

Insurance as an institution of financial and social protection in Russian transitional economy

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The market economy in Russia is in the process of formation. Its main features are:

1. The government is unable to act as guarantee of financial and social security. This aspect was a characteristic of the centrally-planned model of economic development with its state insurance monopoly;
2. The increase of uncertainty and risk in business and human life due to the transitional period of the economy and as well as the globalisation of ecological risks.



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Consequently it is imperative to create insurance institutions and insurance schemes, as a financial and social protection against risks and uncertainty and hence establish elements of the welfare state in contemporary Russia.

1. Historical remarks on the formation of insurance in Russia – USSR – Russia

The history of Russian insurance as a particular type of economic activity can be divided into five stages:

X-XVII centuries

Insurance in the traditional society – in Kiev and Moscow Roos, that was reflected in the Laws: “Russian Truth (Pravda)” X-XI c., “Stoglav” 1550, “Cathedral Law (Sobornoje Ulodzenije)” 1649 and was characterised by

obligatory state insurance and mutual insurance in the peasants’ communes, merchants’ guilds, manufacturing associations and cartels, accompanied by the collective responsibility of the members.

1786-1827

Development of national obligatory insurance as a state monopoly with strong influence of foreign insurance schemes.

1827-1917

In proto-industrial society the national insurance market had the following features:

- A strong state influence (preponderance of obligatory insurance), state savings book offices which insured miners and railways employees;
- State control (1894) with the functions of regulation of insurance activities presumably in the sphere of financial control of technical reserves and statutory capital volume;
- Commercialisation of various lines of business: life, non-life, property-casualty (fire, hail, water, etc.) liability;
- Multiplicity of organisational forms: stockholders, mutual; territorial-administrative principle – city, agricultural; scale and type of activities – small, large, burial, pensions;
- An international character;
- The formation of insurance market infrastructure: legislative, educational, brokers companies, unions and associations of the insurers.

1918-1988

The implementation of a centrally-planned economy had a state insurance monopoly as a necessary element of the financial system. This stage had certain sub-periods of development.

1918-1922. Nationalisation of insurance business and the formation of state monopoly was established through the decree “About the organisation of the insurance activities in the Russian Republic” (28.11.1918), which set out a full state monopoly (excluding mutual cooperative insurance); the liquidation of the insurance as a financial protection institution; absence of the state property insurance; liquidation of the private property, cancelling of life insurance (inflation made voluntary life and non-life insurance disadvantageous);

1922-1929. During the period of NEP (New Economic Policy) an attempt was made to

create a particular socialist model of insurance. According to this model strict state control was established in the special decree “About State Property insurance” (6.10.1921). In reality the system did not function. Through the NEP period, in spite of the conversion of private households’ voluntary insurance into obligatory state property insurance, voluntary cover of industrial enterprises and goods in transit was permitted. Hence by 1925-1926, 60% of the fixed capital was insured. The organisational and financial freedom of the state insurance company (Gosstrach) increased. Cooperatives had a right to conduct mutual insurance as in 1918-1922 under the control from Gosstrach, which reinsured risks of mutual cooperatives. From 1925 Narcomfin (the Ministry of Finance) started to supervise Gosstrach and mutual cooperatives: The scope and scale of insurance increased to include banks, transport enterprises, savings book offices. In 1925-1927 Gosstrach formed a set of representatives abroad – they were involved into the insurance and reinsurance operations in export-import goods and property of the Soviet citizens abroad. Through this period of time one could see that once proclaimed, the state insurance monopoly prevailed.

1930-1988. The liquidation of the insurance market elements and the centrally-planned model of insurance continued to develop. The full monopoly in insurance was instituted, tariffs were standardized, as were rules and conditions of insurance, obligatory property insurance of trusts and large industrial enterprises. After the Second World War, Ingosstrach was formed, in 1949. Its operations were focused on export-import insurance, property and life of the Soviet citizens abroad and foreign citizens in the USSR. In the 1960’s, voluntary types of property and life insurance emerged, springing from the state monopoly.

1989 – until present

Demonopolisation of insurance and formation of an insurance market.

1988-1991. Demonopolisation of the insurance industry

1992-1998. Formation of the contemporary insurance market.

Summing up, it can be seen that throughout the history of insurance, there are distinguishable cycles: from prevailing state insurance of traditional society to formation of an insurance market; from the market to full state monopoly; from state monopoly to market insurance mechanisms.

