

# PROSPECTS FOR INSURANCE IN RUSSIA

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## Abstract

During the transition from a planned to a market economy, the Russian insurance industry has grown strongly. The premium income had a very high growth rate and increased from US\$ 2 bn in 1998 to US\$ 9 bn in 2001. The proportion of insurance income to GDP increased from 0.6% in 1992 to 3% in 2001.

The initiation of market reform ten years ago upset the monopoly held by the state insurance organizations Gosstrakh and Ingosstrakh. By the beginning of 2002, more than 1300 private insurers were operating in the market, including 54 insurance organizations with foreign participation. According to the Insurance Law, a number of additional restrictions were introduced for companies whose foreign participation exceeded 49% of the capital. Now, 2002, a very important problem is the consequences for the insurance industry of Russia's possible entry into the WTO. It is necessary to develop a systematic approach to plan ways in which the insurance sector can be developed so as to include equal treatment for the participation of foreigners in insurance.

The growth and profitability of the insurance industry made insurance companies very attractive for investors. The government of Russia is formulating detailed objectives and plans for the development of the national insurance business.

## Economic Background

The significance of insurance is especially important in the context of economic reforms in Russia, because insurance can stimulate the growth of market interactions and business activity and improve the investment climate. The extent of the development of the insurance market reflects the potential for the economic growth of the country. By enabling a redistribution of risks among economic entities and providing reimbursement for losses from accumulated funds, insurance makes it possible to raise the efficiency of the economy as a whole and of individual enterprises. For that reason, the development of a national system of insurance is an important strategic task in terms of the creation of a market infrastructure. For Russia, where virtually all types of activity entail elevated risk, that is of particular importance.

Experience from around the world points to the close relationship between the social expenditures of society and the level of development of long-term life insurance. Insurance can replacing certain state social programs, removing the burden from the state budget<sup>2</sup>. That is particularly important in Russia because of the crisis with the pension system and adverse demographic trends. Given the shortage of investment resources, using insurance technologies to attract personal savings could become an essential element in the state's fiscal policy and could reduce foreign borrowing.

The significance of insurance is growing considerably during the transition to a market economy and the strengthening of private ownership. Unlike in the planned-administrative system, the state is ceasing to bear responsibility for compensating economic entities and individuals for losses suffered in untoward events, natural disasters, and major accidents. In turn, that promotes the development of demand for insurance services.

**Table 1<sup>3</sup>** Selected Economic Indicators for Russia 1995-2001

Year	GDP nominal (in bn rubles)	Exchange rate ruble/US\$ (end of the year)	Consumer price increase (in %)	Population (in mn)
1995	1540.5	4.64	131	148.0
1996	2145.7	5.56	22	147.5
1997	2521.9	5.96	11	147.1
1998	2741.1	20.65	84.4	146.7
1999	4757.2	27.00	36.5	145.9
2000	7063.4	28.20	20.2	144.8
2001	9040.8	30.14	18.6	144.6

The financial crisis of 1997/98 raised the particularly acute question of the creation in Russia of a suitable institutional system capable of ensuring the mobilization of savings and directing them for investment purposes. The events of 1998 demonstrated the limited possibilities and the extremely dangerous consequences of financing the economy primarily through domestic and foreign borrowing. In light of the low level of collectability of taxes and the steady flight of capital, economic growth in Russia is impossible unless there is a substantial rise in average savings. The insurance system is to play a distinct role in that process.

After the financial crisis of 1998 the economy began to recover and GDP achieved a positive real growth rate. By the end of the 1990s the rate of inflation declined. Table 1 above presents this and other relevant data. The Insurance industry in Russia benefited from the economic boom generated by high oil prices and a surge in exports.

## PROSPECTS FOR INSURANCE IN RUSSIA

### Russian Insurance History

The 'Russia Fire Insurance Society' was established in 1827. The Statutes of Society was confirmed by the Emperor Nicholas I. This year, 2002, Russia will therefore celebrate the 175 anniversary of national insurance.

Beginning in 1861, a decree of Emperor Alexander II led to the development of mutual insurance in Russia. Mutual insurance Societies were very popular in Russia before the 1917 revolution. Compulsory insurance of buildings was the next state intervention which accelerated insurance business. By the end of the 19<sup>th</sup> century there were more than 300 insurance societies and companies in Russia. They had reinsurance connections with companies in England, Germany, Sweden, Norway and elsewhere.

