



German Economic Team
IPM Research Center

Draft of Policy Paper [PP/06/2008]

Reinsurance Practices in Belarus: Barriers to Insurance Sector Development and Investments' Limitation

Anastasiya Glambotskaya, Gleb Shymanovich

Minsk, December 2008



IPM RESEARCH CENTER
Research • Forecasting • Monitoring

About the IPM Research Center

The IPM Research Center was established in 1999 within the mutual project of the Institute for Privatization and Management (Minsk, Belarus) and CASE – Center for Social and Economic Research Foundation (Warsaw, Poland). It is a member of the CASE research network, William Davidson Institute NGO Alliance, and Economic Policy Institutes Network (project of the UNDP's Regional Bureau for Europe and the CIS). The main activities of the IPM Research Center are monitoring, analysis and forecasting of Belarusian economy development, economic research and elaboration economic policy recommendations, promotion of dialogue on the issues of economic development through conferences and seminars, publication of the results of research conducted by Belarusian and foreign economists in ECOWEST journal, and training of specialists in the field of modern methods of economic analysis. Within its cooperation with the German Economic Team in Belarus, the IPM Research Center provides independent policy advice on economic issues to the different official agencies, namely to the Council of Ministers, National Bank, Ministry of Economy, Ministry of Finance and other organizations involved in the process of formation and implementation of economic policy.

The Mission of the IPM Research Center is to enhance national competitiveness through elaboration of the research-based economic policy recommendation and the promotion of professional dialogue on the urgent issues related to economic performance.

IPM Research Center

505 Zaharova Street, 220088, Minsk, Belarus

Tel: +375 (17) 2 100 105

Fax: +375 (17) 2 100 105

E-Mail: research@research.by

<http://www.research.by>

About the German Economic Team in Belarus (GET Belarus)

The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Russia, and Kazakhstan. In Belarus the IPM Research Center and the German Economic Team provide information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

German Economic Team

c/o Berlin Economics

Schillerstr. 59

D-10627 Berlin

Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9

E-Mail: info@get-belarus.com

<http://www.get-belarus.com>

© 2008 German Economic Team

© 2008 IPM Research Center

All rights reserved.

Reinsurance practices in Belarus: barriers to insurance sector development and investments' limitation

Summary

This paper studies the issue of reinsurance sector regulation and development in Belarus. Irrespective of several steps towards Belarusian economy liberalization, reinsurance in Belarus was largely deliberalized and monopolized in Belarus in 2006 by the creation of Belarusian National Reinsurance Organization (Belarus Re). Although the authorized capital of Belarus Re exceeds those of other insurers in Belarus that allows reinsuring higher risks and halting the outflow of reinsurance premiums abroad, its activity is largely based on non-market principles that impeded further insurance and reinsurance sectors development and investments growth in Belarus.

Authors

Anastasya Glambotskaya
Gleb Shymanovich

glambotskaya@research.by
shymanovich@research.by

Contents

1. Introduction	4
2. Reinsurance sector: main features, international experience in regulation and application in Belarus.....	4
2.1. Main features of reinsurance	4
2.2. International experience in reinsurance regulation.....	5
2.3. Reinsurance in Belarus	5
3. Assessment of the current situation in insurance and reinsurance sectors and their influence on investments	6
3.1. Main characteristics of the insurance and reinsurance sectors	6
3.2. Insurance and reinsurance sectors and investments	9

1. Introduction

Insurance and reinsurance markets in Belarus are largely underdeveloped. The share of insurance premiums in GDP accounts for less than 1% that leads to uncovered risks and limited opportunities to investments. Reinsurance allows insurance sector diversify risks and increase business margins. Two years ago Belarusian reinsurance market experienced serious changes. Previously, reinsurance contracts could be concluded freely with foreign partners and Belarusian insurers or reinsurers. In 2006 reinsurance practices were centralized and monopolized by the creation of the Belarusian National Reinsurance Organization (Belarus Re). The share of this organization in reinsuring risks of Belarusian insurance companies is supposed to increase to 100% by 2016, thus leading to further deliberalization and control over the market.

