# DEVELOPMENT OF REINSURANCE MARKETS IN THE ECONOMIES IN TRANSITION

*by*
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**Summary**

The present survey deals with the general development of the insurance markets of economies in transition with special emphasis on reinsurance. While it has not been possible to collect data for all countries of the region, which are of widely varying state of development, it is clear that the early stages of contraction in insurance activity are over and most of them are growing rapidly.

Economic and social conditions -- involving liberalisation, privatisation and demonopolisation -- are stimulating the demand for insurance as the corporate sector needs indemnification in case of major losses and consumers look for protection of their assets in a period of rising crime as well as health care and retirement income for their old age.

Most countries have introduced insurance legislation and supervision and opened up their markets for foreign insurers, albeit some only allow minority interest. The bulk of this legislation, modelled on EU directives, is in a state of flux as the need for an effective supervisory structure is becoming evident. The principal objectives of supervisors are the authorisation of new companies that can be relied upon to maintain their solvency, and the establishment of monitoring systems that assure continuing reserve adequacy. Conditions of rapid growth, high rates of inflation and underdeveloped financial markets tend to expose both insurers and supervisors to challenging decisions.

Beyond considering the impact of reinsurance on the solvency of domestic companies, reinsurance regulation has not received much attention, partly because of the absence of significant domestic reinsurance activity and partly due to the absence of a reinsurance regulatory model in Europe, on which much of insurance regulation in economies in transition are based.

The majority of countries give significant freedom to using reinsurers at home and abroad. However, some restrict placement by individual insurers beyond a certain proportion to one reinsurer, or to one market. There are at least five countries - Latvia, Lithuania, Moldova, Romania and Slovenia - which stipulate that overseas placements may only be made once domestic insurers/reinsurers are unable to accept the business.

A postal survey of 9 insurance regulators in 1996 found that not all collected full information on reinsurance transactions with domestic and foreign reinsurers; some that collected did not publish it. While some regulators said that they have powers beyond requiring to see details of ceding companies' reinsurance arrangements, it is not clear that they have legal instruments beyond persuasion.

Several supervisors doubted if they have adequate technical knowledge or resources to monitor ceding companies' transactions. The majority kept in touch or intended to do so, with supervisors in other countries if they doubted the liquidity/solvency of foreign reinsurers.

While privatisation of formerly state owned insurance institutions has commenced in almost every market, the rate of progress to date varies widely. Advance in some of the CIS markets has been slow, although it has been virtually completed in most the Central European market.

While monopoly conditions have come to an end almost everywhere, genuine competitive conditions exist only in some of the Central European countries. The market share of the largest company has fallen below 50 per cent only in six out of the 11 markets analysed.

Most insurance markets of the region are short of capital. Some are showing aggregate solvency levels as low as 5 per cent of gross premium income. Countries which admitted significant foreign participation are in a better position, but even here market solvency levels are below 35 per cent of gross premium income, even on the most optimistic assumption of their balance sheet strength.

Most countries have several minority or majority foreign owned direct insurers. In CIS countries foreign presence is marginal as difficult market conditions and the 49 per cent ceiling on foreign ownership appear to deter significant commitment.

Premium retention rates vary widely - from 50 per cent to 96 per cent - although the absence of reliable data from major markets, such as Russia, makes estimates tentative. Our best guess is that direct business written in the region

totalled $7.7 billion and reinsurance business ceded amounted to $508 m in 1995. 90 per cent ($457m) was ceded outside region and $51m retained by local insurance and reinsurance companies. After allowance is made for claims and commission, the net outflow averages 2.5 per cent to 5 per cent of premiums ceded, amounting to an estimated $11m to $22m a year.

The development of domestic reinsurance markets in transition economies is at an early stage. The numerous reasons which explain this backwardness include the shortage of capital, lack of experienced personnel as well as the failure to cooperate with competitors to establish appropriate market practices.

International insurance and reinsurance brokers are now established in most of the transition economies, either serving their western clients or placing reinsurance for local insurers with foreign reinsurers. They are also an important conduit for reinsurance expertise and training for local insurers.

The report's recommendations include improved data collection on reinsurance transactions, minimum constraints on placing reinsurance and the avoidance of compulsory cessions. Improved information sharing with other regulators and greater investment in training of insurance professionals in the region by the international insurance community are also recommended.

## I. Introduction

The present study deals with the general development of insurance markets in the economies of transition in Central and Eastern Europe and the former Soviet Union with special emphasis on reinsurance developments. The study's focus is primarily non-life insurance, although matters of relevance on life insurance are also included.

This is a large and diverse region, covering 22 markets. Table 1 includes some relevant economic indicators, which show considerable variation in their development. Due to non-availability of data from a number of countries it has not been possible to prepare a comprehensive survey. However, the survey deals with 10 markets. In addition, where fragmentary information for other countries has been available, this has also been used.

Three of the countries of the region - Czech Republic, Hungary and Poland - are now members of the OECD and thus are no longer viewed to be in transition. However, some of their experience may be of value to the transition countries and thus may be referred to.

Table 2.1 shows the principal indicators of insurance development for the 12 markets where this data was available for 1995, as well as some OECD data for comparison. It signals the wide dispersion in their degree of development.

Table 2.2 contains the 1995 data for 13 markets, showing the breakdown of gross premiums between life and non-life business. The salient point to note is that the share of life insurance in the total is usually much lower than in OECD countries.

## II. Evolution of insurance in the region

The countries of Central and Eastern Europe and the successor countries of the Soviet Union are undergoing vigorous changes towards the creation of market economies, by privatisation, liberalisation and the promotion of entrepreneurial freedom in virtually every facet of their activities.

In the field of insurance this involves the dismantling of monopolistic structures, the reduction and eventual elimination of state ownership of insurance risk carrying in most of its aspects. This usually goes hand in hand with the admittance of foreign capital and expertise and the opening up of the markets to cross-border activities.

This evolution does not mean that the state is to absent itself from the insurance sphere. The state assumes new roles in the form of the enactment of new legislation controlling insurance activities and the building of supervisory structures.

The new situation brings with it new dangers which did not exist under a regime of state ownership and guaranteed claims payments. Inexperienced insurance management can create dangers such as uneconomic pricing, cashflow underwriting leading to insolvencies, outcomes which did not exists in earlier periods. For this reason regulators need to protect the interest of consumers against insolvency risks.

Among the responses that supervisors need to develop are closer monitoring of insurer's activity, encouraging fair competition as well as the establishment of guarantee funds.

The speed of transition from monopolistic regime to a competitive, market oriented structure varies from country to country, as does the perception of the desirability of the presence of foreign participants. However, this is a dynamic process and the ongoing modification of laws and regulations as well as the

creation of association of insurers and other trade bodies are important landmarks in this evolution.

The development of insurance and reinsurance in the transition economies differs in several respects from those of other developing countries which are already operating under a market economy. The transition economies are characterised by the weakening role of state provision in health care and old age income/pension provision together with rising crime. These trends are stimulating the demand for privately purchased insurance. Instead of the previous work-place based provision, usually provided at low cost by the employer, individual purchase of products like personal accident and health insurance is on the rise. Changed labour market conditions - job insecurity and the need to build up personal savings - are expressed in the form of demand for unemployment insurance and personal pensions provision. Most countries are also introducing new compulsory lines of insurances such as motor third party liability and professional indemnity.

The conversion of previously state owned property into private ownership is a major stimulus for the purchase of property and liability insurances by the corporate sector. However, the lack of experience of many firms to transfer risk outside their organisation means that there is a large educational role for intermediaries and insurers to respond to the potential demand for insurance.

At the same time the impoverishment and unemployment of a significant segment of the population in some countries and the need to buy compulsory insurances resulted in the contraction in the voluntary home and agricultural insurances which enjoyed higher take-up prior to the transition to the market economy. An additional stimulant - both for personal and commercial insurances - is the upsurge in crime in most countries of the region.

## III. Insurance legislation and regulation

The change from state ownership and monopoly structures towards a competitive, diversified market has been inaugurated in most of the markets of the region by the introduction of new insurance legislation to set the boundaries of insurance activity and to provide a supervisory and consumer protection role. This has been accomplished in most of the markets of the region.

While the countries of the region have chosen a number of different approaches to insurance regulation, most of them have been influenced by EU insurance directives. This is not the place to summarise the current position of these markets as this has been done elsewhere. However, in many countries the

position may be described as being in a state of flux; in others regulations seem to be less effective than desirable.

A salient indicator of the current status of legislation is the minimum capital requirement for the establishment of a new insurance company. As Table 3 shows there is wide divergence between countries, with figures falling within the wide range of $6 000 to $1.8m for new authorisations. Some of these low figures are explained by the surge inflation since the original enactment of insurance laws, which have not been updated.

The inability of several countries (*i.e.* Romania, Belarus, Moldova) to update their original statutes produced unrealistically low minimum capital requirements. For this reason several countries now specify their requirements in the local currency equivalent of foreign currency sums, or some in terms of the currency equivalent of a multiple of minimum monthly wage. However, frequent updating of minimum capital levels is disruptive insofar as it may not enable some companies to obtain additional capital by the time required and thus lead to either bankruptcies or forced mergers. The closure of numerous small companies (or enforced inactivity) has been reported in several markets due to such circumstances.

## IV. Reinsurance regulation

This section describes the current status of reinsurance regulation in the region. The findings of a postal survey of regulatory views gathered in early 1996 for this survey are reported in section IV, B.

### *A. Current status of regulation*

While the regulation of insurance has advanced significantly in Central and Eastern Europe and the CIS countries - albeit with some serious shortcomings - this cannot be said of the regulation of reinsurance.

Although it has not been possible to prepare a comprehensive analysis of legislative and regulatory practices affecting reinsurance of the region on the basis of the postal survey carried out in early 1996, it is evident that the majority of countries have done little to impose controls on reinsurance activity. Appendix A shows some of the regulations which have been mentioned during this survey.

The most frequently mentioned restraint is that reinsurance may be placed abroad only when is not possible to place it with domestic companies. However,

the administration of such conditions is often problematic. There is evidence that these rules are hard to enforce and in fact are often evaded or ignored.

Among the reasons which may be cited for the relative neglect of reinsurance regulation in economies in transition are the early stage of development of reinsurance, the lack of experience by supervisors and ceding companies in the region as well as the fact that this has not been a high priority in the EU, on which much of the region's insurance regulation has been modelled. Different countries also take different approaches to reinsurance regulation.

A survey by the OECD in 1996[1] notes widely divergent practices on the control of reinsurance activity, which differ in many of its principles as well as in its detail. However, the majority of member countries require authorisation specific to reinsurance activities of domestic and foreign direct insurers (including Canada, Germany, Italy, Japan and the UK). Several countries (including Australia, Austria, Denmark, Ireland, Netherlands, Norway, Spain, Switzerland) require from direct insurers a single authorisation for both direct and reinsurance business. On the other hand Belgium, Finland, France and Greece do not require any authorisation to do reinsurance business. In New Zealand the only requirement for writing reinsurance is to place a deposit of $500 000. Further detail is shown in Appendix B.

## *B. Survey response*

In order to gain a better insight to the current practice and attitudes of regulators to reinsurance in the region, a questionnaire was sent to 11 countries and this section summarises the eight replies (from Estonia, Latvia, Lithuania, Moldova, Romania, Slovakia, Slovenia and Ukraine). It should be stressed that in view of the missing or incomplete responses the findings can not be regarded as comprehensive. However, further information from the press and market sources has also been included here to present an up-to-date picture since the original survey.

### *1. Reinsurance regulation*

There were very few references from respondents to reinsurance regulation/legislation beyond the requirement of preparing a business plan on authorisation which normally demands the setting out an outline of the reinsurance arrangements. Reinsurance is not a separate line of business in most markets (with the exception of Estonia) where separate authorisation is needed to write this class as a line of business.

Three countries authorised a specialist reinsurance company: two have been authorised in Ukraine and one each in Bulgaria and Estonia (although it is understood that this is dormant). In two of the successor republics of the former Yugoslavia (Croatia and Slovenia) there are specialist reinsurance companies and there are numerous insurers in Russia which write more reinsurance than direct business.