During the Communist period in the USSR only two state insurance companies operated: Gosstrakh and Ingosstrakh. They underwrote more than 200 million insurance contracts per year. The most important contracts were social insurance, life insurance, and property insurance. By the end of the 1980s the insurance premium volume of the former USSR was about 3% of GDP.

The initiation of market reforms in the new Russia has overturned the monopoly held by the state insurance organizations, Gosstrakh and Ingosstrakh. Now, 2002, about 1350 insurance organizations are operating in the market, a good many being private companies. Russia now has over 10 years experience of private insurers. In the 1990s, basic legislation was introduced to regulate insurance activities, and a state Insurance Supervision agency was created. That led to the development of commercial insurance and to a rapid growth in the number of insurance companies.

### Insurance Legislation and Regulation

The key elements of a market insurance system, unlike a state monopoly system, consist of insurance contract laws, state supervision of the activities of insurance organizations and insurance brokers, and legal and regulatory measures for foreign insurers in the domestic market.

The legislative basis for the formation of the Russian insurance market are incorporated in the 1987 law 'On Cooperation', which made it possible to create insurance cooperatives for providing insurance coverage for cooperative association participants.

By the February 1992 Decree of the President of the Russian Federation, a special federal agency for state insurance supervision, *The State Insurance Inspectorate of*

*the Russian Federation* was created in order to ensure the efficient development of insurance services, as well as to protect the interests of policyholders, insurers, and the state in the conduct of insurance operations. But in August 1996, in accordance with another Decree of the President of the Russian Federation, this independent federal agency was eliminated, and its functions were given to the Insurance Supervision Department in the Russian Federation Ministry of Finance.

The adoption of the Law of the Russian Federation 'On Insurance' in 1992, and of the Civil Code of the Russian Federation, Pt. 2, in 1995, as well as a whole array of legislative acts between 1992 and 1999, made it possible to form a system of advanced insurance law as an independent legal institution regulating insurance operations.

Despite these numerous sources of law regulating insurance, some basic problems associated with legal relations in various aspects of insurance activities have remained unresolved over the past number of years.

In recent years, Russian law has failed to develop rules for regulating mutual insurance or the activities of mutual insurance companies. Especially important are rules for regulating the establishment of an insurance organization and the acquisition of an insurance license. Russian law specifies a two-step procedure for the creation of an insurance organization as a potential subject of civil legal relations inherent in an insurance contract. Civil law provisions govern the procedure for establishing an insurance company, whereas administrative law provisions govern the acquisition of an insurance license. Those provisions contradict each other and do not provide the necessary test on the part of the supervisory agencies of the good faith of company founders when they are creating an insurance organization or of their subsequent solvency.

The effectiveness of state oversight of the activities of insurance organizations can be assessed by the quality of the following components:

- use of reliable and complete financial information, accounting information, and other information;
- timeliness and completeness of oversight;
- efficacy and promptness in the application of sanctions by the oversight agencies.

By these criteria, the current system for Russian insurance oversight is ineffective. That can be attributed to the following

- there are not enough Insurance Supervision Department (Nadzor) staff members (about 60 people in the central office and about the same number in the regions);

- Nadzor employees have poor qualifications and low pay;
- modern methods for processing and transferring data are absent;
- regional Nadzor offices are used ineffectively for functions of control;
- power to control and the measures to be applied to insurance organizations are inadequately reflected in legislative acts;
- there is no well-developed system of sanctions for violations discovered in the activities of insurance organizations.

Those problems could be resolved, to a large extent, by passing a special law 'On Insurance Oversight', as called for in the Civil Code of the Russian Federation.

Unlike most other countries, Russian Insurance law does not specify categories of insurers, such as those that provide life insurance and those that provide other types of insurance.

### The Russian Insurance Market

In Russia during the transition from a planned to a market economy, the insurance industry has grown strongly. Total premium income had very high growth rate, increasing from US\$ 2.09 bn in 1998 to US\$ 9.18 bn in 2001. The growth in the last three years was: 71.2% in 1999; 69.2% in 2000; and 51.4% in 2001. In those same years the claims ratio was low: 64.5% in 1999; 70.1% in 2000; and 62.1% in 2001. Insurance business is considered to be very profitable in Russia. Table 2 presents the data.

