



PROBLEMS OF INSURANCE BUSINESS DEVELOPMENT IN UKRAINE

By Mykola SUNGUROVSKIY

The success of Ukraine's insurance business depends on the co-ordination of the interests of its main players: individuals and legal entities, as insurance service consumers and insurance premium payers; insurers (domestic and foreign), as "producers" of insurance services; and the state, as guarantor of the wellbeing of its citizens and the economy's efficiency.

UCEPS experts asked the insurance market players to assess its current status, and present their views on the possible ways of reforming Ukraine's insurance business.

Representatives of authorities, insurance companies and enterprises were invited to take part in the discussion. Our "round table by correspondence" welcomed:



Andriy Lytvyn,
Head, Financial
Institutions and
Markets Department,
Ministry of Finance
of Ukraine



Yuriy Lakhno,
President,
"GARANT-AVTO"
Ukrainian Joint-
Stock Insurance
Company



Halyna Tretyakova,
Board Chairman,
"ASKA-Zhyttia"
Ukrainian Joint-Stock
Insurance Company



Katerina Guzik,
Marketing Manager,
Connect Insurance
Services Ltd.



Serhiy Pereloma,
Deputy Financial
Director,
"Kryvorizhstal"
Integrated Plant

UCEPS experts asked the participants three questions:

1. What factors impede the development of Ukraine's insurance business?
2. What is your idea of the strategic directions for reforming Ukraine's insurance market?
3. What priority measures should be taken to improve the efficiency of Ukraine's insurance business?

Presented below are the answers to those questions, UCEPS' poll results reflecting public opinion on some insurance market problems, and conclusions based on the results of this "discussion by correspondence".

FACTORS THAT IMPEDE THE DEVELOPMENT OF UKRAINE'S INSURANCE BUSINESS

Andriy Lytvyn. Although the pace of the insurance sector's expansion produces one of the best indicators in Ukraine's economy, the insurance business' potential is far from being exhausted. The main reasons for this are: (1) absence of the state concept (and subsequent lack of predictability) of the insurance market's expansion; (2) insufficient transparency of the market; (3) its low capitalisation level; (4) a somewhat distorted sector structure; (5) factors unfavourable to cumulative insurance (tax pressure, the population's loss of confidence in the financial structures, etc.).

Halyna Tretyakova. Ukraine has a population of over 49 million, but voluntary insurance covers no more than 10% of that number, while in Europe, every third individual has a life insurance policy. In the former USSR, 20% of the population insured their lives; in Ukraine, that figure exceeded 30%. The state should be extremely interested in the development of insurance, especially life insurance, as "long-term" funds are accumulated in this sector. The expansion of privatisation and emergence of new real proprietors among Ukraine's citizens will be conducive to the development of the insurance business. Therefore, the potential of Ukraine's insurance market is relatively high, but today, the necessary conditions don't exist for its development. There are several reasons why.

First, the state does not have a clear idea of an efficient insurance system model, that is why

the insurance market's structure is fragmentary and developing mainly "from beneath". This trend is often based on incompatible interests, making it difficult to predict the main market development tendency.

Second, there are no legally fixed rules and mechanisms of the insurance market activity. For instance, legislation does not set the norms for indemnification of damages inflicted on third parties, nor does it provide a clear definition for different kinds of insurance; in the medical insurance sector, standards for illness and treatment methods require a clearer definition.

Third, state control mechanisms over the insurance business are unstable and ineffective. This is proven out by the liquidation of the Insurance Business Control Committee, with its functions being assigned to two divisions of the Financial Institutions and Markets Department at the Ministry of Finance of Ukraine. In my opinion, this leads to the lowering of the status (and, consequently, limitation of the powers and capabilities) of the only state body dealing with state policy formation in the insurance business and control over its implementation.

Fourth, the population has no insurance tradition. People lack information, that is why the demand for insurance services remains low.

Yuriy Lakhno. Throughout the world, the insurance system works efficiently not only for its primary purposes (i.e., for the protection against risks), but also as a means for accumulating investment funds. In Ukraine, this system doesn't even perform its primary functions, as the aggregate capacity of the insurance market does not exceed the capital of one large insurance company in Poland. In Ukraine, the investment situation looks paradoxical. On the one hand, annual foreign investments don't exceed \$700 million, and are unlikely to grow noticeably in the near future.

