

"The law of insurance supervision in the Russian Federation"

A study from the perspective of the economic theory of law, with special regard to system transformation

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Chapter 1. Theoretical background

A. Introduction

1. The problem

Nearly ten years since it was demonopolised, the Russian insurance market is facing considerable problems. Although notably dynamic in quantitative terms, the market is not yet fully developed.² Although about 2,300 insurance companies have been given permission to operate, most of them are under-capitalised and some are doing little or no business. The Russian legislature is aware of the need for action. The law on supervision, adopted in November 1992, is to be replaced by a new law.³ We must therefore ask whether the Russian insurance market needs regulation, and which are the criteria to follow if it does.

Traditional legal theory in the continental civil law countries has no independent methodology for answering questions about the nature of legislation and the need for it.⁴ In this essay we will attempt to discover, by using the methods of economic theory, to what extent Russian supervision law stands in need of regulation. In so doing we have to bear in mind that the Russian Federation is a "country in transition" and that being so, a particular set of circumstances prevail. As a result, the methods of traditional economics have to deal with untypical parameters. Thus we also have to consider how the economic theory of law can be applied to a country in transition.

II Methods

1. Framework for the model

The essay is based on macro-economic hypotheses, which assume monetary stability, stable capital markets and economic framework conditions. All values, including those of the subject of study, are taken as constant, relying on the *ceteris-paribus* assumption. The starting point is a partial analysis of the market and a dynamic analytical approach

2. Subject of the study

The Russian insurance market is taken to be a regulated branch of activity in which state-imposed rules regulate the market.⁵ However, we will only consider the law on supervision in the strict sense, disregarding competition law, tax law, and the law on insurance contracts. Hence for the law on supervision, the study focuses on two questions:

- *Descriptive:* How is the Russian insurance industry regulated under supervision law, and what changes have been made as fresh problems have been identified?
- *Normative:* How does regulation influence resource allocation in the insurance industry?

These aspects are evaluated from the viewpoint of the Russian legislature and the prospect of a new law on supervision. To simplify the presentation and structure of the study as far as possible, the subject is approached from two angles: the regulatory organ and the instruments of regulation.

a) The regulatory organ

What kind of body exercises supervision? We have to consider, in both descriptive and normative terms, how it is structured and how it fits into the administrative structure of the Russian Federation. Here elements of constitutional law have an important role to play. Along with the question of organisational competence, we have to ask how this body acts and on what legal basis. This brings us to the question of normative structure in the Russian Federation.

b) Instruments of regulation

When we come to the instruments of regulation, we have to create an additional sub-structure in order to see them more closely. This essay arranges the regulatory instruments from a temporal perspective, distinguishing between entry to the market, use of the market and exit from the market, as follows:

- *Entry to the market* deals with the question of how one is admitted to the business and what conditions are laid down. This includes capitalisation, professional qualifications and legal form.
- *Use of the market* considers the instruments used to regulate an insurance company which has been given permission to operate (ongoing supervision). The key concepts are the calculation of premiums, general terms of insurance and trading rules.
- *Exit from the market* looks at aspects relating to the dissolution of a company, the sale or insolvency of the insurer or the withdrawal of operating licences. We have to consider the state in of the business assets and how this matter is regulated.

c) The problem of institutional comparison

As the study deals with Russian institutions, there are certain methodological problems involved. The theory of regulation has been mainly developed, in recent years, in the United States, and against the background of North American institutions. It has been possible there to tackle the various problems empirically, not just in terms of general formulations. Very little of this has happened in the Russian Federation. Apart from a few individual contributions to the topic of regulation in general, there are few monograph studies on regulation in the insurance industry. In

these, the problems have been defined only in general terms, by contrast with the United States. So far, there has been almost no empirical testing of theory in the context of the Russian insurance market. The existing literature on regulation focuses mainly, and uncritically, on American theories; moreover, it is rooted in different intellectual traditions, and different aspects of the problem are emphasised.

For this reason, the sectoral descriptions which follow are somewhat tentative, not to say speculative. This means an effort has to be made to use the available approaches and the observations made of the transition process to develop scientifically valid conclusions about the Russian Federation.

3. Methodical arrangement

a) The research approach

Our study lies in the field of tension between the different research approaches to the economic theory of law. To make clear which approach to research underpins the study, we have to look at the various considerations which apply.

First, the consequences of legal rules can be identified and evaluated, without deriving from them any recommendations for the lawmaker. This position, described as the positive economic theory of law, yields practical knowledge which enables the lawmaker to play a directional role when intervening in society.⁶ By this means a planned legal amendment can be tested and the present state of the law evaluated.

On the other hand, there is the view that if economic theory stops here, it has no reforming impetus and is therefore without interest from a juridical point of view.⁷ From this perspective, the economic theory of law is concerned with the question how explicit reform proposals can be made to the lawmaker using the economic theory. This position is described as the normative economic theory of law.⁸ The question here is how to reach a conclusion when deciding which of a number of alternative options should be chosen.

In this study we take the view that the economic theory of law is a theory of legal policy.⁹ Thus the study is not confined to a definition of the existing Russian insurance supervision law and its consequences, in the light of a purely positive analysis. Instead we use a combined approach, seeking to bring together normative and positive lines of research.

b) Problems of the normative theory of law

The chosen approach is controversial, and we therefore have to explain our position before proceeding.

The difficulty lies in choosing the primary aim which underlies the normative analysis, and the reasons for it. The economic theory of law can only be usefully relied upon as a theory of legal policy if it is designed to produce a manageable structure of legal norms.¹⁰ In traditional economics, efficiency of allocation is often chosen as a benchmark.¹¹ This manner of proceeding is rooted in welfare economics.

For the economic theory of law, the Chicago school, under Posner's leadership, logically takes the view that the efficiency criterion is the determining criterion for the normative economic theory of law, in order to achieve pareto optimal results in the context of a welfare model.¹² The philosophical basis for Posner's views is utilitarianism.¹³ Posner makes a radical and exclusive claim for the efficiency criterion as against other goals.¹⁴ According to this, lawyers cannot be allowed to set goals for the economic theory of law. Such goals are acceptable only if they produce efficiencies in allocation. There are two arguments against this.

From a jurist's point of view, if the law is geared to the goal of efficiency this is open to criticism, because law and efficiency have different ends in view.¹⁵ This can then lead to a conflict between the subject matter governed by the rule, and the efficiency criterion. On the other hand, although law and efficiency as an economic principle certainly have fundamentally different aims, this has no bearing on the question of how to distribute costs most economically in the context of legal relations. But if it is not the law which plays the major role in governing the distribution of costs, it is nevertheless this aspect which warrants making an economic analysis of the legal relationships among different actors; because if it can be shown with the help of an efficiency analysis that deciding upon a certain form of regulation would result in a less favourable relationship between resource allocation and yield than some other alternative, these costs should also be taken into account by the regulation.¹⁶ This means that a mere reference to the various kinds of goals will not suffice. What is more, the legal and economic goals may become indistinguishable.¹⁷ This is especially true in the area of economic law we are dealing with here, which falls into public law.

The economic counter-argument carries more weight. It asks why law should be efficient anyway.¹⁸ It queries the "pareto optimum" which has nothing to do with a supposedly desirable state of society, but rather with the actual situation prevailing at the outset.¹⁹ In this connection Kirchner invents an example in which the proposal to amend the economic constitution of an oligarchic dictatorship can be rejected by reference to the "pareto optimum", because the amendment would inevitably place certain players in a worse position than before.²⁰ This weakness is recognised by Posner, who tries to remove it by means of a pragmatic adjustment of the criteria.²¹ The Kaldor-Hicks modified efficiency criterion should be decisive, since in nine out of ten cases in which policy or the State are efficient, there is a Kaldor-Hicks efficiency.²² According to this, amendments which increase welfare are those in which the gains of the better-off players can compensate for the losses of the worse-off. But even this definition of efficiency fails to convince. Two fresh problems arise: whether benefit comparisons between individuals can reasonably be made, and whether an offsetting benefit which is possible but does not actually occur can be said to improve welfare.

Initially, the Kaldor-Hicks criterion does not contemplate any benefit analysis as between individuals.²³ However, such a comparison becomes necessary when the utilitarian decision-maker, the "legislator", tries to determine the "useful effects" of a legal prescription through a normative economic theory of law via the Kaldor-Hicks criterion.²⁴ But this can only be done by means of a monetary assessment of the advantages and disadvantages in the context of a cost-benefit analysis. For the

purposes of our study, we must therefore ask whether the losers under supervision law, based on monetary compensation payments to the winners, would behave the same way by comparison with the status quo ante, so that the winners would continue to hold the advantage. Such a procedure is simply not practicable where there are several parties involved.²⁵ All in all, the attempt to justify the efficiency goal directly through the Kaldor-Hicks criterion does not seem convincing. For this reason, we do not use the Posner approach, or its modified version, in this study.

c) Indirect basis for the efficiency goal

With the chosen approach, however, we still have to establish why it is that a normative study, relying on the efficiency goal, is valid for Russian supervision law. As we have seen, there is no direct justification. There is however Eidenmüller's argument, that the basis for the efficiency goal can be derived indirectly.²⁶ If there is another goal of legal policy to be taken into consideration, it can be assessed by a direct comparison with the efficiency goal. By means of a comparative evaluation, where necessary, the advantage can be seen to lie with the efficiency goal, if economic efficiency is the better choice in a comparative sense. Next, the various theories of regulation should be considered in the light of their legal policy goals, and these in turn weighed against the efficiency goal. In so doing, we have to take account of the particular preferences and economic realities of the transition process.