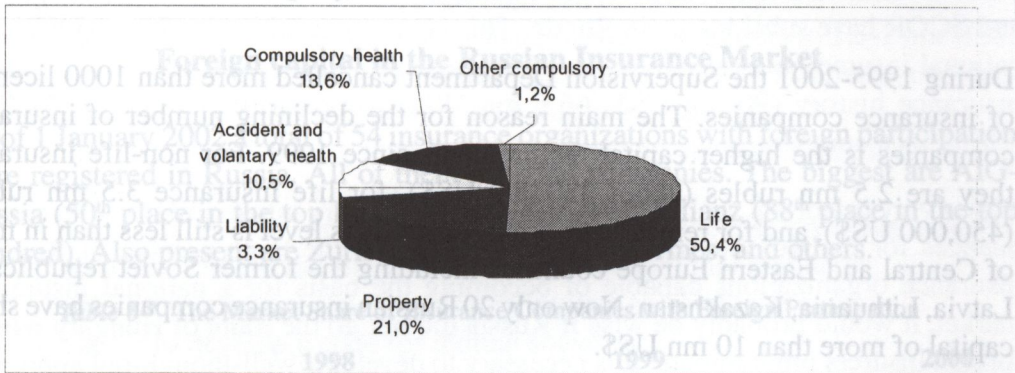
**Table 2<sup>4</sup>** Insurance Premium Income and Aggregate Claims Costs

Year	Insurance premium volume		Insurance premium volume	
	in bn rubles	in bn US\$	in bn rubles	in bn US\$
1995	23.18	5.00	16.81	3.62
1996	29.11	5.24	23.46	4.22
1997	36.37	6.10	26.49	4.44
1998	43.07	2.09	32.99	1.60
1999	96.60	3.58	62.30	2.31
2000	171.00	6.06	119.80	4.25
2001	276.60	9.18	171.80	5.70

The share of life insurance premiums in this total premium income, grew from 29.66% in 1998 to 40.41% in 2001. The long-term life insurance that is typical of a market economy is virtually undeveloped in Russia. The share of long-term life insurance (5 years and more) is only 5% of life insurance premium income. Poor laws and an adverse economic environment have strengthened negative trends in marketing of life insurance. Some companies use the mechanism of insurance to escape the payment of taxes.

Table 3<sup>5</sup>

The Distribution of Total Premium Income in 2001



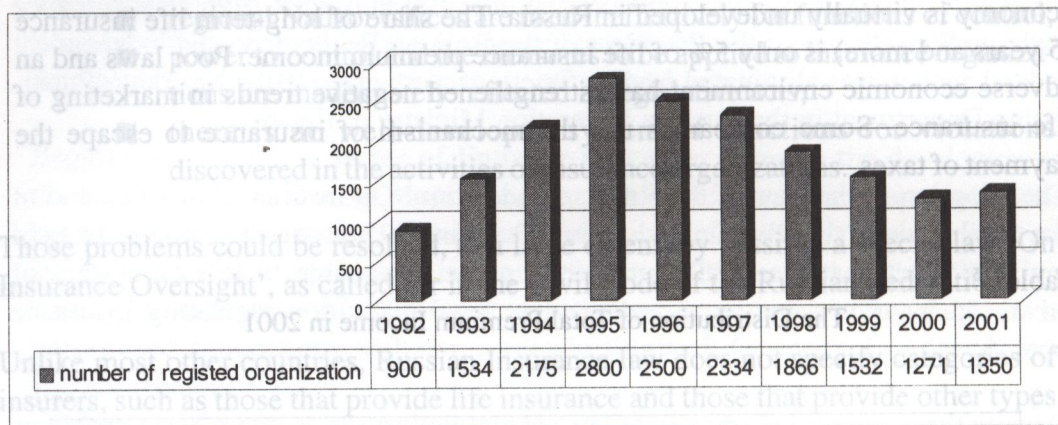
The share of compulsory insurance has declined from 40% in the middle of the 1990s to 14.8% in 2001. The share of life insurance has grown from 27% to 50.4%.

The distribution of insurance companies by region is extremely disproportional. Moscow and Moscow region companies dominate, with about 75% of the total national premium income, yet the population of these two areas is less than 10% of Russian population. In a number of regions voluntary insurance is virtually lacking. The share of the Central Federal District's share of premium volume in 2001 was 78.5%; the Ural Federal District, 6.7%; the Volga Federal District, 4.7%; the Siberia Federal District, 1.3%; the Far Federal East, 1.2%<sup>6</sup>. (About Insurance, No.10, 2002).