*2. Data collection*

The majority of the supervisors responding collected data on reinsurance transactions within their markets. In some instances this is done by insurance company associations. Some supervisors collect this data but do not publish it. Several do not distinguish between reinsurance placed in the home market and placed abroad.

*3. Control powers*

Respondents were equally divided between those that have powers to control reinsurance activity at the company level and ask about the nature of reinsurance contracts in force and those that do not. However, it is not clear what powers they have in this regard. Estonia, Latvia and Moldova have powers to specify limits on net retention levels (see Appendix A)

All but one of the respondents indicated that they collect data from companies regarding their solvency status (which takes into account the impact of reinsurance). Two of these do so annually, the rest quarterly. All but one (with the exception of Ukraine) have looked at the ownership relationships of insurers in the solvency context.

*4. Reinsurance security*

Several supervisors were uncertain if they have adequate technical knowledge to monitor complex reinsurance transactions. An equal number answered 'yes' and 'no' to the question about having adequate expertise. Only one respondent (Estonia) associated potential problems of insolvency and suspensions associated with inappropriate/inadequate reinsurance. Most supervisors monitor domestic companies' reinsurance programmes and prepare an analysis of insurance company reserves. However, the only country to report the preparation of a list of approved reinsurers was Ukraine

The majority of respondents also said that they lack adequate powers to issue "cease and desist" orders in the reinsurance context. Ukraine is the only country which reports powers which enables it to refuse placement overseas if the reinsurance purchased is not in line with local regulations. The majority of respondents have kept in touch with supervisors in other countries with regard to the solvency/capital adequacy of foreign domiciled reinsurers, although it is not known if this is done on a regular basis.

Several people consulted referred to the complexity of monitoring reinsurer security and the expertise needed to form correct judgement about their soundness. It became evident that few supervisors in the region have the necessary expertise. One appropriate response to these difficulties could be to make use of the insurance rating services (*e.g.* AM Best, Standard & Poor). However, the main obstacles to their use are firstly, that few of the domestic reinsurance companies in the region publish adequate information to enable analysis to be undertaken and secondly, that the cost of these services may be higher than some regulators in the region would be prepared to meet.

### *5. Minimum Capital*

Only one country (Lithuania) referred to adjustment to minimum capitalisation to respond to inflation and exchange rate changes, although the fact that solvency minima were or intended to be specified in terms of US dollars or ECU (Russia and Ukraine) goes some way to meet this desideratum.

### *6. Deposits*

In some countries supervisors require that reinsurance treaties concluded domestically contain clauses providing that technical reserves must be left at the disposal of ceding companies . This provides the ceding company with additional security in the event of problems with the reinsurer. However, reinsurers draw attention to the fact that the rates of return on deposits held by ceding companies are often far lower than the rates that could be earned by them. This practice may increase the cost of reinsurance. The survey has not identified any countries in the region demanding deposits

### *7. Pools*

Five countries - Latvia, Lithuania, Romania Slovenia and Ukraine -referred to the existence of insurance pools, all on a voluntary basis. These usually are

concerned with the insurance of nuclear facilities within their region. However, there may be several others, not identified due to non-response.

### *8. State owned reinsurer*

The only country which is currently considering the formation of a state owned national reinsurer is the Russian Federation. There have been several proposals put forward, but none of them have come to fruition. The current status of this proposal -which has been debated widely within the market - is not known. In addition, Romania was also proposing to form a specialist reinsurance company, although there is no information about the suggested ownership, nor the current status of this proposal.

### *9. Limiting reinsurance outflow*

There were some obstacles in responding countries to the transfer of a large proportion of the business (*via* reinsurance) by a foreign controlled domestic company with the main constraints listed in Appendix A. In addition Estonia commented that there was some "pure fronting with parents", but "so far we have not taken steps against it". This would need amendment to the insurance act. However, none of the responding countries controlled the activities of foreign reinsurance companies.

Several countries view the low capitalisation and the high volume of reinsurance premium outflow as a problem especially in non-life business. (Lithuania, etc.). The Romanian response refers to the formation of a reinsurance operation "to increase the proportion of transactions with Romanian insurance/reinsurance companies to approx. 25 per cent next year".

At the same time, most respondents are aware of the low volume of domestic reinsurance activity. However, quantitative information is lacking about the split of reinsurance placements between domestic and foreign in most of the countries covered in this survey.

### *10. Brokers*

The activities of insurance/reinsurance brokers were on the whole lightly controlled. However, Estonia and Ukraine are about to introduce broker legislation and Belarus also intends to make foreign reinsurance brokers a subject of regulation/legislation.

However, it is evident that many companies prefer to place domestic reinsurance transactions without the use of brokers. Ukraine noted that they rely on international brokers only when dealing with foreign reinsurers.

### *11. Using foreign reinsurance*

The majority of companies make use of foreign reinsurance, often on a proportional treaty (quota share) type. The Lithuanian response refers to substantial amount of motor third party liability and green card business being reinsured abroad. But in other markets the principal risks being reinsured are marine and aviation risks as well high exposure property accounts.

The findings of the supervisory survey as well as discussions with other participants in the market indicated that the current state of reinsurance activity in transition economies is in need of further development. *There is evidence of a need for better understanding of the techniques as well as the potential dangers and consequences of current reinsurance practices among supervisors as well as for local insurers and reinsurers.* In order to assist insurance legislators, supervisors as well as other market practitioners in the improvement of their approach, the present report includes section IX, entitled Reinsurance and its regulation which describes the chief types of reinsurance and their application. Prepared by Professor R. L. Carter, this section also includes suggestions for improving supervisory oversight and monitoring reinsurance security by the use of regulatory techniques which are appropriate in the current state of the development of transition economies**.**

## V. Privatisation

The transfer of insurance activity from state ownership to the private sector has made significant progress in most countries, although the rate of progress varies widely.

Privatisation has taken various routes. Almost every country has completed the conversion of insurance departments responsible to the state into joint stock companies. Some have sold the majority of these shares as part of the voucher privatisation process (Slovakia) or transferred part of the shares to other state owned entities such as banks or holding companies. Albania has also announced that it intends to follow this route with its monopoly company INSIG.

Other routes to full privatisation include the splitting up of the original monopoly supplier and selling shares to domestic investors, usually banks, with Romania as an example.

In several republics of the former Soviet Union as well as in Bulgaria and Romania the state sell-off has not gone far due to the absence of local investors.

There are several countries where there is reluctance to allow foreign investors to take a significant stake in these previously state owned units as some governments regard them as strategic assets. Similar situations exist in some of the Baltic republics.

## VI. Market development

This section aims to set out data for a number of countries on their progress towards a diversified and competitive market. This may be measured by the number of companies active and market concentration as well as other features such as capital adequacy and foreign participation. It is evident that significant progress has been made in new authorisations as well as in the admission of foreign capital. However, capital remains scarce, which may hamper healthy growth.

### *A. Number of insurers*

A key indicator of market development in transition economies is the number of authorised insurers. There has been rapid development in most countries, with some 3,500 companies in place in the 12 markets shown in Table 4.1**.** There is no doubt that there has been excessive, virtually uncontrolled growth in some of the successor republics of the Soviet Union, as the number of undercapitalised, unskilled and often unprofessional insurers cannot be regarded as a sign of healthy development. There has been rapid growth even in the smaller, better supervised markets such as Estonia, with a population of 1.6 million, authorising 22 insurers.

While the proliferation of insurers is a sign that there is growing diversity of supply and consumer choice, the question of professional competence, low capitalisation and scarcity of skilled personnel and supervisory overload are negative aspects that should be born in mind. It is also clear that many of these companies are dormant or have been suspended due to inadequate solvency levels.

### *B. Market concentration*

A rise in the number of companies does not guarantee the rapid arrival of competition and consumer choice. As Table 4.2 shows the dominance of previous state monopolies has not been erased in the majority of markets. There are very few markets where the market leader's share - which is usually the successor of the previous monopoly company - has fallen below 50 per cent. This is hardly surprising, as it takes many years for new, greenfield operations to acquire critical mass at which it can represent a competitive force.

### *C. Capital adequacy*

A key factor holding back the healthy development of domestic insurance. and reinsurance markets of transition economies is the shortage of capital. There is acute shortage of domestic investment capital, partly due to the weakness of local capital markets and partly to the underdeveloped nature of the middle class which is able to accumulate savings. The depth of the recession and high inflation are contributory causes. The consequences of low capital levels include the formation of small companies, exposing them to large, random fluctuation in profitability, especially those covering large commercial risks. In addition, the smallness of local markets makes it impossible to secure local risk spreading and demands the purchase of covers on the international markets for protection against natural disasters.

Although information on the aggregate solvency margin is fragmentary, what is available for three markets, (see Table 4.3) shows them to be well below the levels seen in OECD markets. This is a key reason for the increasing volume of the purchase of reinsurance, the absence of which would result in the cut back on the ability to of the growth of direct business.

### *D. Accounting difficulties*

Financial information of the kind shown in VI, C above regarding solvency levels "need to be interpreted with great caution", according to a note "Financial Reporting in Central and Eastern Europe", prepared by accountants KPMG for the present report (see Appendix C).

There are several factors which imply that the balance sheets of insurers in the region are over-optimistic about capital adequacy and solvency levels. It is pointed out that "transition from cash accounting to accruals accounting is difficult to bridge as cashflow accounting overstates income and understates claims costs."

An additional point is that "there may be lack of congruity between accounting and tax principles" which may make it difficult to persuade insurers of the need to establish adequate technical reserves if they are unable to obtain deduction in calculating taxable profits.

At present "regulators may lack the information or the power to seek information to demonstrate that companies are inadequately reserved" and "the fundamental principles underpinning generally accepted accounting practice may not have been incorporated into local accounting practice, or if incorporated may not be well understood."

A reliable system of insurance company financial reporting is a fundamental foundation of a system of solvency monitoring and many countries in the region have embraced EU inspired solvency monitoring regimes. However, “many are still wrestling with the challenges".. of this technique and " may be hampered by outmoded insurance laws which have not kept pace with rapid market development."

KPMG also believes that the accounting skills and other professional resources which are regarded as necessary in developed markets are still rare in Central and Eastern Europe. They think that it will take several years and "a pragmatic stance" to bring technical reserves and solvency levels to adequate standards.

Lately, their suggestions point to the need for further training by relevant funding bodies and help from accounting and auditing professionals as well as insurers, reinsurers and trade associations to help close the gap.

### *E. Foreign participation*

All countries reviewed in this survey allow at least a minority participation by foreign investors in local companies, although some (*e.g.* Belarus, Russia, Ukraine ) still limit investment to minority interest. The last country to bring to an end the absolute domination of the state is Albania, which reported that it is to approve the sell-off to local interest of a minority in INSIG the state monopoly, and allow the start-up of new companies with foreign participation.

Table 4.4 does not fully reflect the relative importance of foreign companies in these markets. There is no doubt that they have acquired a considerable presence in Romania and the Slovak Republic. The relatively high figure of 74 in Russia however is not a sign of substantial foreign presence, in view of the 49 per cent foreign ownership ceiling but is a sign that some investors from other parts of the former Soviet Union have secured a foothold.

An indicator of foreign interest is the number of foreign insurers and intermediaries which are already represented in the region in the form of locally incorporated subsidiaries or joint ventures. A survey by the International Chamber of Commerce/*Comite Europeen des Assurances* identified over 130 units (of insurers and intermediaries) in transition economies. Among the most active insurers are American International Group, Alte Leipziger Versicherungs, Allianz Versicherungs and Nationale Nederlanden, Winterthur Insurance and Zurich Insurance. The European Bank for Reconstruction and Development is also active in the region and "is planning to become a catalyst for the development of promising private sector insurers and will play a major role in the restructuring and privatisation of state owned insurance institutions", according to the bank's 1995 annual report. Among brokers Alexander & Alexander, Jauch & Hubener, Marsh & McLennan and Willis Corroon have shown the greatest involvement.

## VII. Reinsurance activity in the region

This section deals with premium retention rates in the region, and presents estimates of reinsurance flows. It also describes various aspects of reinsurance practices in transition economies and presents data which enables comparison with premium retention ratios elsewhere.

