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The Insurance Sector in Belarus: Analysis and Recommendations

Executive Summary

Insurance is important for the sustainable economic development of the country. In Belarus, however, the insurance market is still underdeveloped providing a limited amount of insurance services to customers who lack incentives for risk transfer. This paper provides an analysis of the impediments that hamper a further market development and a set of recommendations to improve the current situation. First, a scheme for the gradual payout of compensation on insurance polices concluded before 1992 should be established. Second, voluntary insurance should once again become tax deductible for enterprises. Third, insurance coverage has to become a concurrent condition to conducting certain economic activities. Fourth, insurance sector de-monopolization, when all insurance companies irrespective of their capital structure are allowed to provide compulsory insurance, has to be conducted. Fifth, discrimination against foreign insurance companies has to be removed. These measures will increase demand on insurance and force for the further development of the insurance market as a whole.

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1. Introduction

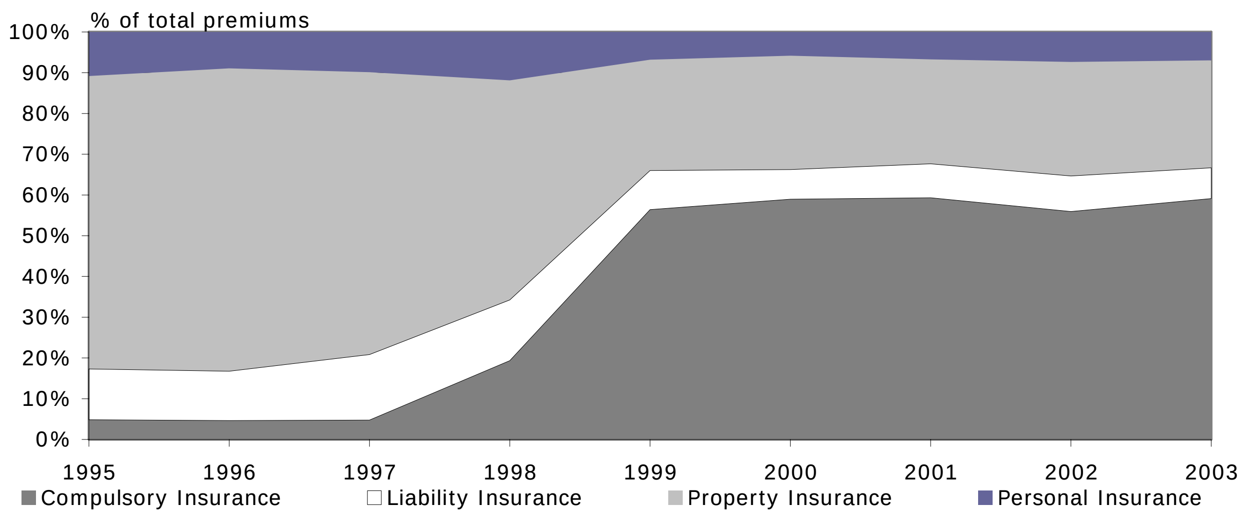
Insurance is important for the economic development of the country for several reasons[1]. First, insurance is an ideal tool to reduce losses through risk management. It can be defined as a convenient device by which an individual substitutes a small certain cost (the insurance premium) for a large uncertain financial loss. The transfer of risk from an individual to a group and the sharing of losses on some equitable basis are the two fundamental characteristics of insurance. Second, insurance is also an integral part of the financial market. The level of insurance company capitalization and concentration is comparable to the financial corporations in developed countries. Their high investment potential provides a stable source of internal investment flow. Thus insurance is one of the major premises for the creation of financial markets in emerging economies that allows sustainable economic growth to be maintained.

In spite of the benefits that would arise from a developed insurance market, the risk coverage level in Belarus is rather low. Moreover, there are several internal impediments that hamper a further market expansion, which for simplicity of analysis can be divided into demand related and regulatory issues. With this in mind, the paper is organised as follows: An overview of the insurance market in Belarus is presented in Part 2. Part 3 examines the aspects impacting on the demand for insurance services from the viewpoint of private households and of enterprises. Regulatory issues are assessed in Part 4, where we examine the effect of compulsory insurance on demand stimulation by focusing on the motor third party liability (MTPL) insurance and related policy failures, as well as the role of foreign investment to make up for existing deficiencies of the insurance market. The paper ends with policy recommendations concerning further development of the insurance market in Belarus.