On the one hand, according to the insurance sector experts, creation of the centralized state reinsurer allows decreasing the amount of foreign exchange traditionally paid to foreign reinsurers. Also, Belarus Re capitalization is higher than those of other Belarusian insurance/reinsurance companies, thus limiting their risks in reinsurance. On the other hand, reinsurance practices are international in their nature. Concentration of risks within one country causes threats to both insurance market and economy as a whole. Moreover, absence of free access to foreign reinsurers with higher capitalisation and better facilities limits the opportunities of Belarusian insurance companies for accumulation of insurance premiums. In turn, it impedes insurance business development and investment opportunities in the country.

2. Reinsurance sector: main features, international experience in regulation and application in Belarus

2.1. Main features of reinsurance

Reinsurance is a type of insurance coverage that one company, the ceding company, purchases from another company, the reinsurer, in order to transfer risk associated with insurance. Reinsurance is a B2B business. Through reinsurance, a reinsurer "insures" the ceding company. Thus, in the reinsurance operation insurance companies can get protection against the risk of losses by transferring part or all of their risks associated with insurance contract to other insurers or specialized reinsurers. Reinsurance allows making insurance companies' results more predictable by limiting larger losses and reducing the amount of capital needed to provide coverage. It allows an insurance company offering higher limits of protection to a policyholder than its own assets would allow. On the other hand, reinsurance allows achieving balanced insurance portfolio and financial stability of operations and income smoothing.

World reinsurance market has been growing by 5.5% on average annually in 2003-2007. The pace of growth accelerated to 9.7% in 2007. The biggest market share belongs to the United States of America (55.7%), Europe accounts for 34.5%. The market size measured as the amount of underwriting premiums accounted for USD 168 bn in 2007. According to the market experts, the size of the reinsurance market could reach USD 223.5 bn by 2012. Among the leading global reinsurers are Munich Re and Swiss Re with 17.5% and 15.8% market shares respectively. Munich Re has remained on the top of the list for several years and its market power grows¹.

According to the Belarusian legislation², insurer (reinsurer) can reinsure part of its risks at another insurer (reinsurer) directly, or with the help of insurance brokers. The primary insurer remains directly responsible to the policy holder even if the risks were further reinsured. Several sequential reinsurance contracts are allowed. The law also allows reinsuring risks both at domestic and foreign reinsurers³, although in practice the freedom of choice of reinsurer is limited by the government.

Transfer of insurance risks to foreign insurers (reinsurers) can only be performed in case the state reinsurer (Belarusian National Reinsurance organization, Belarus Re⁴) rejects to accept these risks. Acceptation or rejection of risks by Belarus Re should follow within 5 days upon the receipt of ceding offer (including all the necessary documentation).

¹ Datamonitor (2008).

² Ministry of Finance Decree No. 53 dated 01.04.2003.

³ Foreign reinsurers should not be residing at offshore zone.

⁴ Terms of operation of BNRO will be discussed further.

2.2. International experience in reinsurance regulation

Reinsurance business is bound to go global, as insurance companies, often global themselves, choose counterparts based on their security, disregarding the residence. Besides, regulatory environment in many countries allows reinsurers operating in the market without having subsidiaries, and even not requiring collateral agreements. However, most major reinsurers underwrite a great part of their business from their home-country offices.

Despite the global coverage, reinsurance practices differ from country to country. In the USA, for example, a discrimination of foreign reinsurers exists. On the one hand, US residency of the reinsurance company allows it operating without using collateral agreement. On the other hand, all non-US reinsurers are expected to use collateral schemes, irrespective of their creditworthiness. In the USA the reinsurance system leans much on collateral. If it is provided, the reinsurance scheme is considered to be safe. At the same time collateral gives a false sense of security, as it washes out responsibility and destroys incentives to manage risks properly. Besides, collateral only secures known claims, i.e. not exceeding the amount reserved, so it does not cover new claims, that the cedent may not primarily show in the balance sheet. The prerogative of national reinsurers and reliance on collateral in the USA results in the fact that cedents tend not to properly conduct their own analysis of reinsurer's solvency, payment record or underwriting expertise. Thus, the decisions about reinsuring risks taken in the USA are often prone to be biased.

