countries, Hungary) or by a combination of both (Poland, Slovenia). In Russia, where the resources of the state budget are scarce in relation to the need to control insurance companies in a very large nation, the solution of a contribution of insurance companies to the financing of the supervisory system should be considered. The normal method is a tax on insurance premiums. The insurance supervisory body is the cornerstone of an insurance system. Its competence and resources have to be excellent. A levy on insurance premiums is highly recommended. The supervisor should be able to hire competent actuaries, and to train and maintain a qualified staff.

The Russian insurance supervisory body was established in 1992 as an independent governmental body. As defined by law, Nadzor's tasks include:

- Licensing of insurance companies;
- Controlling insurance companies; and
- Establishing proper regulations for the insurance sector.

As of 1996, Nadzor is no longer an independent agency. It is a department within the Ministry of Finance.

With a staff of 130 persons, plus 90 inspectors, Nadzor is encountering severe difficulties in controlling a market with thousands of insurance companies. Nazdor's poor quality equipment and limited budget prevent the development of sufficient regional control.

There is no short-term plan to fund Nadzor with levies on premiums. It is even more difficult to sustain Nadzor in its task of controlling and monitoring the market. The weakness of the means and the lack of regional structures are severe. A considerable amount of work is devoted to the registration and the modification of registration of insurance companies. Nadzor and ARIA are willing to establish a rating of insurance companies by pooling their information on insurance companies. Reasons for such ratings are straightforward: the market is very volatile, customers are unable to assess the solvency of companies, and young Russian companies have not yet acquired a reputation.

Licensing

Requirements for licensing are similar from one country to another and do not raise important problems (statutory capital, general insurance policy conditions, professional requirements, and business plan). Information on shareholders is requested in some countries (the Baltic countries, Croatia, Poland, Hungary).

An important problem is the size of the capital requirements to establish an insurance company. These requirements are still very low in Belarus, Moldavia and Romania.

In Russia, on 1 January 2000, around 1,200 insurance companies were registered in Russia. Only 500 of them are still active and sending their balance sheets and reports to Nadzor. The capital requirements for Russian companies were raised substantially and it is expected that these requirements will become more exigent in the near future.

With the hyperinflation period, the capital requirements adopted in 1992 have become dramatically low. From 1994 to 1997, Nadzor withdrew 888 licences (331 in 1997). The main causes of license withdrawal were insufficient mathematical reserves and poor future claims reserves. By the beginning of 1998, only 27 per cent of the insurance companies had a capital superior to 10 million roubles.

The Law on the Organization of the Insurance Market adopted on 31 December 1997 reinforced the capital requirements for insurance companies. Capital requirements are expressed in terms of the "minimum wage". The regulator at the time chose that indicator, thinking it would match inflation. As of 1 January 1999, the minimum capital required is a sum equivalent to:

- 25,000 minimum wages for non-life insurance, i.e. US$175,000;
- 35,000 minimum wages in life insurance, i.e. US$245,000;
- 50,000 minimum wages in reinsurance, i.e. US$350,000.

The strict application of the law will be decisive. It is estimated that only 20 per cent of insurance companies will meet the new requirements in the coming years.

Another important problem is the authorization for foreign insurance companies to establish branches in the country. Belarus, Bulgaria and Ukraine limit foreign capital to 49 per cent. In Russia, since the modification of the insurance law at the end of 2000, foreign insurance companies may obtain a licence, provided:

- They have more than two years' presence in the market;
- The parent company has more than 15 years' experience in the insurance industry.

Moreover, foreign insurance companies are not authorized to be active in life insurance and in compulsory insurance lines.

Skipper (1997) gives four reasons for opening a local insurance market to foreign operators:

- Improvements in customer service and value;
- Transfers of technology;
- Additional external capital;
- Improvements in domestic insurance regulation.

The idea behind "improvements in customer service and value" is that the co-existence of local and foreign insurance companies will force local insurers to offer a better service to their clients and will force a segmentation of the market. Examples of such improvement are often taken from Poland, Mexico, Chile and the Philippines. It has to be borne in mind that from the point of view of existing local operators, if the presence of foreign insurers may largely improve the level of professionalism, the drawback is that they will tend to attract and deal with only the best clients. That tendency exists, for instance, in Poland, where foreign insurers are reluctant to underwrite TPL motor insurance (or are underwriting only the lower risks). That "natural" segmentation of the market may gravely endanger local insurers if no precaution is taken. Precautions can be taken in the conception of premium calculations to protect local insurers from suffering from market disadvantages in mandatory insurance.