On the other hand, tens of billions of dollars are needed for investment, and the state has no way of filling this gap. Greece, whose population is five times smaller than Ukraine's, is a good example for showing what Ukraine is losing. In Greece, non-state insurance companies appeared on the market in 1989. In 1998, total insurance premium amounts reached 1.85% of the GDP (\$2.3 billion); insurance companies invested some \$4.2 billion into the national economy — an amount comparable to Ukraine's state budget.





What hampers Ukraine's insurance business? The reasons are many, but three of them deserve the most attention.

1) *delay in the improvement of the legislative basis*. Our estimates show that, due to imperfect laws and delays in adopting them, Ukraine fails in obtaining around \$200 million a year in the insurance sector alone. Meanwhile, a package of insurance business-related draft laws was present-



ed to the Verkhovna Rada for review quite some time ago, but its adoption is not in sight yet;

2) *inconsistent formation of legal regulatory base*. For instance, a government resolution on obligatory third-party liability vehicle insurance was adopted. However, it was not fully implemented, since no relevant changes were introduced to the regulatory documents defining the mechanisms for control by State Automobile Inspection officers;

3) Ukraine's insurance market is dominated by small companies: out of the present 263 companies, only five or ten are financially sound. *The limited competitiveness of small companies creates preconditions for the outflow of funds abroad* through reinsurance mechanisms, or encourages assets into the "shadow economy". The state is not interested in the agglomeration of insurance companies and the consolidation of insurance reserves.

Katerina Guzik. The growth of insurance premium volume by 30% in 1999 gives the reason for optimism. However the main problem remains that the majority of Ukrainians (both legal entities and individuals) do not consider voluntary insurance necessary. It is basically undeveloped and the majority of insurers are Western managed companies. Among Ukrainian insurers the focus is on voluntary insurance. There are more than 260 insurance companies in Ukrainian narrow market — sometimes it seems there are more fishers than fishes. This causes hard competition when insurance companies are

forced to use dumping tariffs which are sometimes of symbolic value. Therefore, it is not surprising that the companies are reluctant to acknowledge the fact of insurance accident and the sum of damages. The consumer's attitude towards such insurers' conduct is negative. This is a vicious circle which needs to be broken.

STRATEGIC DIRECTIONS FOR REFORMING UKRAINE'S INSURANCE MARKET

Andriy Lytvyn. Insurance reform's main directions are: (1) strengthening of competition on the insurance market according to civilised standards; (2) growth of the potential of national insurance companies; (3) development of cumulative insurance; (4) raising the insurance culture, confidence of business entities and individuals in financial institutions in general, and insurance companies in particular. These developments will lead to the insurance market becoming one of the main sources of investments into Ukraine's economy.

Halyna Tretyakova. The strategic goal of the insurance system reform is to implement the Western model while taking into account specific features intrinsic to Ukraine. I would divide the steps required for achieving this goal *into three directions: legislation, tax regulation, and strict delimitation of functions of the state and insurance market operators*.

Problems that need to be resolved *legislatively* include a methodological definition of the kinds, mechanisms, norms and standards of insurance, including life insurance. The Law of Ukraine "On Insurance", the Civil and Administrative Codes, and other regulatory legal acts need to be improved. Contradictions in the insurance regulatory-legal base lead to violations of insurance licensing rules which, in their turn, force huge sums of money into the "shadow" sector. While the capacity of Ukraine's insurance market stands at around \$250 million, today, actual insurance accounts for only \$80 million of that amount.

Ukraine's *taxation system* does not encourage the insurance business. A high tax (30%) on companies engaged in life insurance, and the uncertainty in matters of precious metals used in banking transactions, create a situation where insurance reserves are not covered by assets. This is directly related to insurance risks, and destroys confidence in insurance companies. Furthermore, the state's tax and preference policy creates unequal conditions for insurance market operators, artificially channelling cash through the

public sector, where the efficiency of its use is low. The situation could be improved by decreasing the above-mentioned 30% tax, improving the preference policy, and introducing the tender system for obligatory types of insurance.