European approach to reinsurance differs from the American one. It is oriented to the single European reinsurance market, and thrives not to distinguish between domestic and foreign reinsurers within the EU. Collateral is required from reinsurers on the basis of their financial strength relative to credit risk, and not on the basis of country of domicile. The European insurers use a risk based approach, i.e. means that insurers (cedents) have to select counterparts according to their financial stance and security, to monitor their risks, and also to take into account geographic diversification need.

The European reinsurance system is being gradually reformed. The EU Reinsurance Directive 2005/68/EC was primarily aimed at the creation of a single European reinsurance market. It includes a mutual recognition agreement that abolishes collateral obligations for EU reinsurers within the EU. Besides, EU member states are free to sign mutual recognition agreements with Non-EU countries. However, the Directive is only an interim measure before Solvency II Project comes force. The sideline effect of the Directive is the assumption of national distinction of reinsurance business. The Solvency II Project, expected to be implemented by 2010, is designed to resolve this issue.

Another aspect of reinsurance business is a role of the state. For example, specialized state-owned reinsurers have existed (or currently exist) in many countries, including Brazil ("IRB Brazil Re"), France ("CCR"), Bosnia (Bosnia Re"), etc. Moreover, the regulation of reinsurance in France resembles the one currently existing in Belarus: the share of risks to be reinsured at the state-owned reinsurer was obligatory. The state-owned "CCR" was restructured in course of time by the division of its commercial portfolio. As the result, the new company "SCOR" was created, which currently belongs to the five leading reinsurers in the world.

2.3. Reinsurance in Belarus

According to the Belarusian legislation, insurance company can retain risk in the amount of 20% of its net worth⁵; excess risks should be reinsured. There were no specialized reinsurance companies in Belarus before 2006, Belarusian insurers were ceding their risks mainly to foreign insurers. Belarusian National Reinsurance Organization was created in 2006 in accord with the President's Decree № 530 «On Insurance» and Council of Ministers' Decree № 1463. It reports to the Ministry of Finance. Its authorized capital was primarily raised in the amount of EUR 20 m from the state budget and further increased to EUR 20 m in December 2008.

Core functions of the Belarus Re, defined by the government are: activity exclusively on reinsurance and control over reinsurance contracts between Belarusian insurance companies and other insurance/reinsurance companies.

⁵ Ministry of Finance Decree No. 16 dated 07.02.2003.

After the creation of Belarus Re, Belarusian insurers were primarily obliged to cede 10% of their excess risks to it. From January 2009 the Belarus Re's obligatory share has grown to 40% of the undertaken liabilities under each voluntary reinsurance contract⁶. The remaining excess risks can be allocated at other Belarusian or foreign insurers/reinsurers. It is expected that by 2016 the share of obligatory reinsurance of excess risks of Belarusian insurers at Belarus Re will reach 100%. Belarusian insurers, underwriting risks of other insurers are obliged to hold a license for the corresponding type of insurance.

Amendments were made to the reinsurance legislation at the end of June 2007⁷. Belarus Re has received the priority right in reinsuring risks of Belarusian insurers. Moreover, insurance contracts written with the state-owned enterprises or contracts written from the budgetary means should be reinsured with Belarus Re. All reinsurance contracts in Belarus should be registered at Belarus Re and insurance premiums associated with these contracts should also be approved by Belarus Re, notwithstanding that primary insurance contract premiums are already regulated by the State Insurance Authorities. The Decree №103 also allows Belarusian insurers reinsure risks abroad only if Belarus Re denies underwriting them. It also determines the size of liabilities between Belarusian and foreign reinsurers for every underwritten contract depending on the insurance object. Belarus Re is granted the right to reinsure risks further at foreign reinsurers. Financial strength of 83% of foreign Belarus Re's reinsurance partners is rated from AAA to A (high rating level).