III. Basic assumptions for the transition process

In order to define the preferences which apply especially to the transition process, in what follows we list certain basic assumptions for this process. In the analytical part, we begin with the particular circumstances of the Russian Federation.

1. The concept of transition

From a sociological point of view, "transition" is a general term for the reshaping of a society. It presupposes a change in the prevailing order of things.²⁷ This change is a process implying the complete refashioning of the social order. The point at which this begins is an altered value system which is at variance with the initial order.

2. Changed circumstances

A genuine system transformation must proceed from an altered economic design.²⁸ The consequence is a complete institutional change within a framework which is changing at the same time. The steps which have to be taken must be taken in parallel.²⁹ The institutions involved impact upon one another. The preferences of the players are not constant, being coloured by the stage reached in the transition. This essay proceeds from the hypothesis that in the medium term, there is a convergence of preferences as between the western industrialised countries and the countries in transition.

From the jurist's point of view, transformation is a simultaneous and successful grappling with problems in various fields of law. It is not a matter of introducing certain individual legal institutions into a legal order which is otherwise perfectly

viable. Rather, there is a mutual impact of transfer processes which are occurring at the same time, within a legal order which is itself taking shape.

B. Theories of regulation

I. The concept of regulation

Regulation is any government-imposed or government-sanctioned limitation placed on the individual's capacity for action and disposition.³⁰ It affects the individual's ability to dispose of himself, of things and rights, whether in a legal, especially a contractual sense, or in the purely material sphere. Thus regulation, in the broad sense, can be understood as any influence exerted by the State on market activities.³¹ As well as so-called "constitutive" regulations, there are also "special" regulations. Special regulations only concern particular groups of actors, such as insurance companies.³² In the case of insurance, alongside the traditional supervisory function, competition law, the law on insurance contracts and tax law, this means a restriction on freedom of decision for prospective insurance clients, as may be found in compulsory forms of insurance. This study is confined to insurance supervision in the narrow sense, leaving aside other aspects of regulation such as competition law.

II. General theories of state regulation

The general theory of state regulation distinguishes between positive and normative models of regulation. The normative variant justifies regulation through market failure.³³ The point of departure lies in welfare theory criteria, hence in the centrepiece of the normative model of regulation there are considerations of efficiency. In the positive theory of regulation, on the other hand, regulation can be traced to the influence of interest groups. The two approaches are not contradictory. The positive approach describes the socio-economic process by which regulation emerges, and the normative focuses on the necessity of regulation.³⁴ In this sense, they may be seen as complementary.

1. Positive theory of regulation

a) Fundamentals

The starting-point of the positive theories of regulation is the assumption that the regulatory agencies are not specialists devoid of self-interest who are concerned only with the common good, but individuals with their own preferences.³⁵ Their decisions are stamped by their political environment and their own interests.

b) Reference model

The reference model is an ideal regulatory agency. Where the goal is taken to be the "public interest", its conduct is assumed to follow the pattern below:³⁶

- *selfless behaviour*: The individual employee of the regulatory agency makes his decisions in the light only of factual criteria, those derived from parliamentary or legislative sources. He disregards any interests of his own which go beyond these.

- *neutrality of remuneration:* The size of the agency depends on the amount of work it has to do, and is unrelated to the earnings of its staff members.
- *complete information:* There are no problems of coordination between the regulatory agency, on the one hand, and the legislature on the other. Nor is there any difficulty in obtaining information when charges are to be altered. The scale which is needed for information purposes is readily available. The regulatory agency acts efficiently.
- *political vacuum:* The government and public opinion do not exercise any political pressure on the routine decision-making of the regulatory agency, other than through parliamentary constraints.

c) The self-interest theory

This theory posits a displacement of goals. According to Hilton, the assumption that behaviour is unselfish gives way to the self-interest postulate.³⁷ Depending on the degree of advantage for the regulatory agency, there will be a certain range of self-interested behaviour. Careers are short, and many workers will be keen to carry on working in the regulated industry. Thus they tend to follow a strategy of minimising conflict. Instead of the public interest, they strive for an amicable bargain with the regulated industry in their own interest. As a result, regulation no longer follows efficiency criteria; instead, the aim of the regulation is to strike a compromise as between interest groups. By conducting themselves in this manner, workers can assure themselves a pension. Consequently, a worker guided by self-interest will seek to maximise divisible monopoly rents which he personally receives as a member of the regulatory agency, especially *after* his term of service in the regulated industry.

d) Bureaucracy theory

Proceeding from the economic theory of bureaucracy, the bureaucracy theory contends that each government-run agency will strive to maximise its budget.³⁸ The displacement of goals, according to this theory, is related to the neutral remuneration. Hypothesis. If the size of the budget correlates with the variables of neutral remuneration, a public official guided by self-interest will seek to maximise the budget during his period in office. The consequence is that government agencies will always try to regulate private industries if regulation will bring with it more administration, more prestige and more income. The goal of regulation in the public interest recedes into the background. Markets are not regulated according to criteria such as efficiency, but according to whether regulation is profitable for the agency. Bureaucracy theory and self-interest theory interact. However, in the context of bureaucracy theory a public official must still endeavour to maximise his influence over the agency's budget *during* his period of office.

Two arguments are brought to bear against the model of expanding regulation under the bureaucracy theory. First, the expansion does not automatically lead to an increase in the budget.³⁹ In a parliamentary democracy where the administration cannot make law, the activities of government agencies can be controlled by means of statute and

case law on the limitation of powers. Secondly, American developments seem to belie the theory, at least to some extent.⁴⁰

e) Stigler's theory of regulation

The basic assumption is that in principle both the state, with its economic policy methods, and regulated industry itself can secure mutual advantage for each other. Stigler argues from this that favourable attitudes to industry on the part of regulatory agencies is no accident, but the result of a market in regulation.⁴¹ According to him, there is both supply of and demand for regulation. Demand exists because it provides the companies concerned with an effective shield from competition, in the form of taxes, price controls and restrictions on entry to the market. The government agency becomes a sort of "licensing agency" for advantageous market positions. By contrast with a private cartel, which is similar in structure, for the industry concerned regulation has the advantage that once it has itself entered the market, there will be no increased penetration from outside. In consequence, these same companies will ask for regulation.

On the supply side is the politician's interest in gaining votes and being re-elected, or in raising money to finance re-election. Here regulation will gain a foothold in places where it will bring about the most promising prospects of re-election. At the same time, the political cost of restricting competition must be less than the extra prospects of re-election. Ultimately, income will be redistributed to well-organised groups which can be readily mobilised.

It is difficult to test Stigler's theory empirically. The objection raised to his supply side arguments is that the examples he quotes are circular, and ultimately are mere definitions of a successful interest campaign policy.⁴² It is not certain what predictable basis there is for success. Moreover, there are objections of principle to the simplifications in the Stigler theory. In his model of society, over-arching social norms either do not exist or are meaningless. In spite of his undeniable familiarity with politics, he fails to show where the essential connection with democratic voting patterns springs from. There is no model of political behaviour. Finally, it has to be asked why the legislature would create structures which only advance the welfare of particular interest groups when there are other instruments of redistribution available, such as taxes and subsidies.

f) Posner's theory of monopoly rent

Posner takes up the criticism of Stigler, developing the competition motive in the market in regulation market via a new approach to the theory of monopoly rent.⁴³ According to this theory, the problem can be traced to the resources which have to be expended in order to create the regulatory agency. Through a study of the welfare losses caused by monopolies, Posner argues that there is competition for regulatory intervention. This results in the emergence of monopoly rents. The only interest of the actors who take part in this competition is to obtain or hold on to monopoly rents, without making any contribution to increased welfare. Furthermore, the monopoly rents are not cost effective. Although all the actors have an interest in gaining a monopoly rent, they are in fact mistaken about the extent of the gain. For this very

reason, the regulated industries will not produce at minimum cost, because the internal expenditure of the actors on lawyers' fees, patents, etc. actually reduce the rents earned. As a result, competition for monopoly rents leads to a waste of resources.

g) Theories of the new political economy

Political economy has developed a range of explanatory approaches, all of which assume that there has to be a political model of choice. Alongside *competition democracy* there is the model of *interest group democracy*.

The idea developed by Downs about competition democracy is based on the notion that in every democratic decision, the taxpayer determines the extent of regulation.⁴⁴ The basis is an idealised model of a competition democracy. If we assume simple majorities, a readily discernible set of preferences and budgetary equalisation, the voting process will bring about an allocation in which costs and benefits are the same for the average voter. However, by comparison with the average voter the regulatory agency has better information about the actual costs of the regulated industries. The voter is a sort of "passive taxpayer", who is not informed of the actual costs incurred in a regulated industry. Thus measures taken by the regulatory agency can yield self-interested monopoly rents in its favour. These monopoly rents therefore derive from the fact that the regulatory agency possesses more information than the voter whose money is to be spent, and more than his representatives in parliament.

