Transnational Reinsurance Corporation

A major reinsurance society to be set up in Russia

Russian reinsurance market is as good as empty:

There are 22 minor reinsurance companies in Russia,
their combined assets being only $ 40 million.
Shaping reinsurance market in Russia is the order of the day.
Investments in Russian reinsurance are promising.

The project:

A group of Promoters
have worked out a project
of a reinsurance company with
the initial authorized share capital of

US$ 100 million

Prospects:

36 scenarios of the Company's behavior
have been analyzed to show that
even under the most unfavorable of conditions
the Company will generate good profit.

Moscow 1998

Russia's just so full of opportunity.
It's like (being) a kid in a candy store.

William G. Lowrie
President of Amoco Production Co

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Investing in Russian reinsurance

SINCE 1991 RUSSIA HAS BEEN PAINFULLY MOVING FROM A CENTRALLY PLANNED ECO-nomy to a free market, striving to be reintegrated into the world community. The intervening years have seen deep economic, political, psychological, and social transformations of the country, with virtually every aspect of life affected by those dramatic developments. What other nations have achieved through centuries Russia has had to grasp in a matter of years, sometimes months. And so everything in the country is extremely dynamic and fluid. This also concerns insurance and especially reinsurance markets.

Tradition

Before 1917 Russia was **one of the fastest developing economies in the world**, its growth rate in 1914 being **higher than that of the United States**. Europe's largest fair at Nizny Novgorod commanded most of European prices. Russian industrialists and merchants were a match to their foreign counterparts. The natural development was disrupted in 1917, when Russia became one of the first totalitarian societies with a closed centrally planned economy.

The Soviet central planning system, with its emphasis on heavy industries and collectivized agriculture, favored cumbersome huge production associations and had centralized distribution mechanisms. There were virtually no horizontal relationships among enterprises.

Everything centered around the so-called Plan, a production target that was valued above all other considerations. Planning targets were delivered from the center and production results analyzed at the year-end. This practice resulted in a very low worker motivation, little prospect of job loss, low productivity and competitiveness. Both sale prices and costs of production were never an issue for the enterprise manager to justify, and marketing and advertising did not exist at the enterprise level.

Transition to a market economy

Gorbachov's reforms returned Russia back to a market economy, but failed to educate the population in the elements of market and business. After the disintegration of the USSR **Russia has been one of the most resolute countries of the former USSR in moving to a market economy**. But the Soviet Union was run with objectives and assumptions so qualitatively different from those prevalent in a market system, that the transition has been an extremely difficult task. And it still is.

To begin with, the Government initiated a large privatization program, removed the infamous "iron curtain," and reduced its intervention (both subsidies and protection) since 1991.

Privatization

The privatization process proceeded so quickly that in 1996 **the private sector made up about 50%** of both GDP and employment, and the **public sector share of GDP in 1996 was only 30%,** a lower percentage than in most developed countries.

Removal of "iron curtain"

Although in Russia it was nothing as spectacular as the pulling down of the Berlin Wall, the opening of the Russian borders makes itself felt in virtually every aspect of life. One sees many foreign-made goods in Russian stores, Russian businessmen are free to travel and visit places the world over, Russian students win scholarships at foreign colleges, majoring basically in economics, business, marketing, and law. This is all extremely **beneficial psychologically and educationally for young Russian managers**, who are extremely receptive to advanced business practices.

Reduced state intervention

Virtually overnight most factories, which used to be just production units, found themselves in a situation where jobs are not guaranteed by the state, raw materials are no more delivered at fixed prices, industrial activities are severed from social services. To become real market-oriented production companies they have now to understand that to compete in the new environment they have to develop managerial, marketing and advertising skill, that output quality (not just quantity to meet the "plan" target) comes to the fore, that a new motivation scheme is needed. To survive they have to adept to the situation.