The waves of economic and social development in Russia are reflected in the insurance history. A small experience of the commercial insurance development of the late 18th and beginning of the 19th century, the NEP period and the modern period of transformation show that as soon as the public demand in financial insurance protection increases, market economy develops, demonopolisation starts, state regulation decreases and the insurance activity flourishes, introducing a new necessary element into the financial system.

2. The insurance market in contemporary Russia

In developed countries the insurance industry is one of the major sectors of the financial market. The market share of the insurance business, together with pension funds in the financial services market of the USA, for example, increased by 32 % in 1975 up to 38 % in 1992, while banks decreased their operations by 37 % in 1975 to 26 % in 1992.¹

Modern national Russian insurance as a financial protection institution was born after the implementation of three main legislative acts of 1987-1989: “Cooperative Act”, “Lease Act”, “Individual Labour Entrepreneurship

Act”, “State Enterprise Act” when the possibility of non-regulated and non-controlled outflow of financial resources from the state sector appeared. Top managers of state enterprises as well as the so-called party-comsomol nomenclature started to create different commercial structures (or to merge with them): investment and pension funds, holding companies, insurance companies, so-called financial pyramids and other forms. As state insurance began to be demonopolised, the insurance market began to be formed. The market includes three main elements:

- companies insuring various kinds of property;
- insurance products addressing the demand of different social groups of the Russian population;
- insurance infrastructure.

2.1. Insurance companies

Domestic insurance business has been analysed in Russian economic and juridical literature but not very thoroughly. It concerns first of all the quantitative issues of the insurance development.² The increase of the number of insurance companies (including the conversion process of state insurance into stock companies) was impressive. In 1988 there were only two state insurance companies, in 1995 there were already about 3000. This number diminished somewhat in 1996 to 2474³ and, due to the supervisory measures by the government, decreased even more by the beginning of 1997 to 2138 licensed companies who submitted their financial reports to the Financial Supervisory Department of the Ministry of Finance. The new-born insurance market has the following characteristics:

- A low level of insurance competence development for the majority of businessmen as well as ordinary citizens. Only 10% of the

employees in the insurance industry have specialised juridical and economic education. In 1995 among 1000 businessmen respondents to an inquiry by the St. Petersburg Sociological Institute of the Russian Academy of Science only 18% had insured their business, 50% didn't know that it could be done and 40% refused to be insured at all⁴;

- The legal possibility of money laundering of funds from the Communist Party of the Soviet Union – CPSU and Comsomol. About 70 % of the insurance firms are small companies created for money laundering and to accelerate trade and financial operations. 54 % of the insurance companies were created only three years ago, in 1995, 5 % in 1994 and 5% in 1993 or earlier. The number of employees increased from 140.000 in 1993 to 250.000 in 1997 presenting approximately 0.4 % of the active labour force (57.2 million employees) that is 4 times less than the level of large developed countries;
- Insurance companies have the following composition:
 - 58% – mixed companies with state capital
 - 36% – private companies
 - 5% – state enterprises and
 - 1% belongs to the municipalities and public organisations;
- 73 companies in Russian have foreign capital, with 49 % of the share capital according to the restriction of the Law of Insurance;
- The market share of the 100 top insurance companies of Russia (4.7 %) in 1997 was 58 % of premiums and 63 % of claims. Technical reserves of Russian insurance companies are not sufficient for claims adjustment. According to the judgement of the Head of the Financial Supervisory Department of the Ministry of Finance only 200 insurance companies from 2747 were solvent in 1996 according to their financial reports. As of April 1997, 2138 insurance companies were registered in the State Register Chamber but only 1,0-1,5 thousand were functioning in reality;
- The preponderance of premiums and claims is provided by Rosgosstrach on the domestic market and by Ingosstrach on the international market. In 1997, the assets of Ingosstrach were 1/3 of the total assets of the 100 top insurance companies, amounting to 9.4 billion Roubles. The network of the 80 Rosgosstrach companies having 2500 affiliates at the beginning of 1998 had 1.9 billion Roubles in assets⁵. Both companies are highly monopolised, have experience, an agent network, qualified personnel, traditionally big insurance field, the system of professional and personal contacts on the level of the state bureaucratic apparatus and in the national economy as a whole. However even the 100 top insurance companies are considered to be small in comparison with the Russian banks, not to mention foreign insurance firms. Of the 100 largest insurers, only 6 companies have shareholders-equity exceeding 10 million US \$. According to estimate of the Financial Supervisory Department of the Ministry of Finance, only those insurance companies that have an aggregate share holders-equity exceeding 100 million US \$ could compete with the foreign firms after the opening of the Russian insurance market in 1999⁶;
- Comparison of private and state stock companies permits observers to define their features. The state companies obey the law, they are reliable in claims payment and competent in the types of insurance characteristic for a centrally-planned economy. At the same time state companies are very slow in their investment activities, in the implementing of new insurance products,