### *A. Retention rates*

The ending of state monopolies, and the market oriented evolution of insurance activity resulted in the rapid growth of reinsurance in the region. Even before beginning to phase out state ownership, several monopoly companies have embarked on the purchase of reinsurance cover from the late 1980s, in order to protect their portfolios from catastrophe losses and cover their hard currency liabilities arising from foreign trade and inward investment transactions. However, the integration of these markets into the world economy, the proliferation of new, privately owned insurance companies and the need to protect their solvency have placed reinsurance on an entirely different footing.

The motivation for purchasing reinsurance in Eastern and Central Europe is not different from that of other developing regions of the world: to improve the spread of risks, protect insurers from heavy fluctuation of their result and protect their solvency. However, the shortage of local capital in most of these countries (see VI, C above) and the lack of insurance experience provided extra stimulus for companies in this region to make significant use of reinsurance

The need for reinsurance varies widely between countries as well as between companies within the same country, depending on type of risks underwritten, the amount of capital and free reserves under insurers' control, the ownership structure of the company among others.

Information collected for this survey from a range of markets shows that net retention rates of gross premium income varies widely between countries, falling within the range of 64 per cent and 96 per cent, (see Table 5.1).

Premium retention rates in the above table (many of which are estimates) have been calculated on the basis of total (life and non-life) business, although most reinsurance deals with the non-life account. Specific *retention rates for non-life business* were available only for a few markets, which are shown below. These figures fall within the range of retention rates seen in OECD countries as shown in Table 5.3 below and confirm the general pattern that a higher proportion of non-life business is reinsured than for life business.

On the basis of Tables 5.1 and 5.2 and information from market sources it is possible to estimate the volume of reinsurance premiums ceded in transition economies. Premiums ceded by the 10 markets amounted to $394m giving net retention rate of 94 per cent.

Allowing for gross premiums of $1.2 billion for other countries in the region (including Albania, Bulgaria and the former Yugoslav republics and Central Asian NICs) and assuming a 90 per cent retention rate, reinsurance generated in the region is estimated at $512m. With 90 per cent of reinsurance ceded abroad and 10 per cent retained by local insurers and reinsurers, premium outflow is running at the rate of $460m, (0.9 times $512m). However, it should be noted that this does not allow for inward reinsurance from outside the region for which there is no information, although it is believed to be very small.

Direct insurers in the smaller countries of the region tend to rely very heavily on using foreign reinsurers, as their own markets have neither the capacity nor the domestic reinsurers to handle all but the smallest proportion of outward reinsurance. The countries falling in this category are the three Baltic republics as well as Romania and Slovakia. However, Slovenia, although it is a small country with only 13 authorised companies, has been able to retain more than others of a similar size due to the presence of two domestic reinsurance companies as well as their policy of restricting reinsurance with foreign companies until domestic capacity is exhausted. There are some smaller countries (*e.g.* Slovak Republic) which have also been reinsuring only a relatively modest scale, largely because of the highly concentrated nature of their markets (with former monopoly companies retaining major shares).

The practices of the two largest CIS countries - Russia and Ukraine - are also characterised by high retention rates. There are projectionist practices in place, which may be designed either to conserve foreign exchange outflow in the short term or to make up for the inadequate capitalisation of domestic insurers/reinsurers.

One may expect two opposing tendencies to act on retention rates. The arrival of new companies, more capital and increased expertise by local insurers are likely to increase retention ratios. However, fragmentation and privatisation are working in the opposite direction. Additional detail on the reinsurance practices in the countries surveyed is included in the Market Profiles section of this report.

The figures on retention rates in transition economies in Table 5.1 may be compared with two sets of data. In OECD countries, the average retention rate for combined life and non-life business in 1994 was 88.7 per cent (see Table 5.3), although the non-life retention rate, at 81.5 per cent, was substantially lower than in life, as would be expected.

While data for less developed countries is not directly comparable with the OECD figures, a survey by UNCTAD in 1987 showed that the majority of countries retained over 90 per cent of motor business while in fire and transport insurance the retention rate by the majority of 60 countries surveyed was below 50 per cent (Table 5.4).

The tentative conclusion, based on the above incomplete data, is that despite the inadequate capitalisation of local markets, retention levels in transition countries are higher than in OECD economies. The factors which may explain the comparatively modest use of reinsurance include the underdeveloped nature of domestic reinsurance arrangements, the lack of technical know-how as well as the restrictions designed to reduce the outflow of reinsurance premiums for balance of payments reasons. There is also evidence (from outside the region) that small companies tend to retain a larger proportion of business because they cannot afford to buy all of the reinsurance they need. In addition, several contacts attributed the reluctance to use coinsurance for the spreading of local risks to the fear that they would lose the business on next renewal if they coinsured it with their domestic competitors.

Improvements to risk spreading in the region will depend on eliminating the obstacles to enhanced reinsurance uptake by improved local market practices (*e.g.* coinsurance, local reinsurance companies), greater efforts to diffuse reinsurance expertise and the relaxation of restrictions on cross-border reinsurance.

### *B. Domestic reinsurance activity*

Only a few countries publish information which distinguish reinsurance placed with other local companies from business ceded abroad (or on inward reinsurance.). While country data are not all on a comparable basis, it is worth citing some of these figures as they shed light on the different approaches to reinsurance. Some additional information is also presented in the Market Profiles section of this report.

*Estonia* The Insurance Supervisory Authority publishes information on the retention ratio for most classes of business and also for each company. The class of business with the lowest rate of retention was motor business (20 per cent), while the largest company, Eesti Kindlustus, retained 72 per cent of its gross premiums.

In *Slovenia*, where reinsurance business (SlT 8 718m, in 1995 or $67m) was handled by the two locally authorised reinsurers, Sava Reinsurance Co. and Inter Reinsurance Co. 45 per cent of the reinsurance premiums collected was placed abroad.

### *C. Data presentation*

Although there is some information collected on reinsurance transactions, few countries publish statistics on their balance of payments impact. This stems from the absence of data collection on all aspects of the reinsurance transaction, which would enable the calculation of such a figure. Several countries collect data on premiums ceded to foreign insurers and reinsurers, but they do not have information on the claims and commission paid by reinsurers. In addition, there is insufficient information on how much reinsurance is written by local companies, which does not have a balance of payment impact, unless there is retrocession to foreign reinsurers. Inward transactions (*i.e.* claims and commission) go long way to offset the outflow and in years of catastrophic events push the inflow well in excess of the premium outflow. The survey has found very few examples of accepted reinsurance from outside the region.

In order to enable the collection of comparable information on the impact of reinsurance transactions on the balance of payments, it would be desirable for countries of the region to adopt a format used by some other countries along the following lines.

- Outward reinsurance premiums minus commission and brokerage received minus claims received = outward balance

- Inward reinsurance premiums less commission paid less claims paid = inward reinsurance balance
- Overall balance = total reinsurance balance (1)+(2)= (3)

Commission figures should incorporate profit commission.

## VIII. Role of international insurance/reinsurance brokers

The development of local insurance and reinsurance markets as well as their integration with the international insurance industry are greatly assisted by the services provided by the international insurance and reinsurance brokers. They are not only the conduit of insurance and reinsurance transactions but also a vital source of information to local companies of the practices and requirements of international reinsurers. They advise ceding companies on the best type of reinsurance programmes and place the business based on their knowledge of market availability and price. In the first instance many of the brokers are present in these markets to serve their western multinational clients and later begin to get involved with local companies. Brokers also bring information on new risk transfer techniques such as captives, and advise on the security of reinsurance providers.

Brokers are also an important source of educational opportunities on reinsurance techniques and often arrange courses for staff of ceding companies with western insurance and reinsurance companies as well as other brokers.

Foreign brokers have to operate against the background of fast moving regulatory climate for insurance agents and brokers in local market, which is under review in several countries in transition. They have established a presence in most countries of the region, with Aon Hudig, Alexander Howden, Bain Hogg, Lowndes Lambert, Marsh & Mclennan, Willis Corron having a presence in several markets. This is either in the form of a representative office or a subsidiary. A list compiled by BIPAR, covering nine countries, identified the presence of 22 affiliates of offices by western insurance intermediaries in the region. There is no doubt that the number of units with some western broker interest is growing rapidly.

## IX. Reinsurance and its regulation

Reinsurance enables insurance companies to further spread the risks they insure among other insurers, known as reinsurers. It can be used to: increase an insurer's (ceding company's) underwriting capacity; reduce fluctuations in its

net underwriting results, so stabilising earnings; meet a required margin; enable it to withdraw from particular types of business; and reinsurers often provide underwriting, claims management, training and other services.[2] Reinsurers may in turn reinsure (retrocede) risks they have written.

The purchase of reinsurance will affect the timing and amount of the ceding company's accounted profits (or losses), and its financial security. Companies' reinsurance needs differ according to their capitalisation; the amount, types and nature of the business transacted; their business policy and attitude to risk; the experience of their management and staff; regulatory rules; etc. Various forms of reinsurance have been developed to meet those differing needs.

### *A. Reinsurance and the solvency of ceding companies*

The smaller are a company's capitalisation and its portfolio of business, and the riskier the composition of that business, the greater will be its need for reinsurance, and the more dependent will be its solvency upon its reinsurance arrangements.

The relative size of the fluctuations in a company's aggregate annual claims experience will be:

1. inversely related to the number of independent exposure units included in its total portfolio of business; and

2. directly related to its maximum liability on any one risk, and to its exposure to accumulations of losses *a)* from any one event, and *b)* in any one year.

Therefore, its reinsurance programme should be designed to deal with the nature, geographical scope, and size of its loss exposures. Many companies in the transition economies are lowly capitalised and their portfolios are exposed to accumulations of losses from natural disasters.

When placing its reinsurance programme, a company must be careful to disclose all material facts. It must also observe all contractual terms and conditions (*e.g.* the recording, and sometimes notification, of all individual risks ceded to a surplus reinsurance treaty; the notification of claims; and accounting terms). Any breach of contractual duties by a ceding company will enable the reinsurer(s) to repudiate liability.

Even if ultimately all claims are met in full, a reinsurer in financial difficulties may unduly delay payment. Therefore, it is an insurer's responsibility to try to

evaluate any prospective reinsurer. To do so it will need from its broker, a security rating agency, or direct from the company, details of:

1. the reinsurer's market reputation and history, including any recent changes in its ultimate owners; the qualifications and reputation of its management; the composition of its underwriting and investment portfolios; and its own major cedents and reinsurers.

2. its financial standing: five years' balance sheet, profit and loss accounts; its solvency margin; technical provisions and claims reserving methods; liquidity; retention ratio; and if available, its financial rating.

3. country where located to establish if, and if so how, it is regulated, and its exposure to political and economic risks, including exchange controls.[3]

Deficiencies in accounting practice mean that financial information regarding companies located in some countries may be of dubious quality, but security rating agencies may have access to better information. The larger the liabilities to be transferred, the more important is such investigation of the reinsurer's standing.

### *B. Methods of placing reinsurance*

The methods whereby risks may be ceded to reinsurers are summarised in Table 7.

*Treaty* reinsurance contracts provide automatic protection for portfolios of business, either in force, or written and renewed by the ceding company, during the currency of the treaty. They may be subject to annual renegotiation, or renewed automatically each year. The company must ensure that there are no gaps in the cover provided by a treaty and the periods of insurance of the underlying policies, especially following the cancellation of a treaty and its transfer to another reinsurer.

*Facultative* reinsurance is usually arranged to protect individual risks that fall outside the scope, or exceed the limits, of an insurer's treaties. Most contracts are proportional reinsurance, but excess of loss covers are arranged for some classes of business. Administrative costs for both parties are higher than for treaty reinsurance, and the insurer must ensure that there are no gaps in cover at inception, or on any alteration to or renewal, of the underlying insurance.

*Facultative-obligatory reinsurance, and open covers,* are arranged when an insurer, or broker, may frequently require facultative reinsurance for certain types of business.

*Pools* may be arranged to provide the underwriting capacity required for very large risks (*e.g.* atomic energy) or for substandard risks. The business may be shared among participating insurers on a direct, net line basis, or with a reinsurance pool, members may cede to the pool risks that are then co-reinsured among members. In both cases external reinsurance protection may be purchased to protect the pool against very large losses.