Belarus Re main foreign partners are «Hannover Re» (Germany), «Munich Re» (Germany), «SCOR» (France), «Polish Re» (Poland), «AIG» (USA), Lloyd's syndicates, insurance brokers «Beauchamp & Savrassov Limited», «Willis Limited», «Cooper Gay Eastern Europe», «R.L.Davison & Co Ltd» (Great Britain), «Filhet-Allard Maritime» (France), «Moscow Re», «Ingosstrakh», «ROSNO», «Eastern Reinsurance Company», «Leksgarant» (Russia), etc.

With the aim to develop further international cooperation and incoming reinsurance, Belarus Re aims to acquire financial strength rating in 2009. It currently holds negotiations on these issues with the international rating agencies Standard&Poor's, A.M.Best Company, Fitch Ratings.

It also aims at the establishment of the National Insurance Nuclear Pool for insurance and reinsurance of nuclear risks connected with the Nuclear Power Plant construction in Belarus as well as the establishment of the National Insurance Pool for major risks insurance and reinsurance, including space, aviation and other risks to further develop its operation and increase its market power in Belarus.

3. Assessment of the current situation in insurance and reinsurance sectors and their influence on investments

3.1. Main characteristics of the insurance and reinsurance sectors

In 2008 twenty four insurance companies operated in the Belarusian insurance market, including 8 with the state ownership (full or partial), 16 private (among them 11 with the foreign ownership)⁸. Belarusian insurers are allowed to conduct reinsurance in case their net worth allows these operations.

Share of private insurers in the gross written premiums is currently 16%. Their number, on the other hand, is twice as high as those with state ownership. This situation is caused primarily by the restrictions for private companies to deal with compulsory insurance. In the beginning of 2008 the National Bank prepared decree with changes for the decree №530 with the aim to return for the private insurance companies the opportunity to provide voluntary insurance. These propositions are not adopted yet.

Belarusian insurance business concentration is still very high. Herfindal-Hirshman index for the insurance sector in 2007, calculated on the written premiums was 0.35⁹. Main shares of pre-

⁶ The BNRO's obligatory share increases by 10% annually.

⁷ Decree of the Ministry of Finance № 103 from 28.06.2007.

⁸ Hereinafter, statistical data will be provided from: "Financial Stability in the Republic of Belarus", National Bank, <http://www.nbrb.by/publications/finstabrep/2007.pdf>, Ministry of Finance, <http://www.minfin.gov.by>.

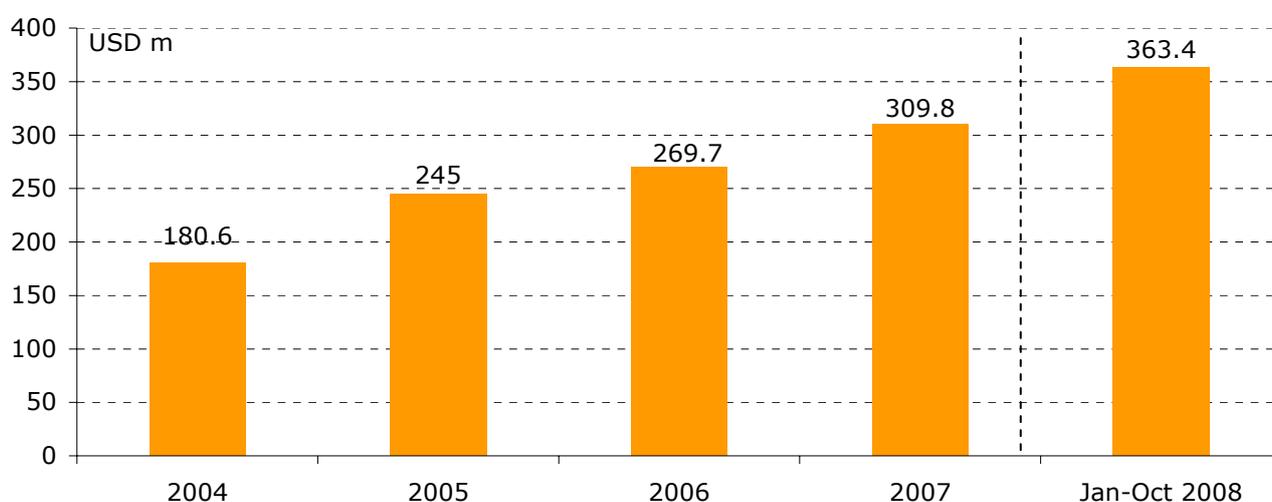
⁹ "Financial Stability in the Republic of Belarus", National Bank, <http://www.nbrb.by/publications/finstabrep/2007.pdf>