new rules and conditions of insurance. Private firms are very free in application of legislation and often risky in setting reserves. Tax evasion is an issue. When they go bankrupt they can vanish, only to appear in another location under another name. They may not cover their claims, exploiting the weakness of the state supervisory organisations. The positive features of the non-state insurance companies in case they have sufficient reserves to be solvent are: minimum period of claims adjustment, provision of the services connected with the type of insurance (health care, auto motor vehicles reparation, security service in property insurance), flexible individual approach to the client: special proposals, tariffs, rules, contract conditions, etc.; flexible investment strategy, interesting advertisement, new insurance products implementation, application of historical Russian and foreign experience;

- Rating of the insurance companies is reflected in
 - the system of estimates: technical reserves, tariffs, conditions and the rules of insurance;
 - estimates by independent experts;
 - public opinion.

According to these three parameters the most reliable companies are: Rosgosstrach firms, Ingosstrach, and the largest captive companies created by the “natural monopolies” which have a possibility to implement mandatory insurance. These are the captive companies of Gazprom, Ministry of the Railways, Telecom, Ministry of Defence, and the largest air transport companies. Through the period 1989-1995 the activities of the most part of the insurance firms were universal. Beginning from 1996 the biggest insurance companies started to be more specialised. The insurance market was already shared between the stable lead-

ers with determined specialisation. For example, the insurance companies of Gosstrach system specialise in life and property insurance. Group life insurance of the employees is concentrated in the insurance companies of Gosstrach system too, “Energo Garant”, “ROSNO”, mandatory military insurance – Military Insurance Company; air risks – AVIKOS, AFES, LEXGARANT, Ingosstrach; cargo and casco risks – Ingosstrach, “Roos”. The first company that started the insurance of leasing is “Russian World”.

- Reinsurance in Russia in general, as the system has not yet developed, but there has already appeared several specialised reinsurance companies. The reinsurance is actually carried out chaotically. The large risks are transferred to the foreign insurance companies, and small-sized are allocated between the main insurance companies without observance of a principle of interregional division of risk and diversity of reinsurance portfolio.⁷ The North-western Insurance Pool was created in April 1994 and still actively works involving Ingosstrach-Saint-Petersburg, Rosgosstrach-Saint-Petersburg, Progress-Neva, ASK-Saint-Petersburg. These four companies, due to large size of the capital, can assume insurance, coinsurance, reinsurance of very large risks.⁸ The insurance opportunities of the Pool are steadily rising. If the capacity of the insurance Pool at its creation in 1994 was 1 million US \$, by the beginning of October 1995 it had increased by about 1.5 times. By 1998 in it had increased by 3 times. It must be kept in mind that the capacity of the entire St. Petersburg insurance market was estimated to be 30 million dollars.⁹ This capacity is insufficient to cover risks for large enterprises and projects. There is the necessity in similar situations to use special reinsurance compa-

nies, insurance intermediaries – brokers – for redistribution (reallocation) of risks.

- There is still no real competition between the functioning insurance companies. However the competitive insurance market development is going on due to the following factors:
 - The narrow spectrum of services provided by the insurance companies (though that could be explained by the level of the insurance competence and immaturity of the market);
 - The absence of effective demand for insurance services and low level of insurance education of potential clients;
 - The heavy tax burden. According to the Order of the government 661 signed on July 1, 1995, insurance premiums were paid out of enterprise profit. This obviously does not stimulate the enterprises to insure their risks. Only since January 1996 could insurance premiums be paid by enterprises from costs. But the insurance business growth was not very significant;
 - The change of aggressive direct advertising for indirect basically spread through the solid business newspapers, magazines, thematic broadcast;
 - The majority of the insurance companies has refused distribution of the insurance policies through the system of insurance agents. Today about 90 % of the insurance companies work with the help of direct underwriting.¹⁰