2. The current situation on the insurance market

In the 1990s, Belarusian insurance market was characterized by having the most developed infrastructure among CIS countries and a relatively favourable legal framework. In 1996, Belarus was the first to introduce tax deductibility for the corporate premium of life insurance. The distinction between life and non-life insurance was already defined in law in 1998, though de facto it had been in practice since 1994, at a time when similar legislation had not yet been adopted in many post-soviet countries. The insurance sector received special attention from the government, which emphasized the importance of compulsory insurance and gave a leading role to the state-owned company Belgosstrah, in the late 90s[2].

Figure 1. Premium structure



Source: Belarusian Insurance Union.

Other developments were also taking place on the market. Belarus was among the first in the post-Soviet region to successfully introduce MTPL insurance in 1999. At present, MTPL

[1] The term *insurance* here stands for non-social or commercial insurance. An overview of the social insurance field is beyond the scope of this paper, as it covers a quite different sector requiring a separate detailed analysis.
[2] After the hurricane in 1997, compulsory insurance for separately located buildings owned by private households was introduced. Belgosstrah was given the exclusive right to cover this field.

insurance covers 72.3 percent of all vehicles in Belarus, which, despite being lower than the figures for Poland (94 percent) or Germany (99 percent), is well above the number for Ukraine (10 to 20 percent). Of course, the insurance market growth was heavily influenced by the imposition of the compulsory insurance lines, including MTPL insurance, during the last several years (Figure 1). Insurance premiums in USD terms have increased almost three times between 1995 and 2003.

Despite continuing developments during the past years, the insurance sector still remains relatively small offering a limited number of insurance products according by western standards. Insurance coverage of private households and enterprises is still comparatively low. The two basic ratios: insurance density and insurance penetration can be used to evaluate the insurance sector's significance (Table 1). Insurance density is calculated as the ratio of premium per capital, and insurance penetration presents the premium as a percentage of GDP.

Table 1. Density and penetration levels, 2002

Country	**Insurance Density, (premium per capital), USD**	**Insurance Penetration, (premium as % of GDP)**
United Kingdom	3879.1	14.75
United States	3461.6	9.58
Finland	2272.1	8.98
France	2064.2	8.58
Germany	1627.7	6.76
Canada	1563.2	6.69
Italy	1435.4	6.97
Spain	1091.5	6.77
Slovenia	557.0	5.05
Czech Republic	272.6	3.99
Hungary	186.9	2.88
Croatia	160.7	3.16
Slovakia	148.8	3.38
Poland	144.5	2.96
Latvia	68.5	1.91
Russia	66.6	2.77
Lithuania	57.9	1.46
Bulgaria	43.1	1.90
Turkey	35.0	1.31
Romania	22.3	1.09
Ukraine	17.1	2.01
Belarus	**9.5**	**0.63**

Source: Swiss Re (Sigma): World Insurance in 2002 (published November 2003) and own calculations.

Although the generally low penetration level is typical for developing countries, it is still three times smaller in Belarus than in Ukraine (2.01 percent) and almost five times lower than in Russia (2.77 percent). Likewise, insurance payments per capital are very modest. The premium level of USD 9.46 per person suggests noticeable underinsurance on the market.

Insurance premiums increased by BYR 50 bn in 2003, which is 1.4 percent in real terms. The growth was achieved by an increase of 7 percent in the compulsory insurance premiums, while the voluntary insurance premiums collection rate decreased by 5.9 percent in real terms. Similarly, the share of the voluntary insurance premiums in the total amount of premiums collected decreased from 44.1 percent in 2002 to 40.9 percent in 2003.

3. Problems on the demand side of the insurance market

3.1. Problems for private households

People are mainly concerned about three major issues, which cause them to distrust insurances:

- The non-fulfilment of insurance contracts concluded prior to 1992 by Gosstrah,
- High inflationary expectations, and
- Fraudulent pyramid schemes in the recent past.

(i) No compensation for insurance contracts concluded before 1992

For decades, people did not need to treat insurance as an indispensable instrument for their personal risk reduction. The Soviet type of insurance assumed a general welfare state, where the government was in charge of all kinds of indemity. After Belarus' independence the insurance sector development was hampered by the problem of how to pay compensation based on the devalued premiums paid under various insurance contracts. Today these compensation payments would require BYR 300 bn (considering the increase in the consumer price index between 1992 and 2001) to pay off all the contracts that were valid prior to January 1, 1992. The state-owned company Belgosstrah has established special fund to accumulate required sources, which are currently insufficient for reimbursement. This situation causes distrust in the ongoing insurance system, and will be further aggravated if the government does not adopt a policy of gradual payouts on these old contracts in the near future. Both Russia and Ukraine have started compensation payments, and already reap the benefits from this policy. Unless urgent measures to recover the people's trust are soon taken in Belarus, the whole system will continue to suffer for many years.