The functions of the state and insurance company should be clearly delimited. The state should concentrate on obligatory insurance, involving budget payments, and exercise control over the insurance business. In Western countries, for example, state control is very tight, and the state can initiate the replacement of insurance company managers. In Ukraine, insurance companies could assume responsibility for those types of obligatory insurance where payments are not made from the budget, and for all types of voluntary insurance.

Yuriy Lakhno. The strategic directions for reforming Ukraine's insurance market are: (1) improving the regulatory-legal base; (2) perfecting the mechanisms for the establishment and operation of insurance companies; (3) improving the forms of the state's presence on the insurance market. Relevant measures should be all-inclusive. The main targets should be: growth of insurance reserves from the present 0.4% of the GDP to 2-3% of the GDP within 3-5 years, which could bring an additional \$100-200 million of investments into Ukraine's economy annually; estab-



lishing clear and uniform rules for all players in the insurance business; legislation support of Ukrainian insurance companies' competitiveness.

Katerina Guzik. The strategy has to take into account three factors. First, there is a need to attract more Western insurers into the Ukrainian market with their capital, management and experience on insurance market. Secondly, the minimum amount of authorised fund should be increased in order to support national insurers that reached both success and customer's trust. That will not lead to the misuse of capital concentra-

tion since it already exists. Thirdly, the support of insurance brokers and agents should be assured — in Western countries they provide for significant amount of insurance contracts entered. And last, but not least: all this should be based on a viable State programme.

PRIORITY MEASURES THAT WILL IMPROVE THE EFFICIENCY OF UKRAINE'S INSURANCE BUSINESS

Andriy Lytvyn. Liquidation of the Insurance Business Control Committee and the assignment of its functions to the Ministry of Finance of Ukraine marked a new stage in the development of Ukraine's insurance market. Tribute should be paid to the Committee for its role in the establishment of a control system over insurers, and the prevention of bankruptcies and financial collapses. Taking into consideration the Ministry of Finance's potential, not only will control over the insurance market be retained, but the institutional ability to influence the strategy of its development will improve.

The new stage should begin with the creation of a qualitatively new state concept of insurance. The prospect and concrete targets in the insurance market's development, the criteria and mechanisms for monitoring and regulating the insurance business should be defined. Furthermore, the insurance business cannot expand without the establishment of direct communications between the Government and insurance market players.

Halyna Tretyakova. The new draft Law of Ukraine "On Insurance" already accounted for the key proposals. This law should be adopted without delay. Regulatory acts should set the implementation stages of civil liability insurance, co-ordinate them with the results of economic reform and the advance of the living standards.

Yuriy Lakhno. First steps won't require significant amounts of extra funds, and will presume mainly organisational and legislative measures. The following can be considered priority steps:

1) *an increase in the insurance companies' authorised funds (to 0.5-1.0 million euro) and amendment of their licensing rules.* Provisions should be made that companies whose authorised funds exceed 1 million euro can apply for all-around insurance licences, while those with authorised funds between 0.5 and 1.0 million euro can receive licences for specific types of insurance only;

2) *encouraging the concentration of insurance companies' capital by eliminating excessive restric-*



tions on their acquisition of other companies' shares. At present, national insurance companies can acquire only a 5% share interest, while foreign insurers are entitled to 49-50%. This limits not only the activity of domestic insurance companies, but also their market competitiveness;

3) *encouraging the competitiveness of domestic insurance companies.* At present, 95% of life insurance premiums in Ukraine is collected by foreign insurance companies, and eventually returns to us in the form of interest-bearing credits. Furthermore, due to the operation of small companies, significant funds used for risk insurance also remain abroad (through the reinsurance mechanism), are laundered, or move into the "shadow" sector. The amount of funds flowing out of Ukraine totals \$80-100 million a year. This factor has become a threat to national security. The Government should adopt a resolution regulating the risk reinsurance process in order to provide for the placement of relevant funds on Ukraine's insurance market, and allow reinsurance via foreign insurance companies only where domestic insurers are unable to assume the risks;