Downs says that as well as the competition for monopoly rents, there is a political competition. Political competition creates practical opportunities for gain for political activists. By offering more regulation during the election campaign, politicians who favour regulation can encourage voting by interest groups. This however assumes that the politicians are actually able to pass the monopoly rent on to the voters. While this is going on, the regulatory agency is torn between two extremes: the more independent it is, the greater its advantage in terms of information. The result is a proportionally declining interest on the part of the political activist in regulation as a motive for his political decisions. However, if the regulatory agency becomes more independent, the advantage in terms of information becomes less, and the self-interested activities of the regulatory agency fall off.

Downs himself admits that his model of competition democracy is somewhat unrealistic.⁴⁵ Neither the voters nor the politicians are fully informed about the costs and benefits involved. The resulting information deficit is taken advantage of by institutionalised interests, such as associations of insurance companies. They supply information to the actors, but on a selective basis according to their interests.

This is where the variant called "interest group democracy" begins. The destructive information process produces inequality among the electors, so that one may speak of imperfect competition for the power of political initiative. The politicians do not necessarily have to pass on the monopoly rents earned from regulation to the voters, but can instead appropriate them, even as favours or bribes. Bribes in this sense will involve, for instance, supervisory board positions for politicians, and the kind of conduct defined by Stigler. If the politicians are not sufficiently alert, regulatory

agencies may themselves accept favours.⁴⁶ Thus it cannot be determined exactly via this approach who will be receiving the rents.

2. Normative theories of regulation

a) Fundamentals

As we have already said, in the normative theory of regulation market failure is the theoretical basis which justifies state intervention in the market. For a long time, the traditional "market failure theory as justification for state intervention" has looked somewhat threadbare.⁴⁷ It does however enable the material to be clearly structured, as it did before, and this is why we take it up here. Defining a market failure presupposes that there is a reference model for the market. Only when there is a clear definition of a functioning market and of competition, and understandable conditions for the functioning to take place, is it possible to recognise situations in which these conditions are not fulfilled.

b) The reference model of the market

The reference model for the normative theory of regulation is the model of perfect competition.⁴⁸ The following idealised conditions have to be met:⁴⁹

- an atomistic supply and demand structure;
- homogeneous products;
- free market access for potential competitors;
- limitless speed of reaction;
- unlimited divisibility of all factors of production and goods;
- constant production technology and a constant range of products;
- supply and demand adjusting to quantity.

If these preconditions are met, the market in question will be balanced by the assumed conduct of the participants. This balance must be "paretooptimal". Resource allocation in this balance scenario will be paretooptimal if the first theorem of a welfare economy is fulfilled.⁵⁰ According to this:

- a market exists.
- all the consumers and producers act competitively,
- and balanced competition is present.

If these conditions are met, we can speak of market success. Any departure from this pattern is regarded as a market failure. According to the above definition of market success, market failure occurs whenever there is either no market, or the behaviour on it is not competitive, or balanced competition does not exist.

Market failure must be distinguished from *government failure*. Government failure occurs when the State does not create individual rights of disposal over scarce goods in such a way as to ensure a just use of them.⁵¹ It also occurs when the State does not make available, to the requisite extent, goods which it is the prime duty of the State to provide. There is a failure to secure proper scarcity use whenever goods which are

scarce are treated like free goods. It is the prime duty of the State to make available goods which meet two cumulative conditions: first, their use does not rival use by another (e.g. the defence of the country); secondly, for this very reason nobody is to be excluded from the use of these goods. These goods are designated "public goods" and are never, or hardly ever, offered for exchange.

c) The Averch-Johnson model

The views of Averch and Johnson derive from the particular practice of American restrictions on profitability. In the normative theory of regulation, the purpose of the regulation is to prevent allocative losses of welfare through monopoly pricing.⁵² The costs of regulation must therefore be compared with those of the welfare foregone. In American regulatory practice, an indirect form of monopoly price control has been imposed through what is called "restrictions on profitability". The intention is to fix the prices in such a way that the regulated enterprises retain only an appropriate profit, instead of a monopoly rent, once other operating costs have been deducted. The restriction on profitability can also be interpreted as an attempted "second-best solution". In the event of natural monopolies, for instance, the allocative optimal solution would result in losses which to achieve allocation neutrality could only be distributed through taxation. But it is a purely notional idea that per capita taxes can be levied where there are no incentives, and it would not be successful in practice. Hence the restriction on profitability is a kind of compromise when faced with totally unregulated monopolies.

Against this background Averch and Johnson have introduced regulated State intervention in the form of a mathematical added condition, in the context of an economic part model. From this they have built a neoclassical theory of state intervention.⁵³ We do not intend to go into the mathematical background here, but we can state the following:

The so-called Averch-Johnson effect has three significant consequences for regulated industries. First, as a result of the profitability restriction the enterprise will not select its prices in the inelastic demand area. Next, it will continue to act as an unrestricted monopolist in the elastic demand area. Secondly, the capital invested by the enterprise will only be employed in a productive manner; there will be no waste. Thirdly, where profitability is regulated there may be a conflict between the goal of restricting monopoly gains and efficiency of allocation.

d) Management theory

There is a range of variants on the Averch-Johnson model. From these, we select here only the management theory, since it offers particularly clear motives for economic behaviour.

Whereas the Averch-Johnson model proceeds from the enterprise goal "maximisation of profits" for the enterprise, management theory, which is a modification of the basic model, assumes that the goal of the firm is to maximise the value of the management.⁵⁴

A second condition is to achieve profits to keep the shareholders happy. This model assumes that regulated industries consist primarily of publicly-quoted share companies.

III. Theories on the regulation of the insurance market

1. Positive theories of regulation

a) Finsinger's positive theory of regulation

Finsinger's theoretical approach distinguishes four phases of regulation:⁵⁵

Phase 1 describes the political process of decision-making about market intervention, and can be described as the *intervention phase*. The basis here is provided by the models of economic theory, and the starting point is normally some kind of crisis. The advocates and opponents of regulation try to gain a hearing with the political decision-makers. Both the costs and the benefits of intervention play a part in the decision, but there is not cost-benefit analysis involved in the process. Thus there is a danger that the side-effects of intervention will be neglected; each party tends to disregard them as insignificant for itself, but taken together they are considerable. At the end of the intervention phase the regulatory agency is set up.

Phase 2 When the task of regulation is carried out, the *consolidation phase* begins. The decisive point here is the availability of information. Information comes from the insurance clients and from the regulated insurance companies. In principle both sides will organise themselves, and here the industry undoubtedly has the advantage. But the insurance clients have considerable potential in the form of electors' votes, by means of which they can lobby the politicians. The politicians who act as lawyers on the clients' behalf are in the best position to exploit this potential. But the information available to the clients is impaired by the economic linkages among the products, which are often complex. Moreover, an insurance client will by no means be first to obtain information relevant to regulation, such as details about the management of the companies and their business results. Two developments follow from this.

First, the regulatory agency, in order to command the information at its disposal, introduces so-called summary procedures, in which the supervisory board negotiates with the industry associations and then imposes the same measures on all the companies. The premiums for a certain type of insurance are not adjusted individually for each company; instead, summary premium adjustments are made. The summary procedures compel the regulated industry to co-operate with the regulatory agency and to adopt an agreed form of behaviour. The role of informant is taken over by the industry association, which possesses the crucial information. Usually, the consumer will not be brought into the negotiation process. Since the insurance companies learn how the regulatory agency translates the information into practice, they will endeavour to colour the facts so as to ensure that the intervention will be as favourable as possible in practice. This leads to a cycle of reaction. The regulatory agency is not unaware that the facts have been painted in the best possible light. It will therefore start to monitor the information which is transmitted. This modified behaviour on the part of the supervisory agency leads to evasive conduct on the part of the companies:

they attempt to make their product decisions in anticipation of the expected regulatory measures. The evasive conduct then produces inefficient combinations of factors of production, and excessive costs. The supervisory agency then reacts anew to these by refining the instruments of supervision. This cycle may be repeated several times.

Secondly, the co-operation between the industry and the regulatory agency becomes increasingly close during the consolidation phase. Compromises are inevitably struck on both sides, and ever more complicated rules are adopted. Soon it becomes worthwhile for the companies to recruit specialists from among former employees of the regulatory agency. In the case of employees already in service, this presents an opportunity to get a high-paid job later on, and they will have a special understanding of the interests of the insurance industry. Thus the consolidation phase follows its cyclical course and shows an increasingly distorted pattern of development.

Phase 3 is a deregulation phase. It begins when the scale of the distortion has taken on inescapable proportions. The proposal for deregulation does not emanate from the members of the supervisory body itself, but has to come from outside, from organs of State authority. The structure of the deregulation phase is similar to that of the intervention phase, except that now the assets which have been built up are defended by the actors who have formed financially significant interest groupings during the consolidation phase. The employees of the regulatory agency are government employees, and there is no question of simply dismissing them. This stage of development then passes into Phase 4.