(ii) High inflationary expectations

Another reason affecting the slow acceptance of insurance is high inflation. In the short run inflation can be quite accurately measured and properly handled, but over the long run the uncertainty is quite high. Thus, the inflation effect can either be less or more significant depending on the term of the insurance policy. Short-term contracts like the ones covering car accidents, damage to property, or the interruption of a production process are defined not by the prevailing inflation level but by government regulations (compulsory insurance) or necessity ("Green card" or CASCO insurance). On the other hand, long-term life insurance contracts are not likely to be lucrative without properly addressing the issue of inflation, which has led to an increasing demand for the terms to be expressed in hard currencies. In many emerging economies the misperceived impact of inflation has led to the outflow of hard currency reserves and thus a suspension of the demand growth for locally provided insurance services. In Belarus this issue was partly solved by the permission to conclude long-term contracts in hard currency. However, devaluation risk is still eminent. High rate of inflation and its poor predictability yet count for the slow demand growth for life insurance in Belarus, which is impossible to tackle only through provision of the insurance contracts in hard currency.

(iii) Fraudulent pyramid schemes in the recent past

The appearance of multilevel marketing companies[3] is also harmful. For many people their first experience with life insurance policies came through pyramid schemes, which left them with a negative attitude vis-à-vis the insurance system as a whole. The creation of a multilevel marketing company or pyramid starts with the establishment of a wide sales network, membership in which requires the purchase of a 10-year policy in a hard currency. Newly fledged life insurance representatives then try to persuade others to join the company and so forth. For every newly recruited member the old member receives a commission, which is viewed as potential coverage of his or her own endowment. Eventually, the company collapses leaving its members with neither valid life insurances nor covered acquisition costs. Insurance premiums are usually transferred abroad and pocketed by marketing professionals. Despite being illegal, the practice of financial pyramids has left a generation of policyholders disillusioned with the whole concept of life insurance in many countries of Eastern Europe.

3.2. Problems for enterprises

Insurance is not viewed as a mechanism for the transfer of risk either by private households or by enterprises. Undoubtedly, the lack of an insurance tradition and of proper incentives account primarily for the slow expansion of insurance usage in the CIS countries; however, some regulatory peculiarities are not helpful either.

(i) Existing traditions and lack of incentives

Industrial property insurance did not exist in the former Soviet Union. State-owned insurance companies were mainly in charge of some limited compulsory lines. Industrial losses were traditionally covered by the state. Belarus inherited the monopolistic Gosstrah system in the early 90s together with the rules covering the insurance sector administration. In the mean time many insurance companies have emerged on the market. These currently offer a variety of personal, property and liability insurance products; however, the popularity of insurance services has not changed much. Enterprises still underestimate the significance of insurance as

[3] Some examples of such multilevel marketing companies are MMM in Russia, Yugoskandic and Dafiment Banka in Serbia, Caritas and FNI in Romania.

a powerful instrument of risk transfer, which can assist in promptly covering unexpected losses without the need to use internal operating capital, and thereby endangering their operations. Having managed without insurance for decades, many enterprise managers have yet to be convinced that they should now spend their cash on it. This is particularly true where an enterprise is operating at far bellow capacity and/or where state ownership removes the need for accountability to shareholders. Even though in some countries industrial insurance is arranged, usually it is not sufficient to cover the total replacement costs, since many policyholders only purchase insurance for an amount equal to the book value of the object at risk. Poor insurance traditions to transfer risks require a gradual change in attitude, which neither economists nor the government can bring about. Still, this lack of interest can be successfully tackled, for example through obligatory building and production line insurance such as have already been introduced in Russia, and through legislation related to taxation, which are under the direct control of the government.