4) *improving legislation to encourage insurance company activity.* Legislative definitions of different insurance types, and a division between obligatory and voluntary insurance would help in reaching this goal. Obligatory insurance should encompass: medical expense insurance; pension insurance; third-party liability vehicle insurance; extra professional risk insurance; state individual insurance of power-structures personnel. The Civil Code should provide for a third-party liability mechanism. This will ensure the protection of victims when the guilty person's solvency is limited, and encourage the demand for insurance services;

5) *regulating insurance company currency operations.* The ban on insurance companies' foreign currency reserves causes the outflow of capital abroad. Insurance companies should be allowed to keep their insurance reserves in hard currency. Insurance companies propose depositing such reserves in the National Bank of Ukraine on acceptable terms (LIBOR) in order to prevent taking currency out of circulation and the devaluation of the Hryvnia.

First of all, we should understand that without improvement of the economic situation, there will be no broad demand for insurance services from the population. Second, no economic revival is possible without investments, including those accumulated in the insurance sector. Third, Ukraine's insurance market already possesses the potential for investing in the national economy. No additional budget expenses are required for attract-

ing available resources: the only thing needed is legislation designed to stimulate the insurance business. According to expert estimates, implementing the above proposals will allow Ukraine to invest an additional \$400-500 million a year in its economy.

THE OPINION OF AN INSURANCE SERVICES CUSTOMER

Serhiy Pereloma. The issues of life and health insurance for employees are vital and simultaneously tortuous for every enterprise. The Law of Ukraine "On Taxation of Enterprise Profits" allows for charging expenses on insurance of fixed assets, enterprise property, goods, other commercial and financial risks to a prime cost account. However, payments made as per the employee life and health insurance policies cannot be charged to a net expenditures account.

In my opinion, the life and health of employees are no less important to an enterprise than the



safety of its fixed assets. It is normal practice throughout the civilised world to insure employees at enterprises' expense. Even company losses related to the deaths of their CEOs can be insured. Top priority, therefore, is attached to personal insurance. I think that the same approach should also be implemented in Ukraine. Proper conditions are required for this, and foremost, in the area of taxation. Should relevant changes be made in applicable Ukrainian laws, allowing for payment out of an enterprise's gross expenditures under an employee's private insurance policy, everyone will be in the money. *Employers will be able to allocate more funds towards insuring their workers, employees will get the required level of social protection, and insurance companies will increase their revenues from such important types of insurance as personal and life insurance. In general, the Ukrainian population's insurance culture will improve.*

The social aspect of this problem is also important. Quite often, a person's standard of liv-

ing does not allow him to earmark insurance expenses from the family budget. For many, it is problematic acquiring necessary medication and paying other medical expenses. An insurance policy will help to resolve this problem. *And when an employer is ready to assist in solving an employee's problems, doesn't he deserve certain preferences?* Permission to charge insurance payments to a net expenditures account will somehow stimulate such insurance. For instance, the "Kryvorizhstal" Integrated Plant employs around 45 thousand workers. At minimum tariff rates, their accident insurance will cost the works around UAH 500 thousand, given the insignificant amount of insurance liability (UAH 1000). Those are minimal expenses, but if medical insurance is involved, this amount will rise several dozen times. Such a situation is typical for any enterprise.

INSURANCE PROBLEMS: THOUGHTS OF UKRAINIAN CITIZENS

In order to determine the attitude of Ukrainians to the problems that are the subject of



this discussion, the sociological service of the Ukrainian Centre for Economic and Political Studies conducted a poll throughout all of Ukraine's regions¹.

The results of the poll demonstrated the *reluc-*

tance of people to use the voluntary pension insurance offices. At present, only 3.1% of those polled is ready to invest their money in this type of insurance. The main reasons for their refusal included mistrust in non-government pension funds (13.6%) and the certainty that the money will be stolen (18.2%). *More than 40% of individuals considers this question unimportant because of the lack of money.* A majority of those polled (over 63%) is not tempted to use insurance services, even if insurance companies are allowed to receive premiums and repay compensation in hard currency. It is not unusual, therefore, that *only 8.4% of those polled is now covered by voluntary insurance.*

The overwhelming majority of respondents does not trust any financial institutions, whatsoever. The "leaders", by level of mistrust, are: insurance companies — 88.7%; insurance funds — 85%; commercial banks — 83.3%. They are followed by state insurance companies (77.5%) and funds (70.2%). Most trusted are state banks: 24% of those polled is ready to invest in these structures.