Personnel

The main problem of this incipient market culture is the **shortage of managers, marketeers and other operators**, who make a market economy tick. The Soviet system had millions of party and industrial bureaucrats, who used to be extremely good at "passing on the buck." Good decision-makers and analysts were in short supply. On the other hand, the intellectual and **educational potential of the population is extremely high**.

When private enterprise became legally possible in this country, most would-be entrepreneurs had to begin from scratch, by trial and error. This accounts for the high mortality rate among young Russian companies including insurance companies earlier on and for the fact that **the most successful are young Russian businessmen who have been educated in the elements of business in the West.**

Insurance in Russia

The first insurance company in Russia was established in **1827**. By 1917 Russia had a well developed insurance market and high insurance culture with millions of Russians insured in one form or another.

In 1896 the first Russian reinsurance company was set up by Russian insurance companies that had excessive assets. It was highly successful.

In the former USSR everything belonged to the state, including Gosstrakh, the only insurance company in the country. There was also Ingosstrakh that was involved in international insurance operations. **The insurance culture declined dramatically.**

Russia is now having a **renaissance of its insurance industry**. It is still struggling with its growing pains, the main problems being inadequate insurance legislation, low insurance culture, lack of insurance experts, and the low capacity of Russian reinsurance market.

Russian reinsurance market

At the moment there are 22 minor reinsurance companies in Russia. Their combined assets are around $30 million, with the result that **many risks are reinsured abroad.**

It is safe to say that the **reinsurance market in Russia is as good as empty.**

Prospects

Russian insurance industry is **one of the few successful sectors of the national economy**. It is currently attracting much attention of the banking and investment communities, especially now that inflation in the country has subsided.

Foreign investment legislation

A concise **overview of Russian foreign investment legislation** is given in the Appendix.

It is to be noted here that work is under way to **bring it more in line with international norms and regulations.**

Transnational Reinsurance Corporation

A group of Promoters have worked out a proposal to set up a major reinsurance company

THIS JOINT-STOCK REINSURANCE SOCIETY (THE COMPANY) WILL BE BASED ON INTERnationally accepted principles of reinsurance business and at the same time its structure, strategy and management will reflect **some Russian business traditions**. It will draw on the **best brainpower** available in Russian insurance and reinsurance markets to solve some problems dictated by the peculiar Russian situation. Specifically, it will act as **consultants** to governmental committees and initiate bills.

It will welcome among its shareholders **Russian and foreign companies** alike.

Promoters

The group of Promoters consists of **representatives of major insurance and average companies, research and analytical groups, and the Treasury**.

Commercial Strategy

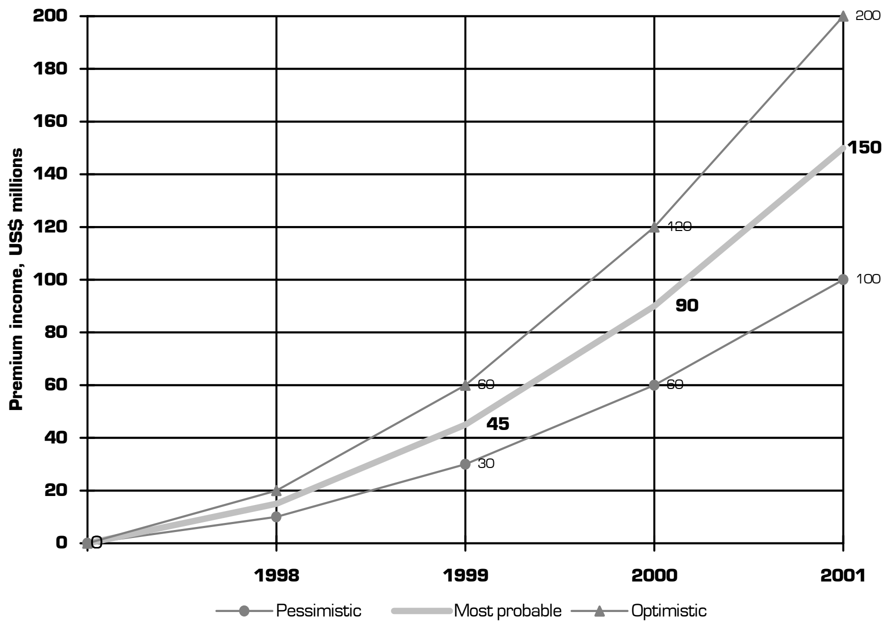
As customary in reinsurance industry, the Company will in addition to reinsurance be quite active **investing assets in stock**, especially in securities and stock of Russian **undervalued** blue chips. There are plans to buy some interests in Russian and international insurance and reinsurance companies, and **control interests** in medium-size companies.