Whichever method of placing business is used, contract terms must be checked to ensure that they provide the type and scope of reinsurance cover, and limits to the reinsurer's liability required. Contracts should be committed to writing promptly to minimise the likelihood of disputes.

The *reciprocal exchange of reinsurance* between a company and its reinsurer(s) can enable it to increase retained premium income and acquire a more diversified portfolio of business. However, care is required in selecting portfolios to be exchanged, and in monitoring exposures and results.

### *C. Types of reinsurance*

Reinsurance contracts fall into two broad forms - proportional and non-proportional, which in turn take various forms. The appropriateness of those forms to the types of losses to which insurers are exposed is shown in Table 8.

Under both forms of *proportional reinsurance* the reinsurer accepts liability for a pre-determined share of any losses incurred on individual risks, and in return is entitled to the same share of the original premium as the liability accepted, less a reinsurance commission. Whereas it used to be common for proportional treaties to provide also for the payment of profit commission, reinsurers now prefer various forms of profit and loss sharing agreements, including the payment of reinsurance commission on a sliding scale related to the treaty results.

In as far as the reinsurer will be liable for its share of all individual losses, a proportional reinsurance provides some protection against accumulations of losses arising from either a single event (*e.g.* an earthquake) or over any one year. However, it is increasingly common for proportional treaties to place a limit on the reinsurer's liability for the total reinsured losses from one event.

*Surplus reinsurance* allows a company to retain more of its premium income, and is more efficient in reducing relative fluctuations in aggregate retained losses, because the ceding company retains in full that proportion of all risks accepted that lie below its retention limit. The ceding company must transfer to the reinsurer the balance of any risk accepted that exceeds its retention limit, subject to the treaty limit; the reinsurer then takes a pro rata share of the original premium and is liable to pay the same share of any loss. Surplus reinsurance can only be used for classes of business with a large sum insured, such as property and marine insurances.

A major obstacle to the use of surplus reinsurance treaties is the expertise and sophisticated systems required by ceding companies for fixing retentions, ceding risks that fall above the retention, dealing with alterations during the currency of an insurance, and recovering the reinsured portion of any claim.

Special forms of proportional reinsurance, known as the *risk premium method*, and the *modified risk premium method*, are extensively employed for life assurance business. They provide protection against adverse mortality experience, but enable the ceding company to retain the accumulated reserves in respect of the policies reinsured, so minimising the reinsurance premium payable.

*Non-proportional reinsurance* contracts are both more efficient than proportional reinsurance in reducing the variance in a ceding company's aggregate claims distributions, and enable it to retain more of its premium income. The company must have adequate systems to identify claims recoverable from reinsurers, particularly for treaties covering accumulations of losses. Care is needed with treaties arranged in layers to ensure there are no gaps in the cover and in allocating losses to the different layers. Among the difficulties with non-proportional reinsurance are:

1. The fixing of a premium that is fair to both parties in relation to the liability transferred, particularly when there is little reliable past loss experience, such as with new companies, and with the top layers of 'per risk' excess of loss treaties and catastrophe covers where loss probabilities are very small.

2. What provision, if any, is made for the reinstatement of cover under a treaty following the payment by the reinsurer of a loss.

3. The defining of an 'ultimate net loss', and of a 'risk', 'event', or 'occurrence', to which a treaty's limits will apply, so determining the liability of the reinsurer(s).

4. Inflation and exchange rate movements can affect a reinsurer's claims liability, unless provided for in the contract terms.

5. The increasing unwillingness of reinsurers to provide unlimited cover, even when the original liability insurance is unlimited. Also cover may be limited, or even excluded, for certain types of risk, notably pollution.

6. The payment of the reinsurance premium at the inception of a treaty year may impose a financial strain on a ceding company, though that may be eased by its payment in instalments.

7. Unless the retention limit (the deductible) is fixed lower for a 'per risk' excess of loss reinsurance than for a proportional reinsurance, the ceding company will require a higher capitalisation to maintain the same security.

*'Per risk' excess of loss* reinsurance covers the balance of any loss on an individual risk (as defined in the contract) that exceeds the ceding company's retention (the deductible), up to a specified limit. It is used for property, casualty and marine and aviation insurance business; it is not regarded as suitable for life business. Like proportional reinsurance, a treaty may contain a limit to losses arising from one event.

*'Per event' excess of loss reinsurance* covers accumulations of losses arising from specified events or occurrences, such as damage to many insured properties caused by a single event (*e.g.* a storm, flood or earthquake), or the multiple loss of insured lives in an aircraft crash. The ceding company may be required to participate in reinsured losses (*e.g.* the reinsurer's liability may be fixed at, say, 95 per cent thereof), and normally property catastrophe and marine treaties are subject to restrictive reinstatement provisions.

*Stop loss reinsurance,* although arguably the best form of reinsurance from a ceding company's standpoint, is regarded as undesirable by reinsurers as a primary form of reinsurance protection, except for a limited class of risks (*e.g.* hail crop insurances). It provides cover against an accumulation of net retained losses in any one year that exceed either an agreed monetary sum, or loss ratio, subject to an upper limit. Invariably the ceding company is required to participate in reinsured losses, and the deductible is fixed sufficiently high to ensure that it will incur an underwriting loss before the reinsurer becomes liable to contribute.

A variant on stop loss reinsurance is the *aggregate excess of loss cover* where the reinsurance is on an excess of loss basis for losses arising from one event, or

any one vessel in marine insurance, or one accident for motor business, but the reinsurer becomes liable to contribute only when the aggregate claims incurred by the ceding company in excess of its retention during any one year exceed a specified amount. It is used to provide protection against an abnormally high number of losses.

*Financial, or finite, reinsurance, reinsurance futures and options contracts, and (securitised) catastrophe bonds* are now being used by insurance companies in the industrialised countries to manage their insurance portfolios, including *timing* (*i.e.* speed of claims settlement) and *investment* risks. However, the use of such contracts is not currently appropriate for insurance companies in the transitional economies. Moreover, they raise difficult accounting, insurance supervisory and taxation issues. Therefore, it is not appropriate to deal with them in this section, which will concentrate solely on conventional reinsurance contracts.

### *D. The regulation of reinsurance*

Insurance consumers have an interest in how reinsurance can affect the standard of service and security provided by insurance companies. Therefore, there are two aspects to the regulation of reinsurance business; *i.e.* the supervision 1. of the reinsurance arrangements of ceding companies, and 2. of reinsurance companies, and of direct insurance companies that accept reinsurance business. The regulation of reinsurers may be either direct, or indirect through the supervision of ceding companies' reinsurance arrangements.

Governments in framing supervisory regulations should allow for the technical expertise available both within insurance companies and their supervisory authority. Arguably it is both pointless and would lead to a waste of scarce human resources, to frame highly complex accounting or other requirements when the supervisory authority does not possess the knowledge, expertise and experience to interpret the information supplied. On the other hand, requiring insurance companies to report details of their exposures and reinsurance arrangements may encourage management to be more rigorous in devising of appropriate reinsurance programmes; in other words, sound regulatory requirements may have an educational value for insurance companies.

### *E. Supervision of reinsurance ceded by direct insurance companies*

The regulation of the outwards reinsurance business of insurance companies normally forms part of solvency monitoring requirements applicable to the

authorisation of a new company and the ongoing regulation of authorised insurers, of which the key features are as follows.

*Details of reinsurance arrangements* covering reinsurance programmes and reinsurers for:

1. *new companies,* their proposed reinsurance arrangements in relation to their capitalisation, proposed classes of business and retentions; their reinsurers; and control systems.

2. *authorised companies*, an annual review of existing reinsurance arrangements, including: *a)* retentions and the types of and the cover provided by treaties, in relation to the risk exposures for each class of insurance business written; *b)* reinsurance control systems for monitoring exposures and making cessions and claims recoveries; and *c)* major reinsurers, *i.e.* reinsurers accounting for more than, say, 20 per cent of premiums ceded under any one reinsurance contract and/or 5 per cent of premiums ceded in total.

*Accounting regulations* that require the disclosure of the financial impact of reinsurance ceded on a company's trading performance and solvency by presenting in annual supervisory returns premium income, claims and technical reserves both gross and net of reinsurance ceded.

*The proportion of the business retained*: inevitably if an insurer accepts certain types of risks (*e.g.* aviation) a major portion must be ceded to reinsurers. However, a company should retain a substantial proportion of its total business; otherwise it will be little more than a broker, with the security for policyholders being heavily dependent upon its reinsurers. Therefore, either reinsurance premiums ceded may be limited to a stated proportion of total gross premiums (*e.g.* 75 per cent), or credit for premiums ceded in excess thereof may be disallowed in the calculation of a company's solvency. Some relaxation of the regulations could be allowed for new companies for the first, say three, years until they can build up experience and reserves, subject to closer monitoring during that period.

*Business ceded abroad to foreign reinsurers*: many countries place similar restrictions on the ceding of business to overseas reinsurers that are not established in the country and so are not subject to their supervisory control. However, companies in the transition economies generally will be highly dependent on such overseas reinsurers to satisfy their reinsurance needs, so that limits on such placing, or higher capitalisation requirements, could restrict the growth of local insurance companies and the risks they can safely accept, to the detriment of policyholders and the economy at large. Likewise regulations that

require overseas reinsurers either to deposit funds with the supervisory authority to obtain 'approved reinsurer' status, or to deposit technical reserves with ceding companies, can adversely affect their overall financial security and increase the cost of reinsurance.

A sounder supervisory approach is the recognition of other countries' supervisory systems. Thus, reinsurers established in countries recognised as exercising adequate controls over their activities and financial standing, could be placed on a list of 'approved reinsurers' allowed to operate on an equal footing with locally established reinsurers. Other overseas reinsurers could be allowed to apply to the supervisory authority for listing, providing it with sufficient accounting and other information (including when available, its security rating by a recognised agency) to make a decision.

*Brokers:* ceding companies should be required to obtain promptly from brokers engaged to place their reinsurance full details of contract terms and the names and addresses of all reinsurers with whom the business has been placed, including their individual shares.

*Restrictions on the placing of reinsurance*. Many countries among the developing and transition economies seek to reduce the outflow abroad of reinsurance premiums by either (a) requiring domestic companies to cede a part of the business they accept to one or more local reinsurance companies, or (b) stipulating that reinsurance may be ceded abroad only if the risks cannot be placed with local companies. There are strong arguments against both forms of regulation. Compulsory reinsurance, for example, causes an unnecessary ceding of business, and increases the cost of insurance. Moreover, if local companies are required to subscribe most of a reinsurance company's capital, they stand to lose twice over if it fails, *i.e.* from irrecoverable claims, and the loss of capital invested. Type (b) restrictions are hard to monitor and enforce. And the effect on a country's balance of payments of ceding reinsurance abroad to foreign reinsurers is not necessarily detrimental.[4]

### *F. Supervision of accepted reinsurance business activities*

*Authorisation*: as reinsurance contracts are purchased by insurance companies that should possess sufficient expertise to evaluate them, many countries have not thought it necessary to supervise reinsurance companies. However, following well-publicised failures of reinsurers, an increasing number of countries now require any locally established company that wishes to write reinsurance business to obtain specific authorisation, subject to similar minimum capitalisation, solvency, etc. conditions as apply to direct insurance companies. Companies supplying reinsurance across frontiers are frequently

subject to indirect supervision through the rules relating to ceding companies (see above).

*Supervision of activities*: the acceptance of reinsurance, especially from overseas markets, can be a high risk business. Some types of reinsurance are subject to large fluctuations in annual loss experience and/or exposure to long-term liabilities, and many reinsurers have suffered large losses by naively underwriting international reinsurance business. The acceptance of reinsurance business by a direct insurance company may imperil the security for its policyholders. Therefore, the activities of companies accepting reinsurance business, including specialist reinsurance companies, should continue to be subject to close supervisory oversight. It should embrace the solvency and financial performance of the company; the types and sources of its business; its exposures to loss; its retrocession arrangements and reinsurers; the competence of its management to manage the types of business transacted; and its business control systems. If it accepts business from brokers and/or underwriting agents acting under delegated authority, the company should be required to disclose the terms of such agreements and its systems for exercising control over the business so accepted.