Among insured individuals, most popular are state insurance companies (77% of those polled), only 8.2% of the insurance policies are executed with non-government insurance companies. And even in this category, not everyone is sure of the usefulness of insurance. Only 55.8% of respondents in this category cherishes the hope that the invested money will be repaid in either a smaller or larger amount.

According to 26.8% of those polled, the State Social Insurance Fund should become an independent entity, 25.2% supports the idea of transferring it under public administration, and only 17.4% is sure that the Fund's assets should be managed by the Federation of Trade Unions of Ukraine, as earlier.

One of the factors underlying the low demand for insurance services is the *Ukrainian population's low insurance culture.* Only 3% of those polled considers pension insurance their business, another 10.5% is ready to share this headache with the state, and some 80% of individuals is sure that this problem should rest solely with the state and the employer. 83.5% of individuals does not know what a joint pension scheme is. One-third (33.1%) of those polled is unaware that their enterprises pay wage and salary charges to the Pension Fund. 80% does not know what "third-party insurance" means. After this was explained, 68% of those polled said that they considered it expedient to provide this type of insurance in voluntary, rather than obligatory form.

¹ The poll was held between March 25 - April 5, 2000; 2012 individuals were polled.



CONCLUSIONS

The responses of insurance experts and the public opinion poll results make it possible to classify the problems of Ukraine's insurance market development and the possible ways for solving them.

Ukraine's insurance market possesses significant potential, but its employment is hindered by the absence of a state concept for developing this sector, an economic crisis, an imperfect regulatory-legal base, the low standards of living and, consequently, a low effective demand for insurance services. Other important hindering factors include the poor insurance culture of Ukrainians, and the low level of confidence in insurance companies.

The Government and representatives of leading Ukrainian insurance companies are ready to join efforts for the population's social protection and the investment of people's savings into Ukraine's economy. One of the factors impeding constructive collaboration is the parish pump, corporate interests aimed at preserving the state's insurance sector monopoly, and the establishment of stable and transparent insurance market rules.

According to the polled experts, the strategic directions for reforming Ukraine's insurance system, and the steps that would encourage its development, are the following:

1. Creation of a regulatory-legal base for the insurance market's development:

- a) standard legislative definition of types, mechanisms, norms and standards of insurance, including life insurance;
- b) legislative delimitation between obligatory and voluntary insurance;
- c) amending the Civil Code in order to provide for a third-party liability mechanism;
- d) immediate adoption of amendments to the Law of Ukraine "On Insurance" proposed by insurers.

2. Enhancing the efficiency of state insurance business regulation:

- a) conceptual definition of the targets of the Ukrainian insurance market's development, the stages and mechanisms for its convergence to European standards;
- b) removing departmental barriers on the insurance market, introducing the tender system to select operators for obligatory types of insurance;
- c) easing tax pressure on life insurance, permitting enterprises to charge expenses on their employees' life insurance to a primary production cost account;
- d) improving the population's paying capacity in order to encourage the development of cumulative types of insurance;
- e) improving the efficiency of state control bodies supervising the insurance business; perfecting their operational procedures;
- f) delimiting the powers of state and joint-stock insurance companies concerning obligatory and voluntary types of insurance.

3. Harmonisation of relations on insurance market:

- a) permitting insurance companies to keep their insurance reserves in hard currency, and deposit them with the National Bank of Ukraine on acceptable terms;
- b) raising the competitiveness of domestic insurance companies by removing discrimination against them on the reinsurance market;
- c) encouraging the concentration of insurance company capital, improving their structure through the elimination of excessive restrictions on their acquisition of other insurance companies' shares.

According to the polled experts, such measures would result in better social protection of the population, and growth of insurance reserves from the present 0.4% of GDP, to 2-3% of GDP within 3-5 years, which could bring an additional \$100-200 million of investments into Ukraine's economy, annually.