Predictions

To arrive at meaningful predictions of the Company's activities **36 scenarios** have been analyzed. The parameters varied were the reinsurance premium income, average profitability of investment in Russian markets, and loss ratio of reinsurance operations. Even under the most unfavorable of conditions, the **Company will generate profit**. (The calculations are available.)

Reinsurance premium income

We will only consider here the **premium income**, using three assumptions: most probable, pessimistic, and optimistic ones. The income till the year of 2001 behaves as follows:



Assuming the loss ratio to be 50%, the income will be (US$ million):

Assumption	**1998**	**1999**	**2000**	**2001**
Pessimistic	2.9	8.7	17.4	27.8
Most probable	**4.4**	**13.2**	**26.4**	**42.2**
Optimistic	5.8	17.4	34.8	55.7

Other assumptions:

- **Starting** costs — **US$ 1.5 million**;
- Average **profitability** of investments — **LIBOR + 4;**
- **Overheads** and operating costs — **10%.**

Assuming the average profitability of investments of the assets being LIBOR + 6 and dividends paid annually in the amount of all the profits, provided that the authorized capital will be increased in 1999 to US$ 500 million, the earnings of the Company will be **(in US$ million):**

Assumption	**1998**	**1999**	**2000**	**2000**
Pessimistic	14.6	20.4	75.9	86.3
Most probable	**16.1**	**24.9**	**84.9**	**100.7**
Optimistic	17.5	29.1	93.3	114.2

Or in per cent of the amount of assets:

Assumption	1998	1999	2000	2001
Pessimistic	14.6	20.4	15.2	17.3
Most probable	**16.1**	**24.9**	**17.0**	**20.1**
Optimistic	17.5	29.1	18.7	22.8

Structure

The Company will have the structure of **a fairly traditional international reinsurance company** that will be **adapted** to the fast-changing Russian environment. It will have the Board, consisting of Russian and foreign Directors, that will be responsible for general policy and administration, including the resolution of any conflicts, the overall supervision of reinsurance and investment policies, etc. Executive positions will be **open to Russian and foreign managers alike**. (The draft Articles of Association are available.)

Share Capital

The initial authorized share capital of the Company is **US$ 100 million**, issued as the first prospectus. In two year's time it is planned to make a further prospectus of **US$ 400 million**.

Audit

The external auditor of the company will be **Price Waterhouse**.

The Name of the Company

Various names for the Company are considered. One good candidate name is

Eurasia Re.

First prospectus

The first prospectus is to occur in 1998.

Investors are welcome!

Addendum

Russian Legislation on Foreign Investments

An Overview

RUSSIA IS A CIVIL LAW JURISDICTION BASED ON MANY CONCEPTS FAmiliar to a European lawyer. Since Russia made a U-turn to a market economy, it has had to revamp many aspects of its legislation. Of necessity, last years have seen the volume of new legislation and the magnitude of the changes taking place that are somewhat frustrating by Western standards. Legal acts are published by a variety of State bodies and complete compliance with legal rules and standards, including in relation to privatization and foreign investments, has often been difficult to achieve even for those willing to do so. There is also a lack of precedent in relation to market-oriented legal relations. The espoused Soviet doctrine that all that was not permitted was forbidden led to a lack of confidence in the rule of law and an over-emphasis on form. Now this doctrine has been reversed.