Phase 4 is the "watering-down" phase. Since the actors involved will stubbornly defend the positions they have occupied, the plan for deregulation can only be carried out in a limited fashion. What now occurs is the watering down of the deregulation plan. The former instruments of regulation are replaced by other forms of intervention which conflict with the aims of deregulation. Those responsible for this turn of events are the actors who had already determined the shape of the consolidation phase. The aim is a renewed expansion of market intervention.

b) The public interest theory

The German term for "public interest theory" dates back to an expert opinion by Blankart and Wein, and represents the position of the German insurance industry (GDV).⁵⁶ In the background we discern the fundamentals of the general positive theory of regulation.

The starting point is the question whether in Germany, there is a need for deregulation. The GDV argues that wherever regulation occurs, it serves the public interest, because the situation which then exists is the best achievable.⁵⁷ Consequently, there should not be any need in principle to alter the existing system of regulation. In this light, the GDV approach lacks theoretical underpinning. It is confined to merely stating a certain point of view.

Blankart and Wein's criticism of the GDV is that the public interest must first be shown to be justified before any conclusion can be drawn from it. Since the public interest theory is not a theory in any proper sense, it will not be further discussed.

c) The acceptance theory

The acceptance theory also begins with interest groups. According to this theory, where regulation is introduced it must have been in response to a broad-ranging consensus. The purpose of regulation is to remove any grievances which may have occurred or which are feared to occur. Over time, the regulatory agency is gradually accepted by the insurance industry as representing certain interests, and changes its role to become an agent of the industry.⁵⁸ The insurance industry makes use of regulation to establish and maintain a cartel. The regulation of terms and premiums no longer protects the customers from excess advantage, instead becoming a vehicle for imposing cartel discipline.

One objection to the acceptance theory is that it focuses only on the interest group represented by the insurance industry.⁵⁹ On the other hand, in practice a large number of interest groups are active in politics.

2. Normative theories of regulation

In order to apply the reference model of the normative regulation theory in a straightforward manner to the insurance market, it is assumed that the risks of the customers are homogeneous and that the only insurance contracts granted offer complete cover.⁶⁰ In addition, two of the market failure scenarios which are postulated for the general normative regulation theory seem to be only of secondary importance for the insurance market. First, the existence of insurance markets is undisputed. Secondly, the monopoly problem is a factor which may occur in all markets, and is not peculiar to the insurance market.⁶¹ In what follows we will therefore ignore both aspects, for reasons of space.

A possible cause of market failure remains the absence of balanced competition.

a) Structure of the absence problem

The reasons for this absence may be growing gains of scale, external effects and unbalanced supplies of information (information asymmetries).⁶² These are found in a particular configuration in the insurance industry.⁶³ We have to consider which of these reasons are relevant for the purposes of supervision law.

Adverse selection or unequal information means, in the first place, that the participants in the market lack sufficient information. The model of perfect competition assumes perfect information. If this is lacking, market failure may occur. Intervention in the form of regulation will then be required. Insurance markets, more than other markets, are exposed to the problem of asymmetrical information.⁶⁴ Where there are numerous customers, which is typical the case with insurance, this kind of information asymmetry is frequent.⁶⁵ The problem is that one of the contracting parties knows more, in principle, about the service being sold and the terms under which it is supplied than others. Unequal information leads to faulty decision-making. From the viewpoint of an insurance company, there is a danger that it will not be as well

informed as the customer about a risk which is to be insured. The insurance company will therefore underestimate the true dimension of the insurance cover to be afforded in the event of an accident, and will therefore set a premium which is too low. If the customer is badly informed about the quality of the services on offer, he will either be under-insured or will enter into an insurance contract with the cheapest insurance agent, in the mistaken belief that he has found the best ratio between price and delivery. In both cases, the outcome is negative. Badly informed customers unintentionally choose the companies offering the worst quality, because their preference is fixed on price. A badly informed customer will incur the worst risks without being able to protect himself. Naturally, any customer with an information advantage will select the insurer who offers him the most favourable premium. The insurer must take special care not to endanger his power of performance through risks which are present but which are not known to be bad ones. Typically, this occurs when insurance contracts are drawn up. The customer is alone in possessing the relevant information. There is little prospect of supervision law being able to regulate such cases. From the viewpoint of this study, it follows that adverse selection is not a relevant cause of market failure.

Moral risk or *moral hazard* is a sub-species of information asymmetry. As in the case of adverse selection, the insurer is unaware of the likelihood of the customer suffering an accident.⁶⁶ One speaks of moral risk where the customer, for the very reason that he is insured, neglects to take steps of his own to reduce his risk.⁶⁷ It is only possible for the insurers to protect themselves against such conduct, to some extent, by entering into contractual agreements to cover their obligations and entitlements.⁶⁸ Here state regulation would come into conflict with insurance contract law.⁶⁹ Thus this aspect of information asymmetry lies outside the field chosen for our study, and can therefore be disregarded.

External effects is the term chosen where a product has positive or negative effects for third parties as a result of its production or consumption.⁷⁰ This is not a problem as long as the third party is able to internalise these effects, as through a restraining agreement between the party causing and the party suffering the damage. Acts which have potential external consequences are usually regulated by the lawmaker in a preventive manner. External effects which cannot be internalised are the subject of targeted regulatory intervention by the State.

In the insurance industry, failure of performance is an external factor which may occur vis-a-vis third parties, especially with liability insurance.⁷¹ Competition may itself encourage insurers to be neglectful in regulating accidents. The reason is that the third party victim receives no benefit, whereas the insured customer is unaffected and the public generally remains ignorant of the matter. This instance of what is called the "disrupted insurance relationship" is regulated by the lawmaker through the law of deferred insurance, and is therefore outside the framework of our study.⁷²

Furthermore, information asymmetries may result in external effects.⁷³ If the insurer fails to recognise the likelihood of damage arising for the customer, he will offer his products at average prices, which are too high for sound risks. They will bring the demand for insurance down below the optimal level for appropriate premiums. It follows that the mere existence of bad risks has a negative external effect on good

risks. This external effect, described here as the "domino effect", likewise cannot be internalised, since there can be no negotiated solution where the insurer lacks the requisite knowledge. The insurer can only deal with domino effects in a precautionary fashion, by creating reserves. Since this is at the same time a market failure scenario, state regulation becomes necessary by means of supervision law.

Increasing gains of scale are associated with the cost structure of the insurance products sold by the insurance company. In the centre ground is the (mathematical) law of large numbers.⁷⁴ As a result of this pattern, which is specific to the insurance industry, the risk remaining with the insurance company will fall with each new contract signed. The marginal costs of the risk are reduced. These gains, described as gains of scale, are dual in nature. If insurers are producing against increasing gains of scale, competition among them may lead to instability.⁷⁵ What then happens is described as ruinous competition.⁷⁶ The consequence, in extreme cases, is insolvency. Insolvency is an instance of market failure, and can be prevented through supervision law.

b) The advocacy theory

The initial argument in Germany for this theory is not associated directly, or exclusively, with the problems of unequal information.⁷⁷ However, the arguments deployed rest on the basis of normative regulation theory, since they all rely on market failure as a ground for regulation and thus the need for regulation. They will therefore be presented here as a normative theory. Usually, five arguments are used to legitimise state regulation, here comprised under the heading "advocacy theory".⁷⁸ The advocacy theory derives from the traditional German theory of insurance,⁷⁹ which treats the insurance industry as a community of risk or hazard.⁸⁰

In the theory of the community of hazard, not every insurance company bears the insured risk by itself, rather, all insurance companies are in some sense "linked" through the risks and via the premiums. This is a considerable restraining influence on competition, since otherwise the outcome would be negative. An attack in the form of cheap premiums has an adverse effect not only on the insurance companies which are underbid, but on the whole of the market, and on the attacker itself. The companies under attack lose in particular those customers who have paid high premiums relative to their individual risks. A company under attack can only react to the worsening business situation by increasing premiums, which inevitably accelerates the process of losing customers. The attacking insurance firm is seeking to win over only "good" risks, but in fact only wins those which were good ones only for the company under attack, but which are bad ones at the new rate he is now offering.⁸¹ The lower the transaction costs for the customer, the more willing he is to allocate risk in a manner which he regards as favourable as to cost, but which is negative from the point of view of the competing companies. The consequence is that the customer will also suffer in the long run from the ruinous competition. In such circumstances wide-ranging intervention becomes unavoidable, since insolvency threatens.

The capacity argument

The capacity argument states that there is an essential difference between the terms of an offer in the insurance industry and in other areas of the economy. Whereas resources have to be expended in order to produce material goods and to expand the supply, in the insurance industry it is enough just to print policies. At the same time, there are hardly any barriers to market entry, as there are no limits to capacity.⁸² There is an inherent tendency to over-supply. The consequence is that insurance is provided through premiums offered below cost, and the protection is not reduced even when bankruptcy occurs. In any event, this pattern leads to ruinous competition and thus to market failure.

The calculation argument

According to the calculation argument, only sector-wide co-operation can ensure that the insurance companies make correct calculations. The companies have to base their calculations on anticipated accident, and therefore fix their premiums before the seriousness of the actual damage is known. Only if all the insurance companies reckon by the same anticipations of accident for the whole of a particular line of insurance can their solvency be assured.

The transparency argument

The transparency argument is used in three situations.