miums are concentrated at the small number of insurers, mainly state-owned, as well as one private company with foreign ownership "B&B Insurance". Other insurers are rather passive in their activity in the market.

Moreover, existing restrictions for the activities of insurers with foreign ownership defer investments to the sector. Insurers with more than 49% foreign ownership currently can not perform life insurance (long term), compulsory insurance, insurance of state-guaranteed orders, state property¹⁰. All the above restrictions create preferential conditions for state owned insurers and deprive the market of competition, as well as consumers of inexpensive insurance products of good quality.

Reinsurance is part of the general insurance business and the level of development of insurance sector directly influences the state of reinsurance. The share of written insurance premiums in GDP in Belarus is low, less than 1%. It corresponds to USD 30 per capita in 2008. In the share of written premiums to GDP Belarus lags behind not only developed western countries, Central and Eastern Europe, but also some CIS countries (Ukraine and Russia).

Figure 1: Written insurance premiums, USD m



Source: Calculations based on the data from the Ministry of Finance and the National Bank.

Table 1: Belarus Re performance core figures, USD thsd.

	2007	2008, Jan-Sep
Written premium	2 403.7	9 937.3
Received premium	1 494.6	7 395.1
Number of contracts	2 047	2 720
Liability accepted	2 776 625.8	11 692 729.1
Actuarial reserves	675.4	2 170
Net worth	26 809	28 682
Net profit	1 435.8	1 480.8
Authorized fund	25 416.4	27 232*

* substantial injections of state budget funds into the authorized capital of Belarus Re followed in Dec 2008, the authorized fund has increased to about EUR 110 mln.

Source: Belarus Re.

Thus, limited opportunities of insurance sector inhibit the development of reinsurance. The share of written reinsurance premiums to total written insurance premiums has not gone beyond 3% in the last years. The share of primary national reinsurer Belarus Re in the total written insurance premiums in Belarus was 0.7% in 2007 and increased after 2007 due to insurance market regulatory changes, increasing the obligatory share of reinsurance going to Belarus Re. thus, Belarus Re became the primary reinsurer in Belarus.

Although the written reinsurance premiums of Belarus Re have substantially increased in 2008, its net profit remained almost the same. The rate of net profit to net worth in 2007 was 5.3%, in Jan-Sep 2008 – 5.2%, although for several insurers with the state ownership more than

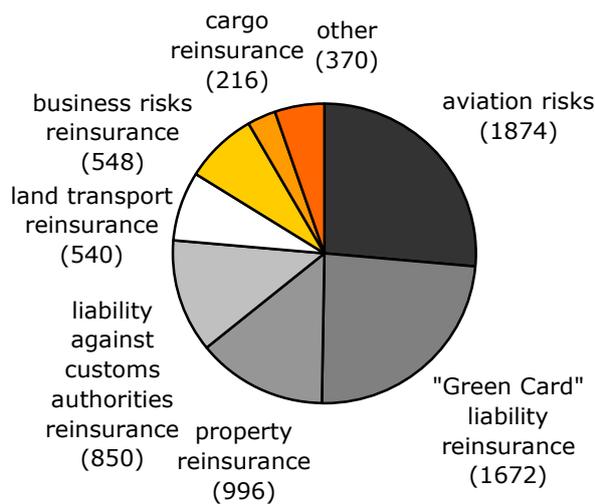
¹⁰ Decree № 530 dated 25.08.2006 "On Insurance".