(ii) Taxes

Essentially insurance payments are a cost of running a business, and thus are tax deductible in most countries. Belarusian enterprises had been treated in the same manner until a recent legislation amendment that discontinued this practice. According to the new regulation compulsory insurance remains cost deductible. However, voluntary property and liability insurance premiums are to be covered by the company's profits and cannot be expensed until the list and the amount of the competent insurance kinds is stated. Evidently, this legislative amendment will discourage private enterprises from purchasing voluntary insurance polices, thus assuming the risks themselves, or in the case of state-owned companies to remain a burden on the government. The new regulations will not be an obstacle for some companies. Casco, cargo, and freight insurance, and forwarder liability insurance comprise about 75 percent of all voluntary insurance premiums paid by enterprises, and are seen as an essential part of business operations. Since these kinds of insurances are not deductible anymore as insurance expenses, companies will buy insurance polices abroad and include their cost with other expense items in their financial statements. For example, cargo insurance and forwarder liability insurance will become part of the freight cost, while Casco insurance for vehicles under international leasing contracts will be transferred to the lessee and will be included in the lease payments. As a result domestic insurers will be deprived of additional business, while tax payments to the state will not be entirely collected anyway. The unfair treatment of voluntary insurance products will deteriorate demand even further; however, proper regulation could induce enterprises to transfer the risk to insurers. The tax regulation will unfortunately distort the real demand for insurance protection and will become a serious reason for impeding the development of the voluntary insurance market, by leaving industrial risks uncovered.

4. Problems concerning state regulation of the insurance market

Generally, the prevailing market trends are significantly influenced by existing legislation, regulations and enforcement. Advanced regulatory acts are able to handle the adverse effects of external and internal forces in a timely manner and can guarantee the required assistance to the market participants. The existing legal framework in Belarus, however, is contradictory[4]. Above all, there is no legislation that either directly or indirectly stimulates demand for insurance or that defines insurance principles. On the contrary, legal discrimination of the non-state insurance companies and restrictions being imposed on operations by foreign insurers are major stumbling blocks at this time.

[4] The Department of Insurance Supervision of the Ministry of Finance fulfils supervisory and regulatory functions, and controls the insurance company operations based on three main documents that require compliance from all insurance market participants. They are: Section 48 of the Civil Code passed in 1998, the Belarusian Presidential Decree #20 "On Improving the Regulation of Insurance Activity In the Republic of Belarus" dated September 28, 2000, and the Statute "On Insurance" enacted in June 1993 as far as it is not contradicted by Decree #20. The Belarusian insurance legislation regulates all insurance contracts described in Section 48 of the Civil Code, on the one hand, and insurance market operation (solvency, and financial sufficiency requirements for insurance companies), license orders, etc., which are defined in the Decree, on the other hand. The difficulties arise with the application, since the Statute was developed as a comprehensive and unique act, while the Civil Code was designed to handle only insurance agreements.

4.1. Discrimination against private insurance companies

To deal with stereotypes and habits prevailing for many years is rather cumbersome and usually takes much time. In some countries regulatory measures introducing compulsory insurance have become an efficient device for educating private individuals about the benefits of insurance in risks transfer. Another way is to provide support to economic sectors, which require insurance to be taken out in order to function. For example, the development of domestic mortgage markets increases the opportunity for mortgage lenders to require household insurance as a precondition for a loan. Likewise, the necessity to utilize leased equipment obliges a lessee to acquire property insurance in order to enter into a lease.

The main function of the insurance sector during the Soviet period was to administer compulsory insurance; therefore, the introduction of compulsory MTPL insurance has become a natural solution to tackling the problem of insurance deficiency in the automobile sector in Belarus. The MTPL insurance market has become the most advanced among the post-Soviet countries obtaining the largest coverage level and a high quality of services provided. The positive changes in this market led to better consumer protection, lowering risks, and improvements to insurance services.

The policy to return to a Soviet type of insurance adopted in 2002 by the Belarusian government has changed the situation. The provision of a socially oriented policy that protects the population is a positive tendency, although better protection could be achieved through private insurance contracts, as private companies are more efficient in reducing the economic costs of insurance provisions than are state-owned companies. The need for state regulation of the insurance market was explained, however, by the unwillingness of some private insurance companies to take certain risks because of non-profitability, or because of the inability of insurers to assess the occurrence probability of insured losses. Thus compulsory insurance became the privilege of the state-owned company Belgosstrah with the exception of the motor third party liability (MTPL) insurance, which can be provided by companies with a state share of more than 50 percent[5] (Table 2).

Table 2. The distribution of insurance companies on the insurance kinds provided, 2002[6]

Capital structure, % of shares in state hands	Number of companies	Kinds of insurance provided	Market share, %
100%	2	All kinds of insurance	56.2
50% - 99%	6	Voluntary insurance and MTPL	11.2
of which with the foreign share	1		
below 50%	21	Voluntary insurance	32.6
of which with the foreign share	13		

Source: Belarusian Insurance Union.