The customers are often unable to judge complex insurance products through the complicated General Terms of Insurance. If as a result there are no standard general terms, there is a danger that individual insurance companies will try to take over the market by means of "mogul packages". But since the customer is unable to assess the cost-benefit ratio of an insurance offer, a supervisory organ must intervene.

It is impossible for the customer to compare prices if there are no standard General Terms of Insurance. He can only make comparisons if the products are actually the same.

The average customer of a mass insurance business is unable to judge whether insurance contracts, especially long-term ones, will be fulfilled in the long run. Especially in the case of socially sensitive types of insurance, such as life insurance, there is a great need for protection. Insolvency is not acceptable in such cases, and has to be avoided by preventive measures.

The co- and reinsurance argument

Major risks are covered by co-operation among several insurers, by means of co-insurance. Since only one policy is issued to the customer, the insurance companies have to agree on the basic terms of the insurance. This is easier where there are uniform terms of insurance, so that in principle all have the same accident experience. Because, logically, only one insurer will then be able to conduct the negotiations, it is possible to save on transaction costs.

In the case of major risks, the insurer can also expand his cover capacity through reinsurance. As it is very expensive for the reinsurer to examine the individual contracts of the assignor where the General Terms of Insurance vary, because of the high cost of doing so, the general terms must be uniform for the whole sector.

The security argument

The security argument aims for sound protection against insolvency, with a view to preventing insolvency altogether. The customer is to be protected against companies which are threatened with insolvency or which are not serious, even if he states that he is prepared to bear the risk of insolvency. No insurance company may go bankrupt, as otherwise the whole sector will have to bear the negative consequences, since the public will lose confidence in the industry.

On the basis of these arguments, an insurance company is not an enterprise which makes and sells a product in order to make a profit. Rather, it is an "advocate" for a risk equalisation concern. The advocate is not supposed to bear any risk himself. It is cheaper to equalise the risks within the concern than as individual entrepreneurs on the basis of mutual contracts. This view of the insurance principle assumes that the insurer deals exclusively with the law of large numbers. The necessary consequence is that competition is invariably harmful for the insurance market.

It follows that the advocacy theory does not follow the legal policy goal of classical efficiency. The argument assumes that competition is no guarantee of efficiency of allocation. Hence the insurance market can only function efficiently if there is no free competition. This guarantee is provided by state regulation through supervision. Since it is ultimately a matter of helping actors on the insurance market "for their own good", this is a paternalistic approach. It is applied by means of insurance which is only conditional, i.e., it can only be made available through supervision.

c) The entrepreneurial theory

This more modern theory of insurance, on the other hand, treats insurers as competing enterprises which have to bear the opportunities and risks of competition to the same degree.⁸³ The entrepreneurial theory does not dispute that insurance is dominated by the law of large numbers. However, it assumes that the companies have far greater freedom of manoeuvre by being subject to this law. In fact, the theoretical assumptions of this law are not fully borne out in practice. An insurance company is not exposed unaided to the technical risks of insurance, since it can influence the anticipated damage by fixing premiums and retained earnings. Moreover, the companies can deal with the danger of having to pay out at the same time by distributing the risk among different categories.

The capital investment policy of the company is likewise crucial. What matters here is its business policy, rather than the structure of the sector and its peculiarities. Here competition is no longer seen as a danger, but as the guarantee for the optimal shape of an insurance product. Accordingly, state regulation through supervision is disruptive, and is to be rejected in principle, unless confined to a necessary minimum.

The entrepreneurial theory assumes that entrepreneurial self-regulation is more efficient. Insolvencies are undesirable, but must be tolerated in order to achieve the most efficient allocation of resources on the insurance market.

3. Other theories of regulation

Alongside the positive and normative theories of regulation on the insurance market, there are various other theories of regulation, which have different points of departure and which are not economic theories.⁸⁴ They will therefore be considered separately. For each line of approach, the legal policy goal will be defined and compared critically with the efficiency approach of the normative variant of the economic theory of law.

a) The danger theory

According to the so-called danger theory, the aim of supervision in insurance is to avoid specific dangers which threaten the public and the individual as a result of insurance activity.⁸⁵ This theory is based on the concept of the insurance supervisory organs as mere industrial policing bodies. As such, they are bound by the requirement in general (German) police law that there must be an immediate or at least a probable danger.⁸⁶ Hence they cannot intervene against dangers which are no more than possible.

The danger theory embraces a purely legalistic goal of regulation. In the sense of legal theory, it is inspired by paternalism. Only the State may decide for the actors what is and is not dangerous. The power to intervene is reserved to the State. In this light the goal of regulation overlaps with state monopoly power. The question of distribution of costs is not touched upon. Thus from an economic point of view, the danger theory seems inadequate. But even seen from the perspective of its own regulatory goal, it falls short. If we accept that there has to be an industrial policing authority, its scope for manoeuvre seems too narrow. According to the danger theory, imminent insolvency on the part of an insurance company is a direct threat to the interests of the customers involved. But how can a supervisory organ be able, without major additional powers, to recognise at the right time that an insurance company is about to go bankrupt?

Moreover, the danger theory assumes the presence of institutions of considerable scope. Alongside a functional general law of administration, there has to be a developed general law of policing and public order. If the danger theory is stripped of its German legal covering, it appears as merely an enhanced form of state monopoly of power. The transfer of German legal thinking as a precondition cannot however be always acceptable for countries in transition. It cannot be expected that German mechanisms of regulation will be transferable as such into Russian administrative law. Hence the theory is not an appropriate one from the viewpoint of the transformation process.

In total, the advantage lies with the efficiency goal as compared with the legal policy goal of reinforcing monopoly power. The danger theory is rejected for this reason.

b) The protection theory

The protection theory attempts to deal with the above arguments against the danger theory. It assumes that supervision law is a part of industrial and industrial policing law, and opposes the notion that supervision has the function of directing the industry.⁸⁷ It says that insurance supervision should not be confined merely to providing a shield against danger, in the sense of a narrow policing function, but should also offer protection for the interests of the customer.⁸⁸ Hence supervision law is not merely an adjunct to general industrial law, but a protection for the creditor of the insurance and the customer who pays the premium. This aspect is fleshed out through the concept of consumer protection. The framework for this is found in the reasons which resulted in an insurance supervision authority being set up.

The protection theory as a modified danger theory suffers, however, from the viewpoint of this study from the same defects as the danger theory itself. It does admittedly overcome the problem of competence to some extent, but the weaknesses of the institutions which are needed remains. It is therefore rejected for these reasons, and will not be considered further.

c) The structure theory

The structure theory is considered and further developed by O.E. Starke.⁸⁹ It states that the supervisory organ is responsible chiefly for ensuring that the insurance industry works as well as possible. The aim is therefore that the supervisory body should play a significant role in guiding the industry, through supervision law. A crucial factor in determining the means and methods of supervision is the concept of the "nature of the thing sought". The structure theory deliberately opts for a broad definition of tasks. The starting point is not specific situations for intervention, but a set of economic policy goals. Thus the structure theory, using a legalistic approach, pursues an economic policy goal. The legal policy goal of this theory can therefore be described in general terms as the direction of the industry.

Against the structure theory, it may be said that despite its legalistic approach, it only seeks to sanction economic policy goals which are already taken for granted. However, these should be explained in theoretical terms and rendered open to examination. It is not clear what the yardstick is supposed to be for determining "optimal" functioning. It could be a state monopoly in insurance, or even a completely unregulated insurance market. Both instances, ironically, would mean that supervision would be pointless. Moreover, the aim of maximum consumer protection could be pursued just as well as the contrary aim of reinforcing the rights of the insurance companies vis-à-vis the customers. Ultimately, the structure theory seems to postulate a method the purpose of which is unexplained.

Since the efficiency goal offers a clear yardstick for assessment as compared with the legal policy goal of guiding the industry, the structure theory is rejected.

Chapter 2. Analysis of the existing supervision law of Russia

A. The background to Russia as a country in transition

1. Macroeconomic parameters

The following can be said, in general, of the institutional parameters for Russia as a country in transition, with their effects on the insurance market:

1. Rapidly changing social conditions

The upheaval brought with it social costs leading to more frequent crime, such as theft. This impacts on premium calculations for certain types of insurance. Where for instance the cost of insuring a heavy goods vehicle in the Soviet Union was around 2 per cent of the value of the vehicle, it is now around 10 per cent.⁹⁰ Although the level of insurance payments is still lower than in the developed countries, it may be expected to rise in future.

2. Demographic trends

The main feature here is the high mortality rate, which has risen considerably since 1989 in the CIS countries. This makes it difficult to calculate life insurance premiums, and results in high premiums for private health insurance.⁹¹

3. Social insurance systems

The chief characteristic of the social insurance systems is the high contributions paid by employers and employees. The state budget is no longer able to meet its obligations, as payments into the national budget are in arrears. The state insurance systems are to be supplemented by the formation of private pension funds. The development of life and retirement insurance is conditional to some extent on progress in reforming the social insurance systems.

4. The inflation rate

Concealed or apparent inflation is high. Following a stabilisation phase, the rouble has again collapsed.⁹² There is little confidence in the national currency. In addition, reserves in roubles which have been built up by insurers are depleted by inflation. Inflation makes it more difficult for the insurer to calculate risk, and can lead to divergences between obligations formed previously and in the present. Extra difficulty in calculating risk is especially problematic for long-term products such as certain types of life and liability insurance.