*Accounting requirements*: it is desirable that in the annual supervisory accounting returns for direct insurance companies, the premiums, claims, etc. relating to reinsurance business accepted should be shown separately from direct insurance business.

## X. Recommendations

Supervisors should collect information from ceding companies on the full impact of reinsurance cessions, including taking account of all relevant inward and outward transactions on claims, commission, (including profit commission) and brokerage paid.

The constraints on placing reinsurance should be minimum, irrespective whether it is placed with domestic or foreign reinsurers. Under conditions of domestic capacity shortages and where small companies are exposed to large random fluctuations in claims experience, it is inevitable that a significant proportion of reinsurance premiums leave the country but the principal consideration should be the security offered by the reinsurer rather than its domicile.

Local insurance supervisors as well as ceding companies should improve their access to information which enables them to assess the security of their

reinsurers - whether local or foreign - including the purchase of rating agency reports

Insurance supervisors should regularly share their views with their overseas counterparts about any potential problems of solvency or liquidity of the companies or the reinsurers associated with their local market.

Greater efforts should be made to educate insurance professionals in the purposes of buying reinsurance protection for direct insurers. International reinsurance companies and insurance and reinsurance brokers should make greater investment in training insurance professionals in the region.

Much needs to be done to bring the standards of claims reserving, accounting and auditing closer to standards existing in OECD countries by the introduction of accounting regulation and more training of local professionals.

Compulsory cessions to reinsurance monopolies or compulsory domestic retention should be avoided in order to avoid the cross subsidy by well run companies of poorly run companies, to preserve the principles of market economy and to be able to obtain the best terms commensurate with security for the ceding company.

Companies wishing to reduce the premium outflow from their direct business should make increasing use of non-proportional (excess of loss) reinsurance and reduce their use of proportional covers. While this implies increasing capitalisation, to be able to increase retentions, excess of loss protection, if based on detailed analysis of the risk characteristics of the portfolio can be more effective in protecting results from wide fluctuations.

## XI. Market profiles

The following section includes readily available information in early 1997 on insurance markets in transition economies, with the primary aim of describing their recent history, current trends and expected future developments.

### *Belarus*

The fragmentation of insurance providers seen following the demonopolisation of Gosstrakh in Russia was also evident in Belarus, and the latest statistics shows over 80 insurers in the country at end 1995, the largest of which is Belgosstrakh with an estimated market share of 40 per cent. However, the low capitalisation, below required minimum, was the principal reason for the issue

of suspension notices to ten companies. In 1994 there were 22 companies with foreign shareholders (whose participation was not permitted to exceed 49 per cent), 18 of which came from other parts of the former Soviet Union.

The 1993 Insurance Act is still in force, although current proposals under discussion plan to strengthen powers by fresh legislation on insurance brokers, compulsory insurances, investment activities . However, the draft legislation planned requires the placement of reinsurance abroad to be authorised by Gosstrakhnadzor, the supervisory authority. It is understood that this has been implemented since mid-1996.

A proposal under discussion by the Ministry of Finance is the creation of national reinsurance company, with a minimum capital of $6m and a 30 per cent state shareholding, with the rest planned to be offered to local insurers as well as foreign reinsurance companies. The current status of this proposal is not known.

The latest available data for 1995, with a premium income of Brb 394bn (US$34m) shows Belarus to be one of the least developed markets, with an estimated per capita insurance outlay of $3.5. Property accounted for 76 per cent of all premium income, credit 10 per cent and life 12 per cent.

***Bulgaria***

The duopolistic set-up prevailing in Bulgaria, where domestic business was confined to Darshaven Zastrachovatelen Institut (DZI) and reinsurance and foreign business handled by Bulstrad has come to an end during the early 1990s. Local reports indicate that there are some 70 to 100 registered insurers, but only about 30 to 50 are active. Bulgaria also appears to permit the activity of branches of foreign companies, although due to the difficult economic conditions there is no evidence that this has been utilised.

Further development may be along the lines of turning DZI into a holding company and separating its life and non-life business, following its projected privatisation.

Insurance legislation in force since January 1997 stipulates minimum capital of Lev 200m for life and accident companies, Lev 300m for property insurers and Lev 400m for reinsurance companies. Existing companies will have to reach these capital levels by 1.1.2000. Life and non-life business will be separated. Foreign insurers will only be allowed to open representative offices and branches from 2004.

Currently there are few foreign insurers present with minority interest; among them is EBRD which has entered into a joint venture with a medium sized local insurer General Insurance Co.

Local estimates put the premium income at Lev 11.2 billion ($206m) in 1994. Around half in non-life premium income comes from compulsory motor and casco business. Life business accounts for a third of market premiums. DZI with a market share of 55 per cent is followed by Bulgaria (24 per cent) and Bulstrad (8.5 per cent).

Bulgaria has set up several insurance pools, including those intended to cover nuclear risks or municipal property. It has also created a Bulgarian Reinsurance Co, (BPK), which is a consortium owned by 14 Bulgarian insurers, including Bulstrad and MIC, each with a 24.5 per cent share. However, due to its modest capitalisation (Lev 200m or $0.5m) it is not expected to make a major impact on the dominant role played by foreign reinsurers.

An adverse feature of the market is that despite the presence of numerous companies the allocation of the insurance of state owned companies is decided by a state committee and this tends to give priority to state owned and well-established insurers. This tends to exclude newly formed companies and reduces competition. Another disturbing aspect is the appearance of a small number of insurers offering "protection", evidently linked to organised crime.

Due to their modest capitalisation, Bulgarian insurers make substantial use of reinsurance. Although there are no reliable statistics, market sources indicate that between 30 per cent and 40 per cent of the business is ceded including life insurance - primarily to foreign reinsurers. Most of this business is proportional reinsurance including motor, property and MAT (Marine, Aviation and Transport). Foreign reinsurers active include Bavarian Re, General Re, Munich Re and Swiss Re.

However, there is growing use of coinsurance with domestic partners. Bulstrad and Sofia Insurance are believed to be writing growing inward reinsurance accounts.

### *Estonia*

Following the introduction insurance legislation in 1992, the state company was converted into a joint stock enterprise. There is an insurance supervisory authority, which also oversees the registration of insurance brokers. The authority publishes an informative yearbook, in Estonian and English with market information.

The law stipulated the purchase of compulsory third party motor business, which is written by insurers as well as a special body, the Traffic Insurance Foundation. TIF is not an insurance company but acts a guarantee fund for uninsured vehicles as well as handles the Green Card motor business.

While Estonia is the smallest in terms of population of the three Baltic markets, Estonia achieved the highest proportion of insurance to GDP at 1.3 per cent. It enjoyed rapid development in non-life business but its life insurance is least developed among the Baltics.

In common with other markets in the region there is a shortage of capital, forcing insurers to cede 50-60 per cent of property risks to foreign reinsurers. The proportion of non-life business ceded to reinsurers is still rising, having reached 45 per cent in 1994. The supervisory authority keeps an eye on reinsurance cessions and in case of suspicion requests additional information from ceding companies.

The former monopoly company, Eesti Kindlustus with a 26 per cent share of the non-life market is currently being privatised, with a 51 per cent share to be sold to non-state investors, 49 per cent retained by the state. In a further development of the market, the law on insurance intermediaries is under preparation. Among the international brokers active in Estonia are Aon Hudig and Lowndes Lambert.

The number of insurers stands at 22, six of which have foreign shareholders from Swedish, Finnish, Russian and US investors.

Estonian companies writing reinsurance have to have a minimum paid in share capital of EKK 20 million ($1.62 million), compared with EKK 10 million for motor and liability and EKK 12 million for life business.

### *Latvia*

The largest market of the three Baltic states in terms of premium income also has the highest number of authorised insurers in the Baltic region, at 43; nine of which have minority and three have majority foreign capital participation. Latvia enjoyed the highest life insurance penetration, with $4.2 per annum, more than double the Estonian figure. Property insurance is the largest non-life class, with 33 per cent of total market premiums.

There are no specialist reinsurers in Latvia, except for the local branch of Cologne Re but local insurers accept a small amount of inward reinsurance. There is one local pool, to which cessions are on a voluntary basis. Insurance

brokers are subject to license by the supervisor and their authorisation is to be renewed after three years.

The supervisor monitors reinsurance activity, ownership structure and takes reinsurance protection into account when monitoring solvency. The average retention in non-life business in 1995 was 50.5 per cent of gross premiums, within a wide range of 10 per cent and 83.5 per cent retention rate among the top ten companies.

Reinsurers have enjoyed profitable business during the past two years, with claims as a percentage of ceded premiums below 20 per cent. Reinsurers active in Latvia include Cologne Re, Lloyd's, Munich Re and Swiss Re. There are at least two foreign controlled brokers, including Tris and Hanzas Garants. In view of the small size of the local market, no international broker has found it worthwhile to locate an office in Latvia.

### *Lithuania*

Lithuania is the least advanced market of the three Baltic countries according to most indicators, although the number of companies has reached 37 by 1995, and the license of 12 additional insurers has been revoked. 6 companies have foreign participation.

However, life business is well developed, accounting for 49 per cent of total gross premium income in 1995. Property, including motor business, was the second largest class followed by health insurance. Gross premium income is increasing rapidly, having increased by 170 per cent in dollar terms between 1993 and 1995.

Information provided by the Lithuanian Insurance Council (LIC), the supervisory body, indicated that in 1995 ceded reinsurance amounted to 8.2 per cent of gross premiums (LTL 152.8million or US$38.2 million) while assumed reinsurance was 9.6 per cent of gross premiums, although it is not clear how much of this is placed with domestic companies. Among the international reinsurance companies active in Lithuania are Swiss Re and Cologne Re.

The largest company, the State Insurance Company [with premium income of Litas 107 million, $27 million)] ceded only about 1 per cent of its gross income. Data from the LIC shows that some of the smaller companies do not reinsure any part of their business; indeed some companies accept more inward reinsurance than they cede.

The LIC has prepared a draft law on insurance, in accordance with EC directives and hopes that it will supersede the September 1990 act ..."which is not perfect as there are no provisions in this law determining the solvency of insurance companies, methods of establishing reserves reinsurance etc.".

***Moldova***

Moldova's insurance legislation came into force in June 1993, and contains provision for the compulsory third party liability for owners of motor vehicles. It also lays down the operation of an insurance supervisory administration which has the power to issue licenses and monitor that insurance tariffs "are based on sound grounds".

The minimum capitalisation for authorisation is the currency equivalent of 2 000 monthly minimum wages (equivalent in 1995 to $11 700). However, the threshold was raised to the equivalent of $64 500 in 1996.

As in other successor republics of the former Soviet Union, the current insurance business in Moldova is based on the Gosstrakh system, with the largest company, ASITO, its successor, still having a commanding market share of 71 per cent. Of the 55 officially registered companies in 1995 only about ten have more than a marginal market share; at least 20 have been suspended due to inadequate capitalisation.

The law also enables the formation of insurance pools to provide for the insurance of "high and very dangerous risks for which coinsurers may pool together to form insurance pools" The law permits the placing of insurance and reinsurance abroad only if it cannot be placed in the country.

The market is dominated by voluntary personal insurances, including life, (accounting for 61 per cent of total premium income) followed by third party motor liability (17 per cent) and property insurances (5 per cent). Total premium income during 1995 was Mleu65.5bn ($14 million), with per capita premiums at a modest $3.2 a year.

***Romania***

The split of the monopoly company ADAS into three, (state owned) units helped the establishment of genuine market in 1990, which is stimulated by the entry numerous foreign companies. However, ASIROM still dominates the scene, with a branch network of 256, largely through its exclusive position in the compulsory classes (until February 1996), which account for nearly

30 per cent of earned premiums. ASIROM as well as one of the other state owned insurer Astra accept some reinsurance from domestic insurers. There is a voluntary insurance pool for atomic energy risks.

As of the end 1995 there were 43 companies, over 27 of which have majority or minority foreign shareholders, which control 29 per cent of the capital in the market. Total paid in capital, according to the Office of Insurance Supervisory Office, amounts to Lei 70 billion against gross non-life 1995 premiums of Lei 289 billion ($143 million). About half of the capital is provided by the state owned companies: Astra, Asiromas well as the export credit insurer Eximbank.