However, the unfair treatment of the insurance market participants in the MTPL insurance field is not legitimate and there are no grounds to consider that market transformation may bring significant economic benefits. Belgosstrah is the least profitable insurer on the market in terms of voluntary insurance provision. The share of compulsory insurance premiums in the Belgosstrah portfolio is much higher than for private companies, which implies decreasing costs for each BYR of insurance premium. Nevertheless, the loss ratio (expenses per unit of premium) was 20-25 percent for private insurers compared to 31 percent for Belgosstrah. The profitability ratio leads to the same conclusion. Private insurers collected BYR 49 m per employee while Belgosstrah took in only BYR 31 m per employee.

Currently, private insurance companies actively reduce tariffs to attract clients and to maintain a certain level of premium collections. Yet the amount of the claims paid outpaces those of previous years. Because the claims payable increase faster than the premiums received, private companies have to increase their reserves to satisfy probable future claims and reduce the risks they incur. As a result, their tax base is reduced, and the government collects fewer taxes than it would otherwise.

5 Act No 1258 "On compulsory motor third party liability insurance" adopted by the Council of Ministers of the Republic of Belarus on October 3, 2003.

6 Life insurance companies are not included in the table. There are six life insurance companies currently operating in Belarus, one of which is state-owned.

The analysis presented justifies equal treatment of all insurance companies as the basis for reforming the entire insurance sector. Return of the MTPL insurance to private companies is vital for a competitive market development, and not because excess profits might be realized in the MTPL insurance field. Recent data by the insurance companies shows that the profitability of MTPL insurance decreased over time. Therefore, MTPL by itself is not that important as are the other benefits that accompany it. Usually insurers prefer to purchase a complete insurance package. For example, purchasing MTPL insurance together with Casco insurance and/or CMR insurance (liability of haulers and forwarding agents) reduces the price and allows customers to pick the optimal insurance program. Compulsory insurance lines such as MTPL insurance are one of the best leverages for improving complimentary insurance products in developing markets. Because private companies were cut off from offering MTPL insurance, only the state-owned companies can offer both compulsory and voluntary insurance, while private companies are left only with limited voluntary insurance lines.

The international practice in insurance market regulation does not justify such a practice; instead it is based on the following principles:

- No compulsory insurance lines should be limited only to insurers specifically designed by the government.
- No insurance company should obtain full state protection.

Demonopolization of compulsory insurance is considered the most efficient way of insurance management. As a rule, compulsory insurance is either unprofitable for insurers or the insurance premiums are stated by the government. Furthermore, state discrimination vis-à-vis private companies will adversely affect the insurance market. Although there are some benefits with compulsory insurance implementation to stimulate demand (as in the case of MTPL insurance), increasing the number of compulsory insurance lines will undoubtedly be perceived as an additional expense by both private households and enterprises. Eventually this might lead to the reverse effect where voluntary insurance lines are foregone while compulsory lines still exist because of strict governmental regulation. Furthermore, the imposition of compulsory insurance has proven to be the least effective way to educate people and promote an environment in which insurance is seen as desirable. The best alternative is to facilitate economic activities, which require insurance coverage to provide the indispensable reduction of the inherent risks. Insurance coverage has to become a concurrent condition to conducting building and manufacturing work, offering international freight traffic, rendering advocacy services, operating objects that pose hazards to life, health, property and the environment, and many other types of economic activities.

4.2 Discrimination against foreign insurance companies

Foreign investment could alleviate the situation on the market if the government entrusted foreign insurers to develop various insurance lines as well as provide compulsory insurance. Generally, foreign capital brings know-how, new approaches to running a business, knowledge, and experience. According to the present regulations, foreign insurance companies can open subsidiaries in Belarus and can invest in companies already existing in the country. Such an investment is, however, not allowed unless the foreign company has been at least ten years in the insurance business or had at least two years of such experience in Belarus. Attraction of the foreign insurance companies could have properly addressed both the general distrust in the insurance system and the harmful activities of multilevel marketing companies in the best way possible. However, unfair treatment of foreign investors prevents achievement of the desired results.