The argument of "transfers of technological and managerial know-how" is one of the most prevalent in favour of greater foreign participation in the local market. The calculation of insurance premiums, claims assessments, distribution policies and reserves management are all technological inputs where experience and knowledge of international standard practices are essential. The presence of foreign insurers permits rapid enhancement of the level of knowledge in the local market. Foreign insurers will hire and train employees. After a few years, these by now skilled employees are able to join local insurance companies. Co-insurance schemes permit the development of local competence, as well as other benefits.

In addition, the presence of foreign insurers provides protection to local insurers from government abuses. There is often conflict in the relations between governments and the insurance industry. Governments may use the financial assets of insurers to fund priority needs or may force insurers to underwrite risks at a low cost level. The presence of foreign insurance companies allows local insurers to resist abusive utilization of insurance funds.

With regard to Russia, the third argument, which is "additional external financial capital", is certainly important. The lack of capital prevents local insurers from underwriting large risks without extensive reinsurance abroad.

An increased presence of foreign insurers would permit co-insurance strategies. In the absence of a mass market, local insurers are too weak to bear large risks.

Nowadays foreign insurance companies are authorized to acquire majority stakes in Russian companies. Nevertheless, foreign insurance companies' activities are still restricted to specific non-life insurance lines of business. The situation should evolve over the coming years with the entry of Russia in the World Trade Organization (WTO).

Technical provisions

The Organization for Economic Cooperation and Development (OECD) reports that the control of technical provisions is often inadequate in transition economies. No guidance or set standards exist concerning the application of regulations.

The methods used to review insurance provisions vary from country to country. In most countries, financial statements have to be examined by auditors. The use of actuaries is not widespread but they do play a role in checking the adequacy of mathematical reserves in Poland, the Czech Republic, Hungary, Slovakia and Slovenia. Poor financial instruments are also an important problem for the insurance industry in the Russian Federation. The main problem of insurance companies is their difficulty in coping with inflation. Due to inflation and general uncertainty, there are no long-term financial vehicles in local currencies. A direct solution would be to authorize premiums and claims payments in hard currencies. Even if impossible from a political and a monetary point of view, it should be noted that reinsurance abroad is in fact an indirect way to cover the inflation risk. If the absence of inflation is a prerequisite for the development of the insurance sector, it is certainly not enough. Experience has shown that the stability of the rouble from May 1995 to June 1998 was not steady enough to permit strong development of a solid insurance system. Long-term savings were not channelled through insurance vehicles and liabilities insurance lines were not developed. It would be a mistake in terms of political economy to consider that insurance is not a priority until the stability of the rouble is reached.

Discussions are underway among the Ministry of Finance, the ARIA and pension funds to issue a new financial instrument – insurance bonds – to meet the needs of the industry in terms of liquidity and the ability to cope with inflation.

The overall financial reserves of Russian insurance companies are estimated to be around RUR 150 billion (US$5.347 billion).

Reporting system and accounting standards

Financial reporting is generally done on a quarterly or semi-annual basis. The utilization of specific insurance accounting principles is generalized.

The accounting system should be improved, with non-ambiguous rules and compatibility with internationally accepted accounting standards. The current accounting system is imperfect and focuses on cash received and paid out. Modifications aimed at creating a system focusing on claims incurred and actuarial evaluation are essential. These modifications will facilitate the supervisor's tasks. Reporting during the current transition period should give particular attention to the investment strategies of insurance companies. Systematic certification of reporting has to be organized with auditing firms and actuaries. Electronic mail delivery of reports should be organized in order to ease the supervisor's work.

TPL motor insurance

The development of the insurance industry in Europe coincides with the compulsory TPL motor insurance. The creation of such a system should be considered a priority. TPL motor insurance will require a great deal of work in terms of legislation and preparation (statistics, agreements with repair centres and healthcare providers, guarantee funds, training of distribution networks, co-ordination with the police and transport authorities). A law on compulsory motor TPL was passed at its first submission in April 2001 at the Duma. It should normally come into force by the beginning of 2002 and will coincide with a large increase in premiums.

5. Conclusion

Today, the premium-to-GDP ratio in Russia is no more than 1.27 per cent, a very low figure when compared with EU Member States and Eastern European Countries. In the absence of a mass market due to the absence of a compulsory TPL automobile insurance, the Russian insurance market suffers important infrastructure problems and has not reached maturity. Nevertheless, important progress has been made recently in legislation with the new version of the Law on Insurance. Further steps have to be taken regarding specific rules and regulations, prudential rules, and compliance with international standards and international agreements. Strict compliance with WTO regulations will suffice to open the market to foreign operators and important progress towards an opening of the market has been made with the recent modification of the law. Moreover, a draft law on compulsory TPL was adopted by the Duma at its first submission in April 2001; the law should come into force in 2002.

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Recent data and information on the Russian insurance market are available online from ARIA: www.allinsurance.ru.