50% it reaches 30-50%. These numbers indicate inefficient performance of national specialized reinsurer in the first years of its existence.

According to the market experts, Belarus Re is in many cases unable to provide reinsurance at competitive cost. It exists mainly thank to administrative redirection of insurance risks from Belarusian insurers to its portfolio. The national reinsurer is largely unable to compete with foreign reinsurers, but national insurers according to the legislation are deprived of the right to independently make decisions concerning the choice of reinsurer, they need to approve this choice at Belarus Re.

The biggest share in the insurance portfolio of Belarus Re belongs to aviation risks (19% in total written premiums in Jan-Sep 2008), «Green Card» liability reinsurance (17%), property reinsurance (10%), liability against customs authorities (8.5%) (Figure 2).

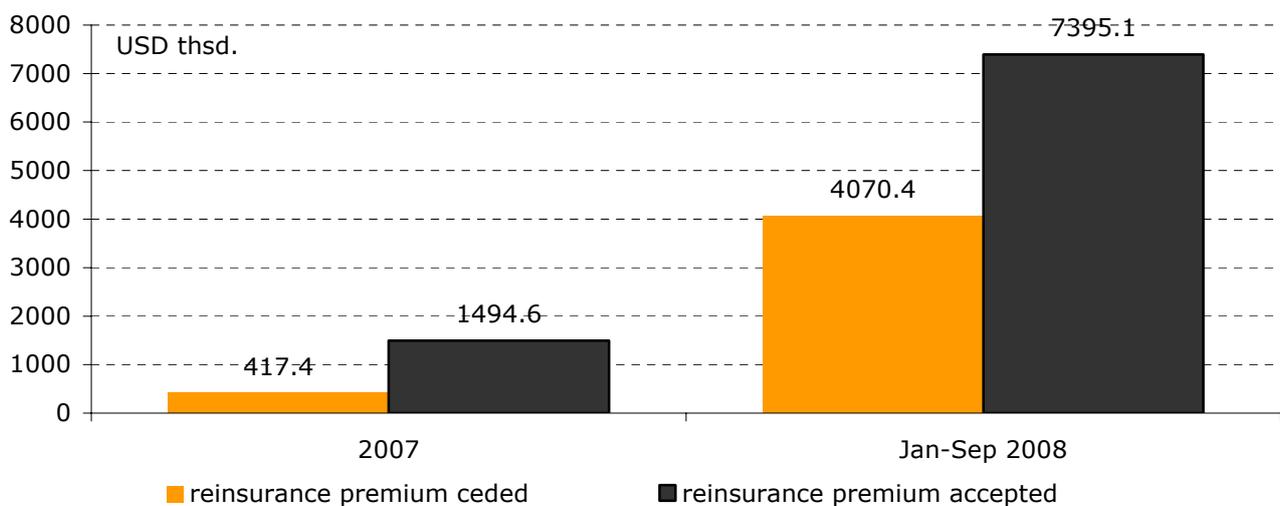
Figure 2: Reinsurance portfolio of Belarus Re in Jan-Sep 2008, thsd. USD



Source: Belarus Re.

At the same time nearly all aviation risks, "Green Card" liability, and half of liability against customs authorities and property reinsurance get further reinsured (retrocession), mainly abroad. The share of reinsurance premiums ceded from Belarus Re to other insurers and reinsurers to total accepted premiums increased from 2007 to Jan-Sep 2008 from 27.9% to 55% (Figure 3).

Figure 3: Reinsurance premiums, 2007 and Jan-Sep 2008, USD thsd.