The minimum capital requirement favours domestic companies. Foreign companies have to possess USD 800,000 of capital versus USD 200,000 required of local non-life insurance companies and USD 400,000 for life insurance companies. This difference might not be a serious problem for many international insurance corporations, which may have to comply with even stricter regulations in their home countries, were it not for the other barrier. The government of Belarus is entitled to stop issuing insurance licenses to foreign companies, once the total foreign share in all insurance companies is above 30%. Moreover, according to Decree #20 insurance companies with foreign ownership exceeding 49% can not provide life insurance, compulsory insurance, insurance related to the fulfilment of delivery contracts, rendering services and carrying out contracts for state needs, and insurance of property interests in the Republic of Belarus.

As compulsory insurance lines are fully under government control, it is rational to attract foreign capital into the voluntary insurance field. However, equal requirements for domestic and foreign companies must first be established. In most countries, the minimum capital requirements are much higher than in Belarus[7]. Since it will be difficult to increase the statutory funds for domestic companies, special preferences will have to be imposed. Overall, these measures should promote competition and increase insurance solvency, which in turn should decrease the insurance tariff burden on individuals and on enterprises, broaden the availability of insurance services, and increase the general commitment to insurance.

Permitting foreign insurance companies to operate in Belarus will also become a positive signal for furthering foreign investment in other economic sectors. Centuries-old practices have accustomed international companies to comprehensive risk coverage in order to secure their business activities. Moreover, many world-renowned corporations are permanent customers of specific insurers whom they prefer to deal with no matter in which country they operate. It is essential to attract foreign insurers who will be equally treated in insurance services provision for brining new investment inflows to the country. A gradual insurance market liberalisation in the light of Belarus' accession to the World Trade Organization (WTO) is required to further develop the insurance market.

5. Policy recommendations

The return to the insurance practices of the Soviet period, the inclination of the Belarusian government to over-regulate the insurance market, allowing Belgosstrah a monopolistic position, and the discrimination of foreign market participants constrains competition and hampers the sound development of the insurance market. Thus, from the analysis presented in this paper, we would suggest the following to improve the insurance activity:

- Proposal 1: A scheme for the gradual payout of compensation on insurance polices concluded before 1992 should be established. The experience of neighbouring countries provides evidence of the positive impact of such actions on the restoration of popular trust in the insurance system and on fixing the demand problem.
- Proposal 2: Voluntary insurance should once again become tax deductible for enterprises. Not being used to the practice of risk transfer to third parties and having relatively low earnings, enterprises are reluctant to insure their loss risk exposure out of their profits. Top management views the non-deductibility of voluntary insurance payments as an additional tax burden that can be easily forgone. Thus only the equitable treatment of all the insurance premiums as expense items will set the right incentives for enterprises.
- Proposal 3: Using compulsory insurance as a way to inculcate an insurance culture in people should be renounced. Obligatory insurance should be reserved to fields where there exists an inability to be involved in or perform certain economic activities such as advocacy, international freight traffic activities and so forth. Legislative amendments regarding these activities are needed to foster insurance market development through providing the proper incentives to all market participants.
- Proposal 4: Remove the discrimination against private insurance companies. The right to offer compulsory insurance services should be given to all insurance companies irrespective of their capital structure, which relates to the criteria required for rendering services and to financial standards (solvency criteria, minimum capital requirement and so forth). MTPL should be returned first, since private insurers have already confirmed their profitability and effectiveness in this field. However, demonopolization of compulsory insurance does not imply that compulsory insurance should be abandoned at the discretion of the insurance companies. The state should run a tariff policy, so as not to allow tariffs understating, which could lead to insolvency and insurance market destabilization.

[7] In Ukraine, the minimum capital requirement is EUR 1 m for non-life insurance companies and EUR 1.5 m for life insurance companies. In the Czech Republic these figures are between USD 0.83 m and USD 4.9 m depending on the insurance services provided, while in Slovak Republic they are between USD 1 m and USD 4 m.

- Proposal 5: Remove the discrimination against foreign insurance companies. Amendments to the Belarusian legislation providing equal treatment of both domestic and foreign companies should become the government's priority. Protecting domestic insurers results in new technologies not being available, which usually accompany foreign capital. The further elimination of existing barriers to the entrance of foreign capital would bring the legislation up to international standards and simplify compliance with the requirements of the World Trade Organization (WTO).

Only when the government ensures that all market players are equal, when it provides compensation for losses previously incurred by the population, when it sets the proper incentives for enterprises, will the national insurance system foster the development of insurance markets and facilitate sustainable economic growth.

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