5. Capital markets

The Russian capital markets are under-developed and prone to crisis. Insurers seeking to build up their reserves on the capital market have little opportunity to diversify their

deposits. There is little real property available. Cadastral rules or equivalent instruments to secure rights to immovables, such as title insurance, are poorly developed or non-existent. Hence inflation-proof long-term investments based on immovables are not profitable.

6. The court system

The courts are poorly funded, and there is no independent system of administrative courts. The judges are not adequately trained for the new laws, and have little experience of dealing with economic law matters. There is no reliable means of prosecuting claims for damages. Consequently, it is difficult to calculate premiums for liability insurance.

7. Legislation

Significant areas of legislation have not been completely reformed. Although new procedural rules have been adopted for economic cases coming before the courts, and large parts of the civil law code have been updated, the criminal code and tax law have still to be overhauled. In these areas, the rules of the former Soviet Union sometimes continue in force; elsewhere, there is a large backlog of administrative rules. There is no general procedural law for administrative cases or for police and public order matters.

8. Public and private budgets

The national budget crisis is continuing.⁹³ According to the International Monetary Fund, the deficit in the Federal budget, e.g. for the first three quarters of 1997, was more than 9 per cent of gross domestic product. This is without taking account of the wide-ranging quasi-fiscal activities of the various ministries at all Federal levels. Receipts to the state budget are in arrears. Large enterprises are forced to offset budget claims against outstanding payments. At the same time, the planned tax reform has been postponed.

The actual level of earned incomes is unknown.⁹⁴ All the figures available are based on unreliable data. According to these, about 20 per cent of incomes are below subsistence level. There are substantial arrears in wage payments. Real average monthly pensions are falling, and real incomes from property, business activity and other sources are stagnating.

II. Micro-economic factors

In the insurance sector, there are certain specific factors applying to the transition process in the Russian Federation.⁹⁵

1. Accident statistics

It is difficult to obtain statistics for the number and scale of insurance claims made. Insurance companies do not have enough reliable and accessible information, and the picture changes rapidly. The bodies which gather official statistics in the insurance

field include, as well as the supervisory organs, the State Statistics Committee of the Russian Federation, "Goskomstat". This is a federal authority which prepares and presents data for the insurance market using its own methods, which are unusual for the insurance industry.⁹⁶ The All-Russian Association of Insurers, the VSS, is planning a voluntary, unofficial survey using the criteria of the insurance industry. However, it has not yet gone further than statements of intent. These various sets of statistics are not all generally accessible to the industry, as they are covered by strict data protection rules. In practice, insurers have to rely on their own figures, or use those of international reinsurance agents.

2. Actuaries

Actuaries play a key role in the insurance market. Their work has great significance for supervision purposes. However, actuaries are scarce in Russia; the market is supplied almost exclusively by foreigners.

3. Bookkeeping

Bookkeeping is to some extent the information medium between various actors on the market. Standard, regulated rules of bookkeeping are therefore indispensable. However, in the Russian Federation the profession is still in its beginnings, and has not yet acquired any special statutory form for the insurance market.⁹⁷ A programme has been adopted by the Government for special bookkeeping rules for the insurance industry, but it is doubtful whether this will be put into practice.⁹⁸

4. Lack of capital

Over 80 per cent of Russian insurance companies are massively under-capitalised. Most companies would verge on bankruptcy if a claim of average dimensions were made. According to Government figures, the total capital volume of *all* Russian insurance companies matches that of about one average-size Western company.⁹⁹ Approximately 100 insurers control 60 per cent of all market operations, and between 200 and 300 firms earn 90 per cent of the total premium receipts.¹⁰⁰ 27 per cent of all insurers, with about 44 per cent of total premium income, are concentrated in Moscow. These problems are exacerbated by the poorly-functioning capital markets and inflation. The share of foreign capital in any Russian insurance company may be up to 49 per cent.¹⁰¹

B. An inventory of Russian supervision law

I. The regulatory agency

1. How it originated

It was in 1988 that the USSR law "On cooperatives", in Article 22 (3) first permitted cooperatives to organise insurance agencies in their own fields. This incursion into the State insurance monopoly was the point of departure for the development of a private insurance market. The state monopoly in insurance finally gave way in 1990,

enabling insurers to practise freely as new legal entities. The development which now occurred can be traced back to two industry groupings.

First, the capital holding of the former monopoly insurers "Ingostrakh" and "Gossstrakh" generated a number of companies which derived their personal and financial resources from the former state monopoly insurers. Ingostrakh was transformed into a public share company of the same name, while Gossstrakh was renamed Rossgossstrakh and remained a state enterprise. Plans to privatise it have not yet succeeded. Secondly, opposite the group around the former monopoly insurers was a large group of insurance companies formed with private capital. Both camps set up rival associations of insurers, and structured the organised enterprises according to their own systems (the Gossstrakh system and the ASSO system). Only in the mid-1990s was it possible to set up an all-Russian association of insurers bringing both systems together.

Because of the rapid increase in numbers of insurance companies, the need for regulation through supervision law was discussed. Here again, two camps were in opposition to each other. The ASSO group took the view that so new a market was not yet ripe for regulation, and that regulation would endanger the growth of the market.¹⁰² The other camp, including the Gossstrakh system, argued that state supervision was necessary to protect insurance customers. Ultimately, supervision would also protect the interests of the industry, as it could guarantee free and ordered competition. Both sides put forward draft laws reflecting their positions.

Under the decree of 10.2.1992 issued by the President of the Russian Federation "On state insurance supervision for the Russian Federation", the "Gossstrakhnadzor" was set up, and provisional procedural rules were adopted. On 30.9.1992 a new name was chosen, the "Federal Inspectorate for Insurance", adopted by decree. With the Russian Federation law "On insurance" of 27.12.1992 (the insurance law), supervision was placed on a statutory basis for the first time.¹⁰³ The basis of the law consisted of preliminary texts prepared towards the end of the former Soviet Union. They were revised with the help of Western advisers from Germany and Britain. Under Article 30 (2) of the law, on 19.3.1993 the Government issued a regulation governing the procedures and powers of the supervisory organ (the Supervision Regulation).

2. Formation and structure

Under Article 30 (2) of the Federal law "On the organisation of insurance activity in the Russian Federation" of 27.11.1992, in the version of 31.12.1997 (the insurance law) supervision of insurance activities by the state is carried out by means of a federal monitoring body. In principle, supervision is within the authority of the Government (para. 3, Supervision Regulation). The responsible body is the Finance Ministry of the Russian Federation. Following the instructions of the Russian Finance Ministry of 14.5.97, a department for insurance supervision was set up in the central apparatus of the Ministry. This is not an independent authority, but a sub-division of the Ministry. Under paragraphs 1 and 2 of the instruction, all decisions must be authorised by the counter-signature of the deputy Finance Minister.

The structure of the authority is hierarchical and centralised. At its head is the director, who is personally liable (paragraph 17 of the Supervision Regulation). He appoints his deputy and determines the internal organisational structure of the authority. Under paragraph 23 of the Regulation, the deputy is appointed to his post and relieved of it by the Government. Moreover, he has no special powers to intervene in the industry (para. 22 of the Regulation). There is a collegiate body set up to exercise the supervisory functions. According to para. 24 of the Regulation, all senior officials of the collegiate body have voting rights, but no veto. The decisions of the collegiate body are followed up through instructions by the head of the supervisory authority, which sets up commissions to discharge its tasks and appoints officials with full powers to investigate insurance companies (para. 12 of the Regulation).

Paragraph 1, second sentence of the Regulation states that the supervisory body operates in the regions of the Federation through territorial organs, called inspectorates. In another regulation, dated 26.6.93, the Government decided upon the structure and distribution of the territorial organs (Territorial Regulation).¹⁰⁴ Under paragraph 1 of the Regulation, the regional structure is determined by agreement with federal ministries and representatives of the administration of subjects of the Federation. The question of reforming the inspectorates is decided, under paragraph 2 of the Territorial Regulation, by the director of the supervisory body together with the representatives of federal authorities concerned and administrative organs of the subjects of the Federation. The appointment and dismissal of the directors of inspectorates is the responsibility of the director of the federal supervisory body (paragraph 19 of the Supervision Regulation). Under paragraph 7 of the Territorial Regulation, subject to the instructions of the Finance Ministry of 29.12.97, the supervisory organ defines the duties and powers of the inspectorates. According to these, they carry out all local investigations. Licensing remains the prerogative of the supervisory organ itself (paragraph 8 of the instruction of 29.12.97).

3 The goal of supervision

According to article 30 (1) of the Law on Insurance, state supervision has several aims to fulfil. Along with legal monitoring, effective development of insurance services and protection of the customers' interests, the supervisory organ is also responding to the interests of insurers, those of the state and those of "other persons concerned".