Source: Belarus Re.

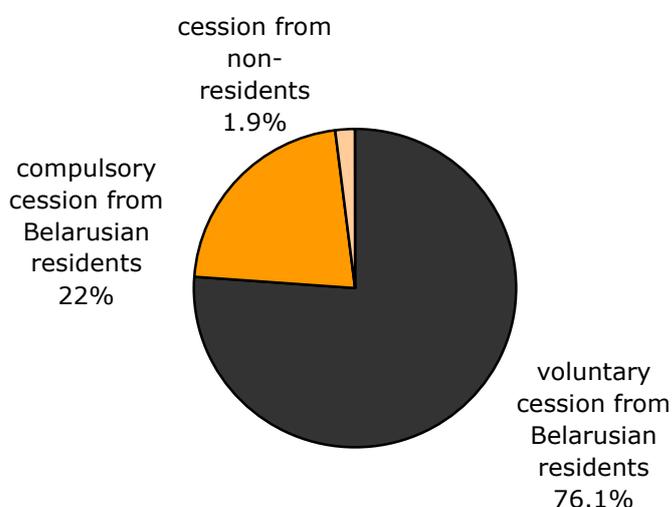
The main aim of creation of Belarus Re, as declared by the government, was halting the outflow of insurance premiums abroad. But, as numbers show, the amounts of retrocession abroad are low not only comparing to the Belarusian GDP, byt also comparing to all insurance

premiums collected in the country. On the other hand, existence of Belarus Re will not deliver Belarusian insurance market from the necessity of reinsuring risks abroad, as some risks are high and cannot be borne even with the increased authorized capital of Belarus Re at the end of 2008 to EUR 110 mln. Moreover, several clients demand their risks to be reinsured abroad; otherwise they do not wish to insure risks in Belarus.

Efficiency of retrocession abroad was proved in the insurance event of the Belarusian satellite "BelKA" crash in 2006. Around half of all claims were paid by foreign reinsurers. Otherwise, USD 16 mln. losses would have to be sustained by the Belarusian market.

Reinsurance is international business by its nature. Specialized reinsurers not only reinsure risks coming from domestic insurers and reinsurers, but also underwrite risks coming from abroad. Although the amount of incoming reinsurance has increased three times in Jan-Oct 2008 to the same period in 2007, the amount of cessions of non-residents to Belarus Re accounts for only 1.9%. Compulsory cession from Belarusian residents accounted for 22% in Jan-Sep 2008, and voluntary cession from Belarusian residents accounted for 76.1%.

Figure 4: Reinsurance premium income of Belarus Re from residents and non-residents of Belarus, Jan-Sep 2008, %



Source: Belarus Re.

3.2. Insurance and reinsurance sectors and investments

Reinsurance is aimed at supporting insurance business, which can become a significant player in the Belarus economy, as the average share of insurance sector in GDP around the world is 7%. Besides, insurance sector traditionally contributes much to the investment growth. According to the Belarusian legislation, insurance companies should invest their reserves in public debt securities, bonds issued by banks and enterprises, real estate or jewellery. The investment portfolio should be diversified according to the structure presented in the Act of Council of Ministers №1750 of December 29, 2006¹. Life-insurance companies should invest not less than 40% of their reserves in public securities (bonds). For other insurance companies this limit is 35%. Besides more than 10% of the reserves insurance companies are obliged to keep on deposits in banks. The rest of the reserves should be allocated between other allowed investment instruments, under condition that the share of each instrument does not exceed 15% (20% for real estate) for non-life insurance companies, and 10 and 15% for life insurance companies respectively.