2.2. Insurance market and consumer behaviour

According to international standards total amount of premiums in the developed countries averages from 3 to 12 % of the GDP. Beginning from the transitional period Russia has the following figures (Table 1):

Table 1. Share of the total amount of premiums in GDP (%) Russia (1992-1999)

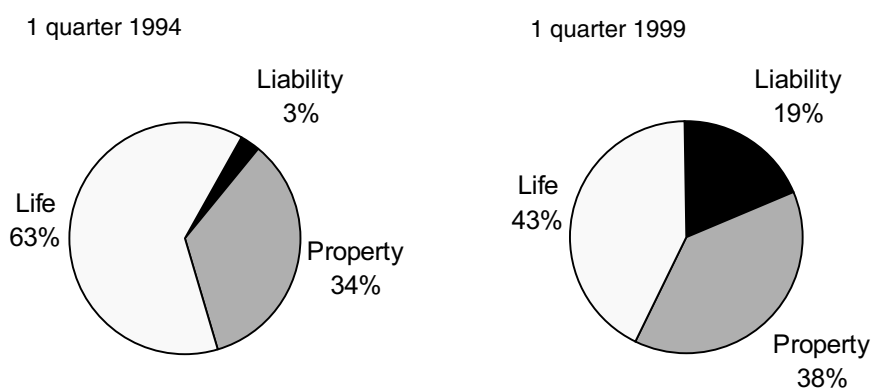
<i>Year</i>	<i>Share of the total amount of premiums in GDP (%)</i>
1992	0,6
1993	0,7
1994	1,2
1995	1,5
1996	1,3
1997	1,4
1998	0,7
1999	1,3

The objective tendency of the market is the change of insurance portfolio structure. Voluntary classes of insurance have increased through 1992-1997 from about 18% up to 36%, for life insurance – from 43% up to 64%. Property insurance is similar from year to year. Liability insurance diminished from 19% to 2 %. This is connected with a rejection of credit and suretyship insurance (See Diagram 1, next page).

The basis of insurance business profitability today is industrial group life insurance of the employees. Russian insurance as such is not based on the principles of classical Western commercial insurance. It is oriented to the reduction (sometimes elimination) of the tax burden and receipt of cash based on personal network. Enterprises, which are favourable to the insurance company (quantity and quality of insurance based on volume of operations, etc.) are already insured. It is very difficult to penetrate into this market with the help of old methods.

The situation in the insurance market is complicated by the fall of interest to the insurance from the natural persons, that is observed with the help of psychological interrogations.¹¹ Through 1996 the premium per capita is 89 000 Roubles (18 US \$), compared to 1200 US \$ in the USA. Consumer demand is characterised by the following features:

Diagram 1. Parity of total payments on voluntary classes of insurance



- A large proportion of obligatory insurance;
- Voluntary insurance is concentrated in the most wealthy group of the population (4.4%) due to income polarisation;
- Voluntary property and liability insurance is concentrated in the private or stock companies sector (property of private and state stock companies, industrial, agricultural, service, trade, intermediaries, cargo, hull, land vehicles, financial risks);
- Life insurance is spread in the sphere of the obligatory insurance of customs and military officers, lawyers, tax clerks, passengers, voluntary and obligatory medical insurance, voluntary life and accident for a period of no more than one year, accident and life insurance for children and teenagers, etc.
- The large proportion of group life industrial insurance is explained by the possibility for the enterprises to reduce or escape taxes as well as by the chance of the social support provision of the employees;
- The majority of the population mistrusts commercial insurance due to lack of information. This lack of understanding of the essence of insurance is characteristic for

the Russian population. 85.8 % of the respondents couldn't answer the question "What is insurance?". Non-satisfactory functioning of insurance companies led to in 1996 to the withdrawal of licenses of 15% of the companies. This was reflected in the investigation of the All-Russian Research Centre of Public Opinion. According to the questionnaire answered by 1000 Muscovites aged 25-55, population's trust for the insurance industry fell in 1996 to 24% compared to 40% in 1995.