Recent legislation reduced the number of compulsory covers, with only third party motor liability in force. However, the minimum capitalisation of current level of lei 25m ($6 000) per authorisation class (currently there exist ten classes) has not been changed as this would need separate legislation.

The Parliament passed provision to restrict direct insurance abroad by allowing placement only in cases of the absence of local capacity (see appendix A for details). The refusal of three local insurers to accept the risk however is sufficient to obtain authority to place risks abroad. However, if the reinsurance contract is accepted by a Romanian company, it must charge the same rate and at the same condition as offered by the international market.

Reinsurance is widely used, with 14 per cent of gross non-life premiums passed to reinsurers in 1995, with net outflow, after claims received standing at 7.8 per cent of gross premium. However, these figure vary from year to year: in 1993 due to heavy claims on reinsurers there was a net inflow of 25 per cent of gross premiums. The most heavily reinsured classes were aviation (with retention rate of 14 per cent), marine and transport (58 per cent) and fire and property (81 per cent). There are signs of growing use of domestic reinsurance capacity although exact information is not available. However an estimate provided by the insurance supervisor put domestic reinsurance acceptances at no more than 5 per cent of the total premiums ceded.

In line with the difficulties of other privatisations, the planned sale of shares in ASIROM in the voucher programme has been delayed.

There has been rapid growth in the number of registered brokers, which reached 71 in 1994. Among these are a number of international brokers including Karo SRL and Marsh & McLennan.

***Russia***

Following the demonopolisation of insurance in the USSR in 1988, there has been rapid and often chaotic development, leading to mushroom-like growth in the number of companies, characterised by the lack of technical skills and the absence of insurance culture. The market is hampered by the presence of too many under-capitalised units, concentration on selling personal lines (compulsory health cover and life) insurances. At the same time there are a small number of still state owned as well as private professional companies, which manage to carry on the high standard of direct and reinsurance activity in the property, marine and transport field.

At the end 1995 there were 2,745 insurance companies, 58 per cent of which were joint stock, 36 per cent were private, 5 per cent were state owned and 1 per cent municipally owned. However, less than 2 000 are believed to be active and many of these are seriously undercapitalised. 27 are authorised for life insurance only and 24 as reinsurers. The top 50 companies account for 43 per cent of total premiums. One consequence of the proliferation of weak companies is the ineffectiveness of supervision; many are forced to close after a brief period of operation.

Following the rapid decline of economic activity, skyrocketing inflation, there has been a decline in insurance penetration (the ratio of premiums to GDP), which has fallen from 2.9 per cent in 1990 to 0.77 per cent in 1993. One reason for the collapse in demand was that insurance premiums were not regarded as production costs and had to be charged against profits. This restriction was removed last year and insurance premiums are now deductible costs, up to 1 per cent of business turnover.

There has been strong recovery from low point by 1995, when premium income in rouble terms jumped nearly threefold, to Rb 21.8 trillion (US$4.8 billion), with much of the rise coming from compulsory health insurance covers. Per capita spending in dollar terms more than trebled between 1993 and 1995. The permission to sell policies denominated in foreign currency from 1 February 1996 in a wide range of trade related insurances is an additional positive feature and will assist further growth.

A key problem of the Russian market is still low capitalisation of many participants, where a sizeable number of companies are unable to raise more than the present statutory minimum of Rb 2 million ($350). Although proposed amendments to the insurance law aimed to raise the minimum to the local currency equivalent of ECU 250 000 for non-life, ECU 350 000 for life and ECU 500 000 for reinsurance companies, this has been rejected by the

president. One reason for the rejection is believed to be the lack of clarity on how existing companies would achieve these higher levels.

There is strong demand for facultative reinsurance of aviation, marine cargo and hull risks in view of the low retention of direct insurers. The same applies for property risks with high exposures. There is growing placement of reinsurance with other Russian companies and coinsurance is gaining ground. Pools are also becoming more popular. Most domestic reinsurance transactions are of a facultative kind, with proportional treaties infrequently used. Well informed international observers estimate that total reinsurance premiums were worth around $220m in 1995, some $100m of which was retained by local insurers, (including Ingosstrakh with $40m and other domestic reinsurers $60m). Of the balance of $120m around $50m is retained by Russian insurers in their offshore vehicles and some $70m finds its way to the international reinsurance market via the professional reinsurers such as Cologne Re, Munich Re and Swiss Re. Information from Lloyd's of London shows that business stemming from Russia amounted to £12.6m in 1994 and £14.2m in 1995 ($23m).

A potentially problematic development in Russia is the planned creation of National Reinsurance Company (NRC), which would take compulsory cessions from the rest of the market. The company, with a planned capitalisation of $150m by the state, would restrict the activities of foreign reinsurers and would go against the aims accepted by Russia in the Corfu agreement, signed with the EU on the liberalisation of financial services and also conflict with GATS provisions. The EU commission is investigating the matter, although it is not known if their views have been taken into account by Russians. There is no information about the current status of this proposal.

Among other obstacles to place reinsurance overseas is the 5 per cent reinsurance tax. Furthermore, insurance companies without access to hard currency (the majority), are unable to use international markets, which does not accept roubles.

Foreign participation in insurers and reinsurers is confined to 49 per cent and to date only a small number have ventured to establish a presence. Even the large foreign companies have a relatively low investment: at RUS AIG, where the American company has management control, the capitalisation is only $3m. Among other foreign investors are Allianz, Alte Leipziger (Interpolis) and Zurich Insurance. EBRD, Scottish Provident and Employers Re have also formed a joint venture life operation. Munich Re has a representative office.

There are a number of insurance and reinsurance brokers with representative offices (which can operate legally) which can operate locally and advise their clients. These include Aon Hudig, Bain Hogg, Sedgwick and Willis Corroon.

***Slovakia***

One of the first countries in the region to enact a new insurance law in early 1991, Slovakia's insurance market enjoyed steady development, in view of the relatively modest inflation levels. Following the removal of a 25 per cent limit on foreign participation, there has been growing interest by foreign investors, with six of the 14 joint stock companies having minority or majority foreign shareholders.

Recent amendments to the insurance law has introduced solvency margin control along with the EU lines, with capital requirements linked to premium income, and claims paid by class of business. However, proposals to create a separate supervisory authority have not been implemented.

The market however remains highly concentrated as a result of the former monopoly Slovenska Poistovna a.s. (SP), now a privatised joint stock company, with state ownership still around 50 per cent. SP still retains the monopoly position in certain compulsory classes. SP's strong position (with 82 per cent market share in life and 78 per cent in non-life business) Second ranked company Kooperativa Druzstevna Poistovna a.s. is 52 per cent controlled by the Austrian insurer Wiener Stadtische Versicherungs. There is evidence of growing competition for property business, which can be expected to intensify when major international insurers such as Allianz and Gerling Konzern build up their local affiliates.

Slovakia is among the countries of the region which makes least use of reinsurance with 11.5 per cent of gross non-life premiums ceded in 1995, probably on account of the relatively high market share of Slovenska Poistovna, which is a well capitalised unit. However, the second ranked Kooperativa reinsured 47 per cent of its gross business on the international market, with the use of treaty as well as facultative placings. The company's leading reinsurers in 1994 was SCOR and it also placed personal accident and life treaties with its Austrian shareholder Wiener Stadtische. The company also makes use of regional reinsurance opportunities by reinsuring its travel insurance portfolio with the Hungarian company Atlasz.

Brokers' role in Slovakia is said to be new, but expanding: Aon Hudig, Jauch & Hubener, Marsh & McLennan are known to be active.

***Slovenia***

One of the smallest of the successor republics of Yugoslavia, Slovenia's insurance has advanced furthest since acquiring independence, by converting their socially owned units into joint stock companies. It is among the few countries of the region to have its own specialist reinsurance companies as a continuation of the practice in the former Yugoslav Federation, in addition to 13 direct companies. Four of the companies have foreign equity participation.

Its insurance law, which came into force in November 1993 is modelled on Austrian and German example and first and second generation of EC directives. It still have a tariff structure, reflecting the fact that the country feels that it needs further protection during its period of transition. It also has a relatively high minimum capital, at SlT 120 million (ECU 0.86 million).

There is no restriction on the entry of foreign capital in direct insurers, but reinsurance will remain in the hands of companies with Slovenian majority capital. Local insurers are obliged to use up the local reinsurance capacity before placing reinsurance abroad. They are not allowed to place risks abroad themselves but must use Sava Reinsurance Co.

Sava Reinsurance dominates the local reinsurance market, writing 96 per cent of reinsurance premiums written of SlT 8.7 billion ($67 million), 46 per cent of which is ceded abroad. The amount ceded is a rather modest 9 per cent of gross market premiums. The relatively modest foreign retrocession is due to regulations specifying that local reinsurance capacity must be exhausted before business can be ceded abroad. The bulk of the business ceded is property, motor liability and transport insurance.

Slovenia also set up a nuclear insurance and reinsurance pool, with the participation of several local direct insurance companies plus Sava Re to coinsure a local nuclear power plant.

Slovenia has the highest insurance spending in the whole of the Eastern European region at $433 per head, despite the relative underdevelopment of its life business which accounts for only 15 per cent of total premium income.

***Ukraine***

Insurance legislation was enacted in May 1993, and the formation of insurance supervisory authority has taken place in September 1993. The last three years have seen the creation of substantial private sector. The pace of the development is illustrated by the fact that the number of insurers have risen

from 368 in April 1994 to 658 in April 1996. 74 of these have minority foreign shareholders, as there is a 49 per cent ceiling on foreign capital.

New insurance law in force from March 1996 raised minimum capital to ECU 100 000 for newly authorised companies but all companies which wish to continue business beyond 1.1.1997 must reach this level. The law specifies 26 types of compulsory insurances.

Premium income in 1995 totalled Ukr Krb 24 436 billion (equivalent to US$136 million at the end year rate of exchange) with claims at 59 per cent. Life business represented 25 per cent of the total and non-life 75 per cent. However, the per capita spending overall at $2.6 is only less than one tenth of the Russian figure.

There is no legislation relating to insurance broking, beyond the need to report the commencement of business to the supervisor, although fresh legislation regarding brokers is expected. The placing of reinsurance by brokers with foreign insurers is prohibited, which makes the placing of reinsurance with foreign companies either illegal or impossible.

The dominant position of Oranta, the state owned company, (the largest of the six created on the split-up of the Gosstrakh system) which writes 100 per cent of compulsory insurances (of workmen's compensation and agricultural insurances) as well as the insurance of state enterprises property covers seems to have been whittled away as its market share is down to 40 per cent. However future legislation is expected to end the monopoly in compulsory covers.

There were numerous insolvencies as a result of the lack of professionalism and the undercapitalisation, and the weakness of supervisory powers also appears to be a contributory factor: 136 companies had withdrawn their licences for one reason or another.

The demand for better spreading of risks has been met to a certain degree by the creation of Ukrainian Re, which is a pooling arrangement among nine local insurers. Each can halve its own retention on a risk via cessions on a facultative basis to Ukrainian Re. Subsequently the reinsurer can retrocede the risk on a facultative basis to the other eight insurers.

### *Central Asia and Vietnam*

The seven countries covered in this section are in the early phase of their transition and this is reflected in the state of their insurance activities, with per capita insurance spending below $1 in most of them. Only limited information

is available on most of these markets although state insurance monopoly has come to an end in each of them. Very little data is available on reinsurance. However, Azerbaijan reports the existence of a local reinsurance company, which need twice the minimum capital required for other classes and Turkmenistan issues special licenses that are exclusively engaged in reinsurance.

*Appendix A*

## RESTRICTIONS ON PLACEMENT OF REINSURANCE

The present appendix list some of the regulation relating to reinsurance transaction which have been mentioned during the survey. It should be noted that this is a fast changing field with rapidly changing regulation and practice and readers should not rely on the statements made here alone.

**Belarus** Placement of reinsurance abroad subject to approval policy by policy. Remmittances abroad to insurers without permanent representation in Belarus are subject to 15 per cent tax**.**

**Romania** The following is a provision of article 6 of Law no 136 of Romania: " The ceding of reinsurance on the international market will be done only when the subject risk cannot be placed on the domestic market".