The overall aims of supervision under Article 30 of the Law on Supervision are defined in detail by the Regulation on Supervision. The starting-point is the regulation of a "uniform market in insurance in the Russian Federation" (paragraph 2 of the Regulation). The chief task, according to paragraph 7 of the Regulation, is legal monitoring, in order to protect the interests specified. For this purpose, the supervisory organ issues what are called "declarations" on the application of the insurance legislation (paragraph 26 of the Regulation). Moreover, the director of the supervisory body has the power, according to article 30 (3) d of the Law on Insurance together with paragraph 18 of the Regulation, to issue normative instructions, orders and directions which are generally binding, within the framework of the statutory powers of the supervisory body.

The supervisory body is subject to a wide-ranging duty of confidentiality, under article 33 of the Law.

4. Finance and personnel

The supervisory body is financed exclusively from the state budget. According to paragraph 21 of the Regulation, the central apparatus and the inspectorates are financed from the budget of the federal authorities, a distinct chapter of the state budget. There are no rules to specify the number of senior employees of the supervisory body. Under paragraph 3 of the Territorial Regulation, the inspectorates have a total of 160 senior staff.

II. Regulatory instruments

1. Market entry

The condition for market entry is possession of a licence to exercise insurance business. Under article 30 (3 a) of the Law, it is the supervisory body which issues these licences. In the light of Russian legal thinking, the licence defines the character of an insurance company. The exception is found in insurance companies with foreign capital participation. According to article 6 (1) of the Law insurers are legal persons who have received a licence to operate. If a company has no licence, it is forbidden by statute (article 6 (2) of the Law) to carry on an insurance business. But closed contracts, according to article 168 of the Code of Civil Law of the Russian Federation, are legally void.

There is no compulsion when it comes to choosing the legal form of a company. According to article 6 (1) of the Law, a company may choose any form it wishes under Russian law. One restriction is that the legal form must be that of a legal person and the company must be registered. Thus an insurance company may choose to be, for instance, a limited liability company or a partnership under Russian law.

The applicant for a licence must, under article 32 (1) of the Law, submit the company's articles of association, the General Terms of Business, the rates charged and a schedule of the planned company structure. There are special rules for reinsurance companies. The application must be processed within sixty days of receipt of the documents. It may only be rejected if the documents submitted are deficient (article 32 (4) of the Law).

The procedure of issuing licences is further spelt out in the instructions issued by the supervisory body on 19.5.94 (the Licensing Instruction).¹⁰⁵ Under paragraph 2.1.2 the licence is issued for an indefinite term for a particular branch of insurance. In exceptional cases the licence may be time-bound. Special licences are granted for personal insurance, goods insurance, liability insurance and reinsurance (article 32 (2) of the Law, paragraph 2.3 of the Licensing Instruction). Special rules govern the combined operation of different branches of insurance. To obtain a licence for the first time, under paragraph 3.2 of the Instruction the applicant must show that the founding capital has been paid in, and submit a business plan (paragraphs 3.3 and 4.1.4 of the Instruction). Paragraph 4.1 et seq. of the Instruction expands considerably

on the documents to be submitted with the application, by comparison with article 32 of the Law. The Instruction contains detailed minimum requirements regarding the General Terms of Insurance (paragraph 4.1.5 of the Instruction).

Until 31.12.97 there were no statutory requirements concerning minimum capital stock. Since the first amendment of the Law, on 31.12.97, there is now a provision in article 25 (2) of the Law on minimum capitalisation for different types of insurance. Paid-up capital for all types of insurance, apart from life insurance, must be at least 25,000 times the minimum wage; for life insurance at least 35,000 times the minimum wage; and for reinsurance, at least 50,000 times the minimum wage.¹⁰⁶ This requirement came into effect on 1.1.1999.¹⁰⁷ However, estimates by the VSS indicate that by April 1998, only 150 companies were actually in a position to put up the minimum capital.¹⁰⁸ By the target-date, over 80 insurers were supposed to have doubled their capital; this can hardly be expected.¹⁰⁹

Under paragraph 4 of the law introducing the Law on Insurance, of 27.11.92, an insurance company must pay a fee of 50 times the minimum wage into the state budget.

2. Exploiting the market

When the licence is granted, an insurance company is admitted to operate in the field of insurance covered by the licence, and may conclude insurance contracts. The grant of the licence has a constitutive effect for the insurance company. Under article 6 (1(2)) of the Law on Insurance, an insurer may not conduct outside business in banking and trade. The company carries on business through insurance intermediaries (article 8 (1) of the Law). The intermediaries may include brokers and agencies. There are no special rules for insurance companies covering the use of intermediaries. However, under article 30 (3 b) of the Law, the supervisory body keeps a central register of brokers.

While an insurance company is operating on the market, the regulatory agency is responsible for ongoing supervision. To discharge this responsibility, the supervisory body has special powers. Under article 30 (4 a) of the Law, the supervisory body is entitled to know the financial position of the insurers. It may exercise this right at any time against questionable insurance companies. It also has the right to receive any information needed to fulfil its functions from companies, institutions, associations and private citizens.

According to article 30 (3) c) of the Law, the supervisory body monitors the setting of rates and the manner in which the solvency of insurers is secured. Solvency, according to article 27 (1) of the Law, is determined through the "normative inter-relationship" of assets and debts. The procedure for determining the normative inter-relationship is regulated by an instruction of 30.10.1995.¹¹⁰ According to article 26 (1) of the Law, insurers are obliged to build reserve funds from their premium income in order to meet their obligations.¹¹¹ From their after-tax profits, insurers may constitute funds to secure their business (article 26 (2) of the Law). Under article 26 (3) of the Law, the insurers may invest, or build security reserves by some other means. However, it is a binding obligation, under the supervisory body instruction of

14.3.1995 (the Reserve Instruction) to constitute reserves.¹¹² According to this instruction, investments which are not in conformity with the options specified in paragraph 2.1 of the Reserve Instruction (paragraph 2.2 of the Instruction) are prohibited. These options include state securities. Paragraph 2.6 of the Instruction provides that for long-term life insurance, at least 20 per cent of the reserves must be invested in state securities, and for other types of insurance at least 10 per cent.¹¹³ Individual branches of the insurance industry, and the private pension funds, were required by government regulations in the spring of 1998 to invest up to 100 per cent of these deposits in short-term state bonds of the Russian Federation, so-called GKO's.

3. Exiting from the market

Exit from the market is governed from two points of view: ongoing supervision sets the wheels in motion, or the company is insolvent and this requires regulation. Since the rules on insolvency of legal persons specify particular requirements in which the supervisory body has to play a role, they will be considered here in detail.

If it appears during ongoing supervision that the insurer is committing a breach of the Law on Insurance, the supervisory body has the right to order the insurer to correct the defective conduct (article 30 (4 c) of the Law. If it fails to comply, the supervisory body is empowered either to suspend the company's licence until the order is complied with, or to place restrictions on it. In extreme cases, the supervisory body may institute a procedure to revoke the licence.¹¹⁴ The supervisory body has set down the procedure for making orders in detailed form in its Instruction of 19.6.1995 (the Instruction on Orders).¹¹⁵ The order must be made in writing and must specify a time limit for compliance. Under paragraph 2.2 of the Instruction, an order may be made if extraneous business is carried on, if unlicensed types of insurance are practised, if the rules on constituting reserves are infringed and if there is a delay in submitting the required documents. If a licence is restricted, under paragraph 3.1 of the Instruction on Orders this means that the insurers concerned are forbidden to conclude any more insurance contracts or to extend existing ones. Revocation means a general prohibition on concluding or extending insurance contracts of any kind. In both instances, existing contracts must continue to be performed. The preconditions for revocation include either repeated, i.e. more than one, restrictions or suspensions of a licence, or a court judgment finding that business has been carried on unlawfully, delay in complying with an order which led to the restriction or suspension of a licence, or any of the other cases provided by the law of the Russian Federation (paragraph 4.2 of the Instruction on Orders). The revocation of a licence means that the company is prohibited from carrying on business at all, at any time (paragraph 4.1 of the Instruction). An exception is made for the settlement of obligations arising from existing contracts. The insurer may use available reserves for this purpose. The contracts themselves cease to be effective (paragraph 4.6 of the Instruction). In practice, a large number of orders have so far been made against insurers. There are detailed statistics on the restriction, suspension and revocation of licences. The supervisory body regularly issues instructions with the data of those insurers which have had measures ordered against them in the course of ongoing supervision. In one instruction alone, that of 6.1.1998, licences were revoked for 39 insurance companies.

¹¹⁶In the period from 14 April 1995 to date, over 21 such instructions were issued by

the supervisory body for the revocation of licences. There are corresponding figures for the restriction and suspension of licences.

Where the law on insurance is repeatedly infringed, the supervisory body also has the right to apply to the court of arbitration for the insurance company concerned to be wound up (article 30 (4 d) of the Law on Insurance).

If the insurer, the state attorney or a client makes an application in bankruptcy, the court of arbitration will decide whether the bankruptcy procedure should be started (see article 97 (1) of the law "On Insolvency" of 8.1.1998 (the Insolvency Law)).¹¹⁷ The procedure begins when negotiations start. Unlike the procedure with banks, before an application is made to institute insolvency proceedings there is no need for the licence to have been revoked (see article 11 of the Law on Insolvency). The supervisory body takes part in the negotiations (article 144 (1) of the Law). If the court decides that the company is bankrupt, it will make a judgment to that effect and order an auction of the company's assets (article 49 (1) of the Law). Where a decision is made by the creditors together to place the company in receivership, the court will order this to be done (article 68 (1) of the Law). According to article 145 (1) of the Law, the assets of the company will be sold. Only insurance companies are permitted to buy them. If the insolvent insurance company has been placed under compulsory receivership, the whole of the contractual stock passes to the purchaser (article 145 (3) of the Law). If the court has decided on bankruptcy and ordered receivership, under article 145 (1 (2)) of the Law the assets may only be sold when the purchaser takes over the contracts which have not yet been valued.