2.3. Infrastructure of the insurance market

The transitional period resulted in crucial changes in insurance legislation. The President and the Government issued more than 300 Acts, Orders, Instructions dedicated to authorisation, supervision, financial and investment activities, taxation and so on in the insurance field. The main acts are: Insurance Act (1993), Obligatory Medical Insurance Act (1992), Rules of Licensing (1994), Tax Act (1994), Rules of Investments (1995), Supervisory and Tax Authorities Orders (1993-1998).

However, insurance legislation is still not very applicable, particularly in licensing and taxation.

The intermediary component of the insurance market is poorly regulated. For example in St. Petersburg there were approximately one dozen registered insurance brokers. Foreign insurance broker activity is forbidden by law. However they usually work through a local (pocket) insurance company, which is an officially Russian insurer, transferring in turn a large part of its risks abroad.

The domestic infrastructure of the insurance market is in the initial stages. In the most part of the cities and towns of Russia there are no loss-adjusters, surveyors, insurance advisers, etc. For example, in St. Petersburg there is only one large surveyor firm (created as joint venture in 1991) having 100% American capital (Marinex/ITS). But the scope and scale of services, given by this firm are already wide. It carries out technical and financial examination in the field of freight traffic, proposes expert technical estimation in courts as well as carrying out estimation of transportation conditions of a load, conditions of cargo handling work and storage of a load, estimation of damage, etc.¹²

Auditing of insurance companies is developing, but it is carried out by Russian auditors, whose evaluations and reports are not recognised by foreign banks, insurers, reinsurers, brokers and etc. Institutions such as loss-adjusters, consultants, brokers, agents and other kinds of intermediaries are still very rare in Russia.

Another important element of the insurance market is specialised insurance education. Higher education is offered in Moscow (the Financial Academy and Moscow State University) and in St. Petersburg (the Institute of Insurance, St. Petersburg State University, University of Economics and Finance).

There are still a number of factors that remain problematic for the contemporary Russian insurance industry. Among them can be mentioned:

- The impact on the insurance industry of the general difficult economic situation;
- Low potential opportunities for allocation of large risks and consequent investment activities in conditions of continued inflation and low investment activities in the real sector of the economy;
- The absence of reinsurance and coinsurance cover for large industrial and ecological risks;
- The absence of insurance infrastructures such as loss-adjusters, brokers, theft and fire prevention firms;
- Imperfections in the legislative base;
- Legislative restriction on the activities of foreign insurance companies;
- Weakness of the state supervisory authority controlling solvency in the insurance industry;
- Absence of a single information centre for the insurers and insureds and absence of a single rating centre.

Notes

- ¹ Kolpakov V. Together is safer? / Your capital. 1995. 12. P. 8.
- ² Kouznetsova Natalia. Development of the insurance market in St. Petersburg / St. Petersburg Echo. 20.10.1993.; Kouznetsova Natalia. Development of the insurance market in contemporary Russia / Vestnik of St.Petersburg University. Series 5, Issue 2. 1994; Lukashevitch Irina. Insurance Market: Short Analytical Review / Vestnik of St.Petersburg University. Series 5, Issue 4. 1994.
- ³ Statistics on Saint-Petersburg from: Bulletin of the St. Petersburg Union of Insurers. 1995. Issue. 1.
- ⁴ Tikchoniv Alexandr. The Report of the

- St.Petersburg Union of Insurers 1995. St.Petersburg, 1995
- ⁵ Center of Economic Research of Interfax Agency. June 1998
- ⁶ Op.cit.
- ⁷ *Economika i Dzin.* St.Petersburg Regional newspaper. 1995. 35. 9.
- ⁸ The insurance market in Russia and in St. Petersburg / *Neva news*. 1995. Sept. P. 2.
- ⁹ From the statement of the director of ISC Ingosstrach-Saint-Petersburg Kolosov K.E.on opening of an exhibition INSUREXPO – 95.
- ¹⁰ The tendency to centralized granting of financial services to the customers abroad is growing. The insurance companies use advanced bank networks and sell insurance policies through them. Experts' estimations are that in 1997 from sale of different kinds of insurance the banks received 20% of income. In St. Petersburg there is a similar practice. For example, the insurance policies of Gosstrach IC are sold by Sberbank, CB "Vicing" sells the insurance policies of Guarantee IC (St.-Petersburg).
- ¹¹ Kouznetsova Natalia et.al. The insurance market in Russia and small entrepreneurship St. Petersburg University Press. 1995. P. 10.
- ¹² *St. Petersburg Echo*. 1995. 38. P. 15.