But as legislative bodies gain more experience and various sectors of economy become more active lobbying their interests and coming up with professionally drafted bills, one sees definite signs of improvement in Russian legislation, including that on foreign investments. By 1999, as Russian commitments to allow free movement of capital across its borders will enter into force, the appropriate aspects of Russian legislation will have to be brought in line with those of the EU.

Russian legislation on foreign investment activities is based on the following codes and laws: Civil Code of the Russian Federation (1995-96), a number of Laws on Taxation (1992-96), Law on Joint Stock Companies (1995), Law on State Regulation of Foreign Trade Activities (1995), Law on Production Sharing Agreements (1995), Customs Code of the Russian Federation and Law on Customs Tariffs (1993), Law on Currency Regulation and Currency Control (1992), Law on Entrails of the Earth (1992), the most important law being the Law on Foreign Investments in the Russian Federation (1991).

As customary in Russia, the above body of laws is elaborated, explained (and confused at times) in dozens of Presidential Decrees, Decisions and Resolutions of the Government, Orders and Instructions issued by various Ministries and Departments, such as the State Customs Committee, Central Bank of the Russian Federation, Ministry of Finance, Ministry of National Economy, Ministry of Foreign Economic Relations, etc.

Operations of foreign legal entities in Russia are governed by the Law on Enterprises and Business Activities of 25 December 1990 and the new Civil Code of the Russian Federation, the first part of which came into force on 1 January 1995. According to these laws, Civil legislative norms apply to all subjects of business activities and to companies irrespective of their form of property or domain of activities, inclusive of foreign citizens, persons without citizenship and foreign legal entities, unless otherwise specified.

Guarantees

Russian legislation guarantees state protection of foreign investments irrespective of property form and activities. Any discrimination to prevent management and disposal of investment is expressly prohibited. Investments cannot be nationalised or requisitioned without compensation. Any damage caused by alienation of property shall be indemnified.

Bank deposits, shares or other securities, gains on property, acquired and withdrawn leasing rights shall be made good to investors in accordance with appropriate legislative acts and expert evaluations.

The Law on Foreign Investments specifically stipulates that a foreign investor shall get “prompt, adequate and efficient compensation” should his property or investment be nationalised or requisitioned. Any profit lost shall be subject to compensation only if the damage to a foreign investor is caused by incompetent actions of authorities or officials.

Repatriation of profits and dividends

Russian foreign investment legislation provides general assurances of the rights of foreign investors to remit profits and dividends from their investments in Russia. In some cases however these rights are subject to currency and tax restrictions. The only restriction concerns transfers of roubles abroad. Rouble profits may be converted into the currency of an investor’s choice and repatriated in accordance with the Law on Currency Regulation and Currency Control. In most cases there are bilateral agreements on protection of investments.

Licensing of certain activities

With the obvious exception of production of weapons, poisonous and narcotic substances, Russian legislation contains no restrictions on activities of foreign investors. But some activities according to the Law on Foreign Investments shall be endorsed or licensed by competent authorities. The following are some examples:

- Major construction or refurbishing projects by a company with foreign investment shall be endorsed by the Ministry of Construction.
- Prospecting and extraction of natural resources shall be licensed under the Law on Entrails of the Earth.

- Projects that can damage ecology or public health shall be licensed by a competent body.
- Banking operations shall be licenses by the Central Bank of the Russian Federation, and insurance activities shall be licensed by the Ministry of Finance.

The Law relegates the right to regulate the list of activities to be licensed to the Government of the Russian Federation.

Taxation

There are three levels of taxes in Russia: federal, regional, and local ones. Federal taxes include the tax on profits of companies, value-added tax, excise tax, tax on exchange activities, tax on transactions with securities, customs duties, charges for reproduction of natural resources, payments for use of the entrails (royalties), individual income tax, highway tax.