The concentration of insurance business is high. The share of the top hundred companies in aggregate premium volume is about 85%.

Table 4<sup>7</sup>

## The Number of Insurance Organizations



During 1995-2001 the Supervision Department cancelled more than 1000 licenses of insurance companies. The main reason for the declining number of insurance companies is the higher capital requirements since 1999. For non-life insurance they are 2.5 mn rubles (about 320,000 US\$), for life insurance 3.5 mn rubles (450,000 US\$), and for reinsurance 5 mn rubles. This level is still less than in most of Central and Eastern Europe countries including the former Soviet republics of Latvia, Lithuania, Kazakhstan. Now only 20 Russian insurance companies have share capital of more than 10 mn US\$.

The biggest Russian companies in 2001 were *Industrial-Insurance Company*: written premiums 43.003 mn rubles (1.43 bn US\$); *Alfainsurance Group*: 19.722 mn rubles (657 mln US\$); and *ROSNO*: 16679 mn rubles (556 mn US\$) (Money, No. 22)<sup>8</sup>. The aggregate authorized capital of all insurance organizations at the end of 2001 was 27.3 bn rubles, with technical reserves of 88.5 bn rubles (about 1% of GDP).

Table 5<sup>9</sup> Selected Macroeconomical Indicators of the Insurance Market

Year	Premiums per capital		Premiums as % of GDP
	in rubles	in US\$	
1995	156.64	33.76	1.50
1996	197.34	35.49	1.36
1997	247.23	41.48	1.44
1998	293.59	14.22	1.57
1999	662.10	24.52	2.03
2000	1180.94	41.88	2.42
2001	1912.86	63.47	3.06

The share of insurance premiums as a proportion of gross domestic product increased from 0.6% in 1992 to 3.06% in 2001. Even so, Russia's share of the world volume of insurance business is still less than 0.1% and the premium per capita about US\$ 64.

The growth of the insurance industry made insurance companies very attractive for investors. In recent months there were several purchases of the best and largest insurance companies by foreign and Russian investors. Allianz have bought 45% share of ROSNO; NIKoil 100% of Industrial Insurance Company; and Troika-Dialog 49% of Rosgosstrakh (40 mln US\$). Ingosstrakh was bought by two Russian investors (Sibal, Nafta) and one foreign investor (Mullhouse Capital). There were some fusions of insurance companies and banks (Interros-Soglasie and MDM, Industrial-Insurance Company and Avtobank under Financial Group NIKoil).

### Foreign capital in the Russian Insurance Market

As of 1 January 2002 a total of 54 insurance organizations with foreign participation were registered in Russia. All of them are joint companies. The biggest are AIG-Russia (50<sup>th</sup> place in the top hundred), and Ost-West Allianz (88<sup>th</sup> place in the top hundred). Also present are Zurich, Alfa Leiptziger, Hermes, and others.

**Table 6<sup>10</sup>** The Market Share of Insurance Companies with Foreign Participation

	1998	1999	2000
Premiums written (%)	6.0	8.4	9.9
Voluntary insurance (%)	9.2	10.7	12.0
Life insurance (%)	8.4	11.7	13.5
Property insurance (%)	10.9	10.1	10.7
Liability insurance (%)	11.4	7.1	7.9

Since 1999 the Insurance Law permits the establishment of foreign companies with more than 49% participation in the share capital. At the beginning of 2002 the volume of registered capital of foreign participation in the insurance organizations was 4.1% of aggregate capital of the insurance companies in Russia. According to the Insurance Law there is a quota, a limit of 15% (for the banking sector the limit is 25%). The free quota for foreign insurance companies is now is about 100 mln US\$. For companies with foreign ownership greater than a 49% share of capital, a number of additional restrictions were introduced specifically. These are:



- they are not permitted to operate in certain classes of insurance such as life insurance, the insurance of state property and compulsory insurance;
- they have capital requirements 10 times higher than for Russian controlled companies (25 mn rubles (about 3.2 mln US\$));
- their Managing Director and Chief Accountant must be Russian citizens;
- the controlling organization must have been operating as a licensed insurance company for not less than 15 years in their own country;
- the controlling organization must have been operating as a minority shareholder in an insurance organization with the Russian Federation for two years;
- Cross-border business is forbidden except for 'Green Cards' for vehicles which travel abroad..