*Source: Correspondence with Romanian Ministry of Finance, Supervisory office of insurance and reinsurance activity, Bucharest.*

**Moldova** According to section 6, Paragraph 17 of the Insurance Act of Moldova of June 1993: "Assignment of risks to foreign reinsurers bearing no special licenses by the Insurance Supervision Administration shall be allowed solely when coverage of these risks in the domestic reinsurance market is not feasible".

**Estonia and Latvia** Insurance law specifies a 10 per cent limit of statutory capital on maximum retention per risk.

**Slovenia** Local reinsurance capacity must be exhausted before business can be ceded abroad

**Ukraine** The insurance supervisor is considering to oversee the annual reinsurance business plan of each company. Information to be provided include the structure of the programme, choice of conditions and reinsurers. Supervisor may also demand additional information and may refuse consent if not in line with regulations. Approval will be needed where over 50 per cent is placed abroad and for excess of loss treaties are placed with foreign reinsurers. Supervisor is also considering the establishment of a list of approved reinsurers.
*(Source: East European Insurance Report, Oct. 1996*)

*Appendix B*

## REINSURANCE REGULATIONS IN OECD COUNTRIES

The practices of OECD countries' supervision of reinsurance activities have been examined with the aim of deriving some lessons for the evolving activities of transition economies in this field. This appendix is based on : Member countries' answers to a questionnaire on reinsurance sent to Insurance Committee delegates.

**Authorisation** of reinsurance activities is far less detailed than that of direct insurance and only a minority of OECD members has specific requirements. Often authorisation for reinsurance is the same as for direct insurance. Countries which require an authorisation specific to reinsurance activities of domestic and foreign direct insurers include Canada, Germany, Italy and the UK. In Italy all reinsurance activities need authorisation while in Canada minimum capital requirements are stipulated. In Germany reinsurance business is examined specifically through the analysis of the operating plan.

Supervision of **reinsurance ceded** by direct companies in OECD countries is normally carried out through the supervision of direct insurance. Supervision may involve the financial and accounting information prepared by ceding companies and may be combined with on-the-spot examinations. Some supervisors review reinsurance treaties and the risk exposure of ceded reinsurance. Technical reserve adequacy is examined by French and Swiss authorities.

The **retention ratio** (of net non-life premiums as a percentage of gross premiums) is required to be a minimum 10 per cent by Swiss supervisors and in Canada the minimum retention ratio is 25 per cent if reinsurers are local and 75 per cent if foreign. In Ireland and the Netherlands direct insurers are required to return details of their reinsurance programmes while in Germany the supervisor can demand to check reinsurance treaties in detail.

It is recognised that the supervision of is problematic as it is difficult to obtain data on all reinsurers, especially if they are foreign. This is reflected in the US

which distinguishes between US-authorised and foreign domiciled reinsurers, with the latter required to provide collateral.

There are few restrictions in OECD countries on the **choice of reinsurers**. Some countries (Belgium and Switzerland) may require plan of reinsurance and guarantees and have preferential rules for domestic ore regional reinsurers. Insurers in Mexico can only use reinsurers registered with the Treasury, while there are quotas for cessions from Turkey.

The majority of OECD members supervise **accepted reinsurance** especially where the business of domestic direct and reinsurance companies is concerned. With regard to foreign controlled companies 16 out of the 24 OECD countries providing information supervise direct insurers and 12 also supervise foreign reinsurers.

About half of OECD member countries' supervisors have requirements regarding the **minimum solvency of professional reinsurers**. In seven countries the requirement is the same for reinsurers as for direct insurers. Denmark and Finland stipulate minimum solvency if the reinsurance company has a subsidiary in their market. Although Germany has no statutory solvency margin requirement the supervisor tries to ensure that reinsurers have a minimum capital of 10 per cent of net premiums.

*Appendix C*

# FINANCIAL REPORTING IN CENTRAL AND EASTERN EUROPE

## 1. Overview

This review describes a number of accounting difficulties facing insurers in Central and Eastern Europe. In addition we highlight specific difficulties regarding:

- claims reserving
- the purchase of reinsurance protection and
- investment activities

The regulatory impact of these issues on solvency monitoring is discussed as well as the steps being taken to enhance standards of reporting in the region.

## 2. Accounting difficulties

The accounting difficulties faced by insurers in the region may be summarised as follows:

- in socialised economies accounting systems typically focused on output which was measured in units of production. For the insurance sector this usually meant the cash received or paid out by the state budget. Generally accepted accounting practice measures profits using accruals accounting, matching income earned in the accounting period with costs incurred rather than purely cash spent or received. Insurance accounting involves long time scales and as a result the results of cash accounting and accruals accounting diverge significantly. Cash accounting by insurers overstates income and understates the cost of claims and benefits. The transition from cash accounting to the accruals method must be faced by all enterprises and is particularly difficult for insurers. It gives rise to reduction in earning and an

increase in claims costs in the year when the change is made. The effect is substantial and may weaken the financial strength of insurers for a number of years.

- accounting regulations may not reflect fully the special features of the insurance industry
- the principles underpinning international generally accepted accounting practice may not have been incorporated into local accounting practice. It these principles have been incorporated they may not yet be well understood.

Besides specific accounting difficulties, the operating conditions experienced by insurers since liberalisation of these markets have been particularly difficult, due to changing economic conditions, limited investment opportunities and rising personal injury awards. These factors make accounting judgements more difficult to exercise and makes reliable financial reporting in the region more problematic. These may create difficulties for different players:

- management do not have reliable benchmark by which to measure the performance of their business
- shareholders, including potential investors do not have reliable yardstick to assess the performance of their investments
- brokers, agents, reinsurers and other participants lack reliable information on which to base decisions
- solvency monitoring by regulators is made more difficult and as a result
- the interests of policyholders is less securely protected.

Faced with these challenges many insurance regulators are strengthening the systems they use to monitor solvency. They may need to sponsor new insurance legislation to widen powers and enhance the transparency of financial reporting by insurance companies. However, the lack of parliamentary time may make this difficult to achieve.

## 3. Specific difficulties

### *Claims reserving*

Reserving for claims incurred is a key task: it influences not only the insurer's current profitability and financial strength; the out-turn is an important guide to

future business. Claims reserving is a relatively new skill in the region as it is at the heart of the transition process from cash accounting to accruals accounting. The extra difficulty stems from high and volatile inflation rates, changing social trends and risk patterns and the introduction of new insurance products.

Even trends towards improved stability and lower inflation can create its own problems for insurers assessing technical provisions with respect to claims incurred but not reported. Insurers in the region may not have access to the computing power needed to analyse claims data and they may also lack historical track record for reliable assessment. Most of them would hold this data in paper record, which cannot be readily accessed.

### 4. Accounting for ceded reinsurance

Reinsurers will typically require accounts to be settled quarterly. This is an area where financial reporting should be on an accrual basis. rather than cash paid or received. This means making an accrual that reflects the estimated effects of reinsurance arrangements on technical provision, which is a difficult and judgmental area.

### 5. Investment opportunities

While insurers have an important role in stimulating the development of local capital markets, the choice of suitable investments available to them tends to restricted. Markets lack liquidity, length of maturity and a positive real rate of return, especially if inflation is high. Consequently insurers in the region have followed investment strategies covering the entire spectrum of from venture capital to investing largely in bank deposits. These present distinct risks, especially for deposits. he close intertwining of the health of the banking and insurance systems which cause concern even in developed markets. The debates on whether to follow cost based or market value based asset valuation is still continuing in the EU and will have its followers in the region.

### 6. Impact on solvency monitoring

In developing a yardstick for solvency monitoring supervisors will look to tools such as the EU margin of solvency or IRIS ratios. These are difficult to apply effectively where financial reporting is weak or financial statements unreliable.

A reliable system of financial reporting for solvency monitoring is an essential regulatory tool. Weakness in financial reporting can have a direct impact on the effectiveness of regulators to protect policyholders. While the situation is improving and varies from insurer to insurer and country to country, our

conclusion is that as a result financial statements in the region need to be interpreted with a significant degree of caution.

## 7. Remedial actions

We would like to highlight the need to enhance the standard of financial reporting in the region and the principal tools in this process affects most segments of the insurance industry, as suggested below.

- regulators are to strengthen their role and broaden their skill through the assistance of sponsors such as the EC PHASE programme and the British Government Know How Fund
- enhance the role of the auditing, accounting and actuarial professions in the region
- the important role played by trade associations, brokers, reinsurers and other expert bodies should be utilised
- increasing sophistication of consumer groups and the development of rating services is to be assisted
- help the development of management skills by the insurers themselves

*Appendix D*

## TABLES

Table 1
**Main economic indicators of transition economies**

| Countries | Population (in million) | Per capita GNP [1] US$ | Private sector share of GDP per cent |
|---|---|---|---|
| Albania | 3.2 | n.a. | 75 |
| Armenia | 3.8 | 2 170 | 50 |
| Azerbaijan | 7.5 | 1 720 | 25 |
| Belarus | 10.4 | 5 019 | 15 |
| Bulgaria | 8.4 | 4 320 | 45 |
| Croatia | 4.8 | n.a. | 50 |
| Estonia | 1.5 | 6 860 | 65 |
| FYR Macedonia | 2.1 | n.a. | 45-50 |
| Georgia | 5.4 | 1 410 | 50 |
| Kazakhstan | 16.9 | 2 830 | 50 |
| Kyrgyzstan | 4.5 | 1 710 | 50 |
| Latvia | 2.7 | 5 170 | 60 |
| Lithuania | 3.7 | 3 240 | 65 |
| Moldova | 4.3 | 3 310 | 35-45 |
| Romania | 22.7 | 2 920 | 50 |
| Russian Federation | 148.2 | 5 260 | 60 |
| Slovak Republic | 5.3 | 6 660 | 70 |
| Slovenia | 2.0 | n.a. | 45 |
| Tajikistan | 5.7 | 1 160 | 15-20 |
| Turkmenistan | 3.9 | 3 950 | 18 |
| Ukraine | 51.7 | 3 330 | 60 |
| Uzbekistan | 22.2 | 2 390 | 30-40 |

[1] Per capita GNP on PPP (purchasing power parity basis)
*Source* World Bank Atlas 1996 EBRD Transition Report 1996

Table 2.1

**Indicators of insurance development: Transition economies**

| Country | Premium per capita US$ 1995 | Premium as of per cent of GDP 1995 |
|---|---|---|
| Albania | 4.3 | 0.70 |
| Belarus | 3.4 | 0.33 |
| Bulgaria (1) | 24.4 | 2.05 |
| Estonia | 34.7 | 1.32 |
| Croatia | 111.7 | 3.26 |
| Latvia | 24.0 | 1.26 |
| Lithuania | 10.3 | 0.69 |
| Romania | 6.3 | 0.42 |
| Russia | 32.4 | 1.32 |
| Slovakia | 67.2 | 2.25 |
| Slovenia | 433.3 | 4.80 |
| Ukraine (1) | 8.8 | 1.27 |

Memorandum item: insurance indicator for selected OECD countries 1995

| | | |
|---|---|---|
| Austria (1) | 1 317 | 5.34 |
| Czech Republic | 181 | 2.84 |
| Hungary | 93 | 2.17 |
| Poland | 59 | 1.90 |
| EU 15 (1) | 1 267 | 6.85 |

(1) 1994

*Source*: Swiss Re, OECD, press reports

Table 2.2

**Distribution of gross premiums: Life - Non-Life 1994-95**

| Country | Life $m (percentage) | Non-life $m (percentage) | Total $m |
|---|---|---|---|
| Albania | - | 14 (100) | 14 |
| Belarus | 4 (12) | 30 (88) | 34 |
| Bulgaria | 67 (33) | 139 (67) | 206 |
| Croatia | 30 (6) | 506 (94) | 536 |
| Estonia | 4 (10) | 48 (90) | 52 |
| Latvia | 17 (28) | 42 (72) | 59 |
| Lithuania | 13 (34) | 25 (66) | 39 |
| Moldova | 8 (54) | 6 (46) | 14 |
| Romania | 15 (11) | 127 (89) | 143 |
| Russia | 2 100 (44) | 2 702 (56) | 4 802 |
| Slovakia | 87 (24) | 269 (76) | 356 |
| Slovenia | 127 (15) | 735 (85) | 862 |
| Ukraine (1) | 34 (25) | 102 (75) | 136 |

*Source:* Swiss Re, press reports (1) 1994.