In practice, Belarusian insurance companies keep 2/3 of their reserves on bank accounts, 1/4 invests in public debt and the rest is divided between real estate and securities of banks and enterprises. Such structure allows minimizing negative consequences of global financial crisis, but it does not contribute much to the investment growth. According to the data available for 11 months of 2008, 48.2% of all investments in Belarus were financed from enterprises own resources, 24.1% from the budget, 12.8% from bank loans, 8.1% from households' savings, 2.5% from external sources. The remaining 4.4% of all investments includes, among other sources, insurance sector. Thus, there is only marginal direct influence of insurance sector on

investments growth in Belarus. Indirectly it contributes via supporting banking sector. However, the reserves of insurance companies at the beginning of 2008 amounted to BYR 438.4 bn, which was equal to 4.6% of passives of Belarusian banks, attracted from organizations², or 1.1% of total passives. It is also relatively low numbers. The role of insurers in banking system was increased at the end of 2008 by the Edict № 687 from December 17, 2008, which provided Belarus Re and Belgosstrah with the budget sources of BYR 350 and 650 bn respectively, that were transformed into the shares of Belagroprombank. So these insurance/reinsurance companies became the main shareholders of this bank, the one of the largest in Belarus.

So nowadays insurance has a very marginal role in fostering investments, both due to weak insurance sector and limited instruments for investing. Liberalization of reinsurance will foster development of the sector. However, it should be accompanied by the active policy promoting financial sector development (stock exchange and so on). On the one hand it will allow insurance companies to diversify reserves placement strategy, and on the other hand it will contribute to the investment growth, as insurance funds will be actively involved in the economic turnover.)

4. Conclusions and policy recommendations

Notwithstanding several reforms in the insurance and reinsurance sectors' regulation in the second half of 2000th, there are no considerable steps towards their liberalization. Moreover, reinsurance has been largely monopolized by the creation of state-owned reinsurer Belarus Re. The lack of free competition between state-owned and private insurers (including those with foreign capital) leads to the overvalued insurance tariffs, low operational efficiency, slow insurance and reinsurance sectors development. Small amounts of insurance premiums (less than 1% of GDP) also restrain potential investments to the economy.

Reinsurance practices in Belarus lead to the monopoly status of Belarus Re. Many insurance market players perceive Belarus Re as an artificial formation, conditions for its operation are largely non-market. It currently works mainly as an intermediary that redirects reinsurance premiums and slows down insurance operations because of coordination expenses. Belarus Re was created with the aim to enhance the development of Belarusian insurance market, but for now its operations led to insurance/reinsurance tariffs increase and halting the pace of insurance operations.

The establishment of Belarus Re and redirection of reinsurance premiums to it has also led to braking down of existing cooperation between insurance and reinsurance companies. Qualifications Belarus Re also lags behind international standards. Besides, small expertise in reinsurance can not provide it with trust from international players.

According to international rules, reinsurer "follows" the insurer. In Belarus national reinsurer sets own rules and norms for direct insurers and plays the role of Insurance Authority with the single aim to collect larger amounts of insurance premiums irrespective of the quality of reinsurance services. Other Belarusian insurers appear more efficient comparing to Belarus Re in attracting risks not only of domestic, but also of foreign insurers.

Moreover, concentration of insurance contracts within the country is unsafe not only for the insurance sector, but also for the economy as a whole, as it leads to the risks of simultaneous claims coverage.

On the other hand, capitalization of Belarus Re is higher than that of other Belarusian insurers, thus making reinsurance safer here. Redirection of reinsurance premiums to Belarus Re also leads to the reduction of insurance outflows to international markets, thus fostering the development of insurance within the country.

The following regulatory changes could bring positive effect for the sector:

- Creation of equal market conditions for state-owned and private insurers and reinsurers;
- Integration of Belarusian insurance and reinsurance sector into the international market, because limited competition lowers performance efficiency of domestic insurers and reinsurers;
- Elimination of obligatory concentration of reinsurance activities at Belarus Re, allowing insurers/reinsurers choose reinsurer (including Belarus Re) based on market reasons;

- Demonopolisation of the national reinsurance system, as reinsurance business is international by nature (disseminates risks); granting Belarusian insurers right to freely choose reinsurers (including "BNRO") based on market factors.