Famous reinsurance companies such as Munich Re, General & Colon Re, Swiss Re, and SCOR have subsidiaries in Russia. This is very important for Russia because national insurers and reinsurers have low capacity. The biggest claims in modern insurance history (90 mn US\$, 66,6 mn US\$) were partly covered by foreign reinsurance companies.

Now a very important problem is Russia's possible entry into the WTO, with consequences for the Russian insurance business. Given the large number of Russian insurance organizations capable of becoming the basis for a national insurance market, it would probably be wise if Russia did not go the route of Hungary where foreign insurers predominate. It is necessary to develop a well-thought-out approach to ways in which the insurance sector can develop so as to include equal conditions for the participation of foreigners in insurance.

### **The Future of the Insurance Market in Russia**

The Russian parliament passed a new Law of Compulsory Motor Third Party Liability, which will be in force from 1 July 2003. There are now about 30 mn vehicle in Russia. Last year there were about 30,000 deaths and 200,000 injuries in Motor vehicle accidents. Currently, only 5% of vehicles have voluntary motor third party liability cover. So this compulsory insurance will be very important for Russia, and it will give a new impulse to the growth of insurance business in Russia. The additional amount of premium income is estimated at more than US\$ 1 bn. The tariffs will be set by the government (Russian Federation Ministry of Finance) but the big problem for deciding realistic figures for the tariffs is the lack of relevant statistics.

The following are key obstacles to the further development of insurance in Russia, including the lack of sophistication of insurance regulation:

- the public have little trust in insurance and there is a low ability to afford premiums;

- the low level of future financial capital of Russian insurers; solvency requirements for insurance organizations do not conform to world standards and reduce the reliability and financial stability of the insurance system;
- the low level of income of policyholders;
- the absence of incentives for insurance, including tax incentives, especially for long-term life insurance
- the absence of effective financial instruments for the placement of insurance reserves;
- the lack of development of the infrastructure of the insurance market, specifically the absence of an institution for actuaries and risk appraisers.

The government of Russia has drafted its ideas and program for the development of the Russian insurance business. Its draft included the following:

- to promote the minimum share capital for insurers to 1.5-2 mn US\$;
- to set up compulsory motor third party liability insurance, compulsory fire insurance, and compulsory travel liability insurance;
- to develop long-term Life insurance and pension insurance;
- to establish a Federal reinsurance system;
- to develop supervision and regulation of the insurance business, the legislation to conform to the EU Directives and International Standards;
- to introduce tax policies to stimulate sales of insurance;
- to develop a code for mutual societies;
- to improve the power of the Supervision authority and strengthen solvency standards;
- to improve the education and retraining of insurance companies managers and staff;
- to create an institution of actuaries;
- to liberalize the insurance market, but over a 7 -10 year period because the Russian companies are not yet competitive in the world insurance market.

With these initiatives, experts estimate that insurance premium income by 2007 will be about 400 bn rubles, and this premium income will then be 4% of GDP.

### Endnote

<sup>1</sup>Professor Igor Kotlobovskiy, PhD, is a member of the Methodological Committee of the Insurance Supervision Department (Ministry of Finance); a member of the All-Russian Scientific Insurance Society Council; a member of the Expert Council on Insurance of the State Duma Russian Federation; and a member of the Editorial Board of the Risk Management Journal. He is the author of 4 books and about 50 academic and professional articles.

<sup>2</sup>Harold D. Skipper, Jr. Foreign Insurance in Emerging Markets: Issues and Concerns. IIF Occasional Paper, Number 1.

<sup>3</sup> Short-term economic indicators for the Russian Federation. Goskomstat (Russian Federal Statistical Agency) 2002.

<sup>4</sup> Insurance in Russian Federation in Figures in 1994-2001. In Koblobovskiy I. editor. Moscow: TEIS, 2002.

<sup>5</sup> About Insurance. No. 10, 2002, p. 12. About Insurance No. 15, p. 2-6.

<sup>6</sup> About Insurance, No. 10, 2002, p. 13.

<sup>7</sup> Insurance in Russian Federation in Figures in 1994-2001. In Koblobovskiy I. editor. Moscow: TEIS, 2002.

<sup>8</sup> Money. No. 22, 2002, p. 58-65.

<sup>9</sup> Insurance in Russian Federation in Figures in 1994-2001. In Koblobovskiy I. editor. Moscow: TEIS, 2002.

<sup>10</sup> Delaygin M. Market of securities, No. 3, p. 54-58.

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