Memorandum item: OECD countries

| | | | |
|---|---|---|---|
| Czech Republic | 345 (27) | 932 (73) | 1 268 |
| Hungary | 284 (30) | 664 (70) | 947 |
| Poland | 763 (33) | 1 524 (67) | 2 287 |
| OECD average | 50.2 % | 49.8 % | na |

Table 3
**Minimum Capital Requirements**

| | Non-life | | Life | |
|---|---|---|---|---|
| | Local currency | US $ *(a)* | Local currency | US $ *(a)* |
| Belarus | BRb 300m | 11 500 | BRb 300m | 11 500 |
| Bulgaria (1) | Leva 300m | 0.61m | Leva 200m | 0.49m |
| Croatia | DM 2m | 1.29m | DM 1m | 0.65m |
| Estonia (2) | EEK 10m | 0.803m | EEK 12m | 0.964m |
| Latvia | Ls 0.6m | 1.089m | Ls 1.0m | 1.814m |
| Lithuania (3) | Litas 1.0m | 0.25m | Litas 1.0m | 0.25m |
| Moldova | Mol 300 000 | 64 500 | Mol 300 000 | 64 500 |
| Romania | ROL 25m | 6 040 | ROL 25m | 6 040 |
| Russia (4) | ECU 0.25m | 0.31m | ECU 0.35m | 0.43m |
| Slovakia | SKK 20-30m | 0.63m-0.94m | SKK 30-40m | 0.94m-1.25m |
| Slovenia | SlT 120m.8m | 0.86m | SlT 120m | 0.86m |
| Ukraine (5) | ECU 0.1m | 0.127m | ECU 0.1m | 0.127m |

Memorandum item: selected OECD countries

| | | | | |
|---|---|---|---|---|
| Czech Republic | CZK 22-156m | 0.805-5.70m | CZK 70m | 2.56m |
| Hungary (6) | HUF 250m-450m | 1.55m-2.78m | HUF 350m | 2.17m |
| Poland | ECU0.2m-0.4m | 0.248-0.49m | ECU 0.8m | 0.99m |

(1) Minimum for reinsurance co is Leva 400m
(2)Estonia: minimum for reinsurance co EKK 20m
(3)Lithuania: legislation under review. In joint ventures foreign investors min $0.5m
(4) Russia : based on current proposals
(5) Ukraine to come into force from 1.11.1997 check life/non life, current proposal
(6) Hungary, include. HUF 100m guarantee capital
*(a)* at end 1996 rate of exchange

Table 4.1
**Number of authorised insurers 1995-96**

| Country | Number of companies (incl. life, non-life and composites) |
|---|---|
| Albania | 1 |
| Belarus | 63 |
| Croatia | 17 |
| Estonia | 22 |
| Latvia | 43 |
| Lithuania | 36 |
| Moldova | 46 |
| Romania | 43 |
| Russia | 2 745 |
| Slovakia | 21 |
| Slovenia | 15 |
| Ukraine | 600 |

*Source:* Swiss Re, regulatory reports, press reports

Table 4.2
**Market concentration: Market share of top and top 3 companies**
Non-life business 1995

| Country | Top company (percentage) | Top 3 companies (percentage) | Year |
|---|---|---|---|
| Belarus | 40.0 | 53.9 | 1995 |
| Croatia | 72.6 | 83.2 | 1995 |
| Estonia | 24.1 | 50.2 | 1995 |
| Latvia | 25.1 | 57.7 | 1995 |
| Lithuania | 58.6 | 80.6 | 1995 |
| Moldova (1) | 71.1 | 83.7 | 1995 |
| Romania (1) | 52.0 | 72.0 | 1995 |
| Russia (2) | 14.7 | 24.4 | 1996 |
| Slovakia | 78.3 | 90.3 | 1995 |
| Slovenia[(1)] | 45.9 | 78.6 | 1995 |
| Ukraine[(1)] | 40.0 | na | 1994 |

Memorandum item: Selected OECD countries

| | | | |
|---|---|---|---|
| Czech Republic | 69.3 | 83.5 | 1995 |
| Hungary | 47.0 | 77.0 | 1995 |
| Poland | 60.9 | 83.5 | 1995 |

[(1)] Life and non-life (2) first three quarter s1996.

Table 4.3
**Market Solvency Levels**

| Country | Currency | Gross premium income | Paid up Capital & free reserves | Solvency ratio (percentage) |
|---|---|---|---|---|
| | | *(a)* | *(b)* | *b/a* |
| Belarus | Brb | 394 bn | 19.0 bn | 4.8 |
| Romania (1995) | Leu | 290 bn | 70.0 | 24.1 |
| Slovakia (1994) | SK | 8 617m | 2 891m | 33.5 |

*(a)* Life and non-life premium income of total market
*(b)* Total market free capital data,

Table 4.4
**Number of insurers with foreign shareholdings (minority and majority)**

| | |
|---|---|
| Belarus | 22 |
| Estonia | 6 |
| Latvia | 2 |
| Lithuania | 4 |
| Moldova | 8 |
| Romania | 19 |
| Russia | 74 |
| Slovakia | 6 |
| Slovenia | 4 |
| Ukraine | 24 |

*Source:* Regulatory reports, press reports.

Table 5.1
**Premium retention rates (a) 1995**
(Life and non-life business)

| Country | Year | Gross premiums $m | Ceded premiums $m | Net premiums $m | Retention rate (percentage) |
|---|---|---|---|---|---|
| Belarus | 1995 | 34 | 8 | 26 | 75.6 |
| Estonia | 1995 | 48 | 20 | 28 | 58.9 |
| Latvia (1) | 1995 | 60 | 21 | 38 | 64.2 |
| Lithuania | 1995 | 38 | 3 | 35 | 92.1 |
| Moldova | 1995 | 14 | 2 | 12 | 85.7 |
| Romania (*) | 1995 | 143 | 18 | 125 | 87.5 |
| Russia | 1995 | 4 802 | 220 | 4 582 | 95.4 |
| Slovakia | 1995 | 356 | 31 | 325 | 91.3 |
| Slovenia | 1995 | 862 | 67 | 795 | 92.2 |
| Ukraine (*) | 1995 | 136 | 4 | 132 | 96.9 |
| Total above | | 6 493 | 394 | 6 098 | 94.0 |
| Estimate for region ** | | 7 693 | 512 | 7 178 | 93.3 |

Memorandum item: premium retention rates in selected OECD countries

| | | | | | |
|---|---|---|---|---|---|
| Czech Republic | 1995 | 1 259 | 109 | 1 150 | 91.3 |
| Hungary | 1995 | 818 | 159 | 659 | 80.6 |
| Poland | 1995 | 2 248 | 599 | 1 649 | 73.5 |
| EU 15 | 1994 | na | na | na | 85.8 |

a) Net premiums as per cent of gross premiums

1) assuming life is retained 100 per cent and 1994 ratios * assuming 1994 ratio unchanged
** see text for assumptions

Table 5.2 **Non-life business: premium retention rates**

| | Retention rate |
|---|---|
| Latvia | 50.5 |
| Estonia | 55.6 |
| Romania | 86.0 |
| Slovakia | 88.5 |
| Slovenia | 91.0 |

*Source*: Regulatory reports.

Table 5.3
**Premium retention rates in the OECD**

| | Highest | Lowest | Average |
|---|---|---|---|
| Life | 100.0 | 71.7 | 96.1 |
| Non-life | 88.2 | 61.7 | 81.5 |
| Total | 91.0 | 66.5 | 88.7 |

*Source*: OECD Insurance Statistics Yearbook 1996

Table 5.4
**Reliance on foreign reinsurance by developing countries**
(number of countries)

| Retention ratio | below 50 per cent | 51-70 per cent | 71-90 per cent | over 90 per cent | total no. of countries |
|---|---|---|---|---|---|
| Line of business | | | | | |
| Total | 19 | 24 | 16 | 5 | 64 |
| Automobile | 2 | 2 | 22 | 33 | 59 |
| Fire | 36 | 12 | 8 | 3 | 59 |
| Transport | 42 | 13 | 4 | 1 | 60 |

Table 6
**Western insurance intermediaries in economies in transition**

| | |
|---|---|
| Croatia | 2 |
| Estonia | 2 |
| Kazakhstan | 2 |
| Latvia | 2 |
| Uzbekistan | 1 |
| Romania | 3 |
| Russia | 6 |
| Slovakia | 3 |
| Ukraine | 1 |
| Total | 22 |

*Source*: BIPAR

Table 7
**Methods of placing reinsurance**

| Method | Facultative | Open cover (or facultative obligatory) | Treaty | Pool |
|---|---|---|---|---|
| Description | Each risk offered individually to reinsurers, who are free to accept what share they desire, or reject. | A reinsurer agrees to accept obligatorily a share of any business conforming to predetermined conditions regarding class of insurance, type of risk, country, etc.<br>There is no obligation on the ceding company, or broker, to offer business. | Subject to terms and conditions agreed between the parties and set out in the treaty, there is an obligation on the reinsured to cede and the reinsurer to accept risks of a class falling within the limitations of the treaty. | Take various forms but often a quota share or surplus reinsurance arrangement between participating members. |
| Type of reinsurance for which employed | Mainly proportional | Mainly surplus | Proportional and non-proportional | Proportional reinsurance |

*Adapted from* R.L. Carter, *Reinsurance,* 3rd edtn, p.85, op cit.

Table 8

**Protection afforded by different types of reinsurance to different types of risk**

| Type of reinsurance | Type of risk exposures | | |
|---|---|---|---|
| | Individual large losses | Accumulation of losses from one event | Accumulation of losses over one year |
| Quota share | Yes | Limited | Limited |
| Surplus | Yes | limited | Limited |
| Excess of loss per risk | Yes | Limited | Limited |
| Excess of loss per event | No | Yes | Limited |
| Stop Loss | No | No | Yes |

*Note:* 'Yes' means that the type of reinsurance is designed to protect against the specific type of risk exposure, and 'Limited' means that in doing so it offers some protection against accumulations of losses.

Table 9.1* **Status of insurance regulation** (Selected Asian markets)

| | Insurance law | Minimum capital | Supervisory body | Foreign insurers | Number of companies |
|---|---|---|---|---|---|
| Azerbaijan | Jan 1993 | $11 200 (f) | yes | joint ventures | 80 (e) |
| Kazakhstan | Oct 1995 | $40 000 | yes | 50 per cent limit | 53 |
| Kyrgyzstan | 1991 (a) | $2 000 | yes | na | 75(b) |
| Mongolia | No | na | no | na | 7 |
| Turkmenistan | Nov 1995 | $15 000 | MoF | 40 per cent limit | 16 |
| Uzbekistan | 1993 | na | MoF | Joint ventures | 60 |
| Vietnam | No (c) | na | MoF | Joint ventures | 7 (d) |

(a) under review: (b) active companies: (c) expected before 1998: (d) In addition 27 foreign companies have representative offices (e) 12 of which ceased trading: (f) minimum capital Manat 50m, for reinsurers Manat 100m

*Source*: OECD workshop on Central Asian markets, March 1996

Table 9.2 **Market premium income 1994/95** (Selected Asian markets)

| | Insurance premiums | | | | Population m | Per capita premium $ |
|---|---|---|---|---|---|---|
| | Amount | Currency | Rate per US$ | US $ m | | |
| Azerbaijan | 8 250m | manat | 4 440 | 1.8 | 7.4 | 0.24 |
| Kazakhstan | 682.4m | tenge | 65 | 10.5 | 17.3 | 0.61 |
| Kyrgyzstan | 19.6m | som | 10.86 | 1.8 | 4.6 | 0.39 |
| Mongolia | 1.6bn | tugrik | 460 | 3.5 | 2.3 | 1.52 |
| Turkmenistan | 800m | manat | 200 | 4.0 | 4.1 | 0.97 |

*Source*: OECD workshop on Central Asian markets, March 1996, author's estimates.

* Tables 9.1 and 9.2 have been included with the aim of making the survey as complete as data availability permits.

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## NOTES

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