Regional taxes include company property tax, forest tax, water-supply tax. Local taxes include individual property tax, advertising tax, tax on resale of automobiles.

Profits (which include capital gains) are taxed at rates of up to 35 per cent, depending of the region where the company is located, but effective rates of tax can be higher because of restrictions on the deductibility of certain types of expenditure (e.g., interest and advertising). In addition, companies are taxed at the profits tax rate in respect of wages and salaries paid above certain limits. Certain activities may attract higher levels of profits tax, while others may enable a company to apply for a profits tax holiday.

Securities

Dividends and any interest paid by a portfolio company to a foreign investor will normally be subject to Russian withholding tax at the rate of 15 per cent. Foreign investors may reduce the rate of withholding tax by the use of available double tax treaty relief.

Unless otherwise exempt, a tax of three roubles per 1,000 roubles of consideration will be payable by both the vendor and the purchaser on each sale/purchase of securities. The tax will also be payable by a subscriber for shares or bonds issued by a portfolio company.

Operations concerned with the circulation of currency, money, banknotes and securities are exempt from VAT, except for brokers' and other mediation services. VAT is also payable on the production and "storage" (i.e., deposit) of securities.

Overall, the tax environment in Russia is evolving rapidly and sometimes the application or interpretation of legislation can be retrospective.

Companies with foreign investment

Companies with foreign investment (CFIs) with over 30 per cent share of foreign investor in the paid-up authorised capital that are engaged in production and registered after 1 January 1994 are relieved of federal budget payments of company profits tax for two years starting from the time of registration, if the share of material production exceeds 70 per cent of the total earnings (including products, work and services). During the third and fourth years such CFIs may pay respectively 25 per cent and 50 per cent of the basic rate to the federal budget, if material production amounts to over 90 per cent of their earnings.

Company tax on income is payable in roubles or foreign currency, which can be purchased by Russian banks at the exchange rate of the Central Bank as of the day of tax payment.

Foreign trade

All companies shall sell to the state 50 per cent of their foreign currency earnings. But if a company wants to keep export currency earnings, it can purchase back the currency at the Russian interbank market or at the Moscow Interbank Currency Exchange at the same time as the obligatory sale, subject to bank commission.

Companies with foreign investment

Certain categories of CFIs enjoy some foreign-trade privileges:

- Foreign party to a production-sharing agreement is exempted from the compulsory sale of 50 per cent of foreign currency earnings. Exports of products belonging to the foreign investor and imports of goods and services in accordance with project specification are exempted from value-added and excise taxes;
- Material contribution to a CFI's authorised capital are imported duty-free within periods established by their Articles of Association;
- If a foreign founder of a CFI plans to produce similar products in Russia, its import duties may be halved for up to 5 years, and its contribution to the authorised fund shall exceed $10 million and its overall investments in Russian production shall exceed $100 million;
- Oil-extracting CFIs can be exempted from export duties and pay excise taxes at minimum rates.

Foreign banks in Russia

The procedure of opening a foreign bank in Russia is governed by the letter of the Central Bank of 8 April 1993 "Terms and conditions of opening a bank with foreign investment in the territory of Russia." To open a bank with foreign investment in Russia one needs a license issued by the Board of the Central Bank. The Board takes into account the name, financial statement and reputation of an applicant bank. Preference is given to banks with a long-term history of intensive correspondent operations with Russian banks. The stake of a single foreign shareholder in a joint or foreign bank shall be not less that $2 million. A license is also required to open each subsidiary, joint or foreign bank in the territory of Russia.

The Central Bank reserves the right to call off the license should a foreign bank show sign of worsening financial situation or should it become unable to settle with Russian creditors and depositors.

A foreign bank operating in Russia shall seek preliminary permit of the Central Bank to increase its authorised capital by contribution of a non-resident; otherwise respective activities shall be considered invalid and may result in a suspension of license. The Central Bank sets a limit on foreign banks' participation in Russia's banking system. At present this limit is 12 per cent.

Special incentives

To encourage foreign investors the Russian Government adopted on 24 November 1992 a resolution "On measures to provide information to Russian and foreign investors on privatisation of state enterprises." One of the measures was the establishment the State Information Centre for Promoting Investments. By a later resolution, of 30 June 1995, the Centre was transformed into the 54-strong Centre for Assisting Foreign Investments under the Ministry of National Economy. It is a consultative and marketing body that renders services to foreign investors and also makes suggestions on improving investment climate in Russia drawing on recommendations of the Consultative Council on Foreign Investments. The latter was established in 1994 under the Prime Minister, and it includes representatives of 20 major specialist foreign companies. The Council, among other things, identifies priority industries and investment projects.

The attitudes of regional authorities, in the subjects of the Russian Federation, is also important. To coordinate their activities the Ministry of National Economy, jointly with some interested federal and local executive bodies, have worked out a plan to encourage foreign investments in the country.

Support of priority projects

The Law on Foreign Investments in the Russian Federation authorises the Government to grant additional privileges to foreign investors in priority industries and territories.

A further development is the Law on Production Sharing Agreements signed by the President at the end of 1995. It deals for the most part with extracting industries, which at the moment are core industries in Russia. One attraction of the Law is that it streamlines a host of things, specifically collection of taxes and duties. Those payments are replaced by production sharing under an Agreement. Throughout the term of the Agreement the investor is exempt of taxes, charges, excises and other payments except for:

- Company income tax;
- Royalties;
- Medical and social security charges (provident fund);
- Payments to the State employment fund.

Under the Law there are three types of royalties payable:

- lump-sum payments (bonuses) at signing the Agreement and/or after a certain result stipulated in the Agreement has been reached. The payments are deductible from the taxable base;
- annuity for prospecting (rentals) per square unit of utilised territory dependent on economic and geological assets of the area, the nature of the resources, the time of pioneering, and risks;
- charges as percentage of resources extracted.

As agreed by the parties to the Agreement, company income tax and royalties can be payable by the investor either in cash or in kind. If international agreements to which Russian Federation is a party stipulate other terms than those in the Law, the former take precedence.

Other privileges to foreign investors are contained in the Presidential Decree of 25 January 1995. It grants customs privileges to certain foreign investors, among them being those who import to Russia goods produced by them while they are implementing large-scale projects in Russia.

A good example is Mars Co., which invested over $100 million in a production facility at Stupino, near Moscow. The project met threshold requirements for preferential treatment. The privilege has been granted for five years.

According to the Law on Customs Tariffs, the Government too may grant customs privileges.

Perspective

Some amendments to the Law on Foreign Investments await approval by the Federal Assembly. It is believed that they would make Russia more attractive to foreign investors. The main amendment is formal confirmation of a CFI's immunity from unfavourable changes in Russian economic legislation, presumably for 5 years. Investors would enjoy the immunity, however, on reaching a certain threshold of their actual investments in Russia (supposedly $100 thousand). Ii is also intended to confirm a CFI's right for duty-free imports of equipment and supplies for its own production in Russia for 5 years.

The Bill on Free Economic Zones awaits implementation by the Duma. So far the only piece of legislation dealing with the subject is the so-called "free customs zone" in the Customs Code. The Bill clarifies the privileges extended to different forms of free economic zones. Some problems have been tackled in part by the Law on Special Economic Zone in Kaliningrad Region of January 1996, and by the Presidential Decree "On certain measures to encourage investment activities in the Nakhodka free economic zone," of March 1996. Both zones acquired the status of a free customs zone, and some related programs to develop federal infrastructures are being considered. Nakhodka enjoys the status of an export production zone with some regional tax privileges that concern customs duties and company income tax assessments.