C. A positive analysis of Russian supervision law

I. Why have supervision?

1. Weakness of the general theory of regulation

The general positive theory of regulation has no conclusive explanation for the emergence of regulation. Both the self-interest and the bureaucracy theories assume, a priori, that regulation exists. Stigler's theory of regulation is able to identify demand for regulation through the industry. However, its weakness is that it cannot offer any political model of choice for the decisions of the President in favour of regulation.

A political model of choice is offered by the theories of modern political economy. But the approaches of modern political economy make a false political assumption in the case of the Russian Federation. They cannot convincingly show from which source the initial impulse by electoral groups will proceed. In its favour may be said that the counter-argument of information being compensated by an association of insurers in Russia also fails to pin down the decision to regulate. The crucial organ of decision-making has not been the Parliament, but the President. Since the taxation rules are mainly set by federal law or administrative prescription, the President could not seek votes in his election campaign by offering more regulation. Hence the subsequent adoption of the Law on Insurance was only a response to a broad

consensus, on the basis of the facts brought about by the President, and could not be seen as an offer by the legislature to mobilise electors' votes in a public debate.

2. Finsinger's model of the intervention phase

However, Finsinger's phase model offers valid schemas to explain the emergence of the Russian supervisory body for the insurance market.

According to this model, the creation of the Russian insurance supervision agency is the product of a conflict between competing interest groups, which have exerted influence on the decision-makers in two respects. First, there are clear indications that the Presidency as a decision-making institution was influenced. At this point in time Ingosstrakh was a leader in the Gosstrakh system. The presidential apparatus has close contact with the former monopoly insurer, Ingosstrakh.¹¹⁸ Second, the passing of the Law on Insurance can be attributed to the interest group around Ingosstrakh being the winner. The Soviet draft, which is mentioned above, was compiled by Ingosstrakh in cooperation with Gosstrakh. Since this draft, in its structure and style, was the original model for the Law, it can be assumed that it was actively promoted by the former monopoly insurers in the Duma.

However, Finsinger's model of the intervention phase does not explain the motivation for regulation.

3. Motivation for restricting market entry

The self-interest theory, the lines of approach in the bureaucracy theory and the acceptance theory are not an adequate basis for an explanation, since they all assume the existence of a supervisory organ and therefore do not explain its emergence. Moreover, all these theories have difficulty with the highly heterogeneous interest structure at the time of emergence.

Stigler's theory of regulation does however provide a credible motive for demand on the part of the insurers, the desire for an advantageous position on the market. Following demonopolisation, the number of new actors on the insurance market multiplied rapidly. The competing systems of Gosstrakh and ASSO both had an interest in making it more difficult for the other system to enter the market. There was the personal and financial continuity of the former monopoly insurance structure to reckon with. The new insurance companies hastening on to the market were foreign bodies, from this point of view. If the proposed regulation came about, the Gosstrakh system would have the advantage, since it was close to the state authorities and better qualified. Consequently, the advocates for this system were able to argue the public interest cause. However, this ideal model is replaced by the desire for intervention in order to restrict competition. This meant that restrictions on market entry only served the self-interest of the group of actors in the Gosstrakh system who were already well established.

If this conclusion is correct, it would result in weak or disempowered supervision. The supervisory authority would then become merely a "licensing agency" for an

advantageous market position. Thus the development of the supervisory authority must be further examined.

II. The development of supervision

1. Expansion

With the establishment of the supervisory organ a relatively strong supervisory agency was created, compared with the size of the regulated market. In the version of 27.11.1992 article 30 (2) of what was then the Law on Insurance provided that the supervisory role should be entrusted to a "Federal service for monitoring insurance activities". According to the Presidential decree of 10.1.1994, "On the structure of the organs of Federal administration", the supervisory body still had the position of an independent federal agency. This was a much stronger position than its present one. As a federal agency the supervisory body had the right to issue instructions and orders independently and without counter-signature. Thus in the federal administrative hierarchy, the supervisory body came immediately below the ministries of the Russian Federation. The directors of the agency were directly responsible to the President (paragraph 1 of the decree of 12.11.1992 "On the supervisory organs of the State" in the version of 12.11.92).¹¹⁹

With these powers, in the period from 1993 to mid-1996 the supervisory body built up a weighty and constantly growing web of generally binding instructions, serving to refine further the instruments of regulation, which were only roughly framed in statute. In order to deal with the increasing pressure of regulatory instructions and the growing number of orders, in 1995 the conflict between the competing associations of insurers was removed by founding the All-Russian Association of Insurers.

Finsinger's theory of regulation describes the progress of development as the consolidation phase. All these elements can be found here. Through instructions the supervisory body institutes summary proceedings which force the insurance industry to cooperate more closely. From the point of view of information, the supervisory body by virtue of its position had the advantage over the regulated industry. The industry was compelled to cooperate more with the supervisory body, and put aside its own turf wars. However, the number of orders for the restriction, suspension or revocation of licences did not decrease. This leads to the conclusion that in spite of ever closer regulation, the cycle of reaction *Instruction - Avoidance tactic - Instruction* could not be broken. Here the cyclical character of consolidation is clear, but increasing failure on the part of the supervisory body has yet to be explained.

2. Degression

The present structure and position of the supervisory body is the result of a dramatic development in 1996.

The conduct of the President was again the deciding factor. Under article 112 (1) of the Constitution of the Russian Federation, the President has the prerogative of organising all the organs of the federal administration. On this basis, two decrees were issued on 14.8.1996 to reorganise the federal administration, as a result of which

the supervisory body was dissolved as an independent authority. This was preceded by lively controversy about the behaviour of the supervisory body in deciding matters of insurance policy. The supervisory body had attempted to extend its powers to the Moscow OMS Fund, the statutory health insurance fund. High-placed individuals in the supervisory body took a personal stance, ignoring an instruction by the government of the city of Moscow and the Federation. From the conflict between the supervisory body and the government grew a public dispute in which the insurers accused the supervisory body of showing a preference for certain companies and pursuing its own interests.

Here too, Finsinger's theory offers a conclusive explanation of what occurred. It says that the reform and weakening of the supervisory agency can be interpreted as the deregulation phase. The industry was able to build up greater assets by forming a single association. The decision to deregulate did not come from the supervisory body itself, but from the President. As the theory shows, the assertion that the employees of the supervisory agency are not to be dismissed is not appropriate, at least as far as Russia is concerned. However, the positive theory of regulation, according to Finsinger, is capable of interpreting the main features of the phenomenon.

The significance of the rising trend of the consolidation phase is also confirmed in the effects of the crisis: the director of the supervisory body and his deputy were taken out of the President's sphere of influence by placing the supervisory body in the Finance Ministry, and could therefore be dismissed from their jobs without his consent. They both, after losing their jobs, transferred smoothly to the private sector. This therefore shows that at this point in time it was already worthwhile to recruit specialists from among the former employees of the supervisory agency.

3. The watering-down phase

The restructuring of the supervisory agency is regarded here, with Finsinger, as deregulation. The President's radical solution surprised all parties. On all sides, it was publicly argued that there must be a strong supervisory body, but there were also complaints about the lack of control over it.

In point of fact, the President disposed of the supervisory body almost completely as an independent actor. Ultimately, the "deregulation concept" is confined to an institutional disempowerment of the supervisory organ. The statutory regulatory instruments, developed through instructions, were untouched. Where the power to issue instructions had been extraordinarily effective for the supervisory body as an independent authority, now every instruction has to be countersigned by the Finance Minister. Hence the supervisory body, at present, has no vested interest left which it can defend on its own account. This has made the vested interest of the interest group represented by the insurance industry all the stronger. Along with the unification of the members of the All-Russian Association, which has already been mentioned, a supervisory organ which ran counter to the interests of the insurers has been successfully disempowered. As if to complete the victory of the insurance industry, the impending career motivation of the self-interest theory can be observed in reverse. A leading long-serving member of the All-Russian Association of Insurance

Companies got the job of deputy director of the supervisory body, and thereby the right to authorise instructions under his own signature.

Against this background, the phenomenon now being observed is of special significance when we consider the present state of the supervisory body. Negotiations are now in train between the insurance industry and the Finance Ministry in order to determine how the supervisory body, in the light of the government's general responsibility under paragraph 3 of the Regulation on supervision, and without involving the President, can again be given greater independence. If this plan succeeds, the "deregulation approach" tending to renewed expansion of the scope for market intervention by the supervisory body, would be enfeebled and watered down.

Finsinger's theory must however be modified in the sense that subsequent restrictions on the supervisory agency causes an increase in the demand for regulation by the industry, because the restriction on market entry, which remains weak, can hardly prevent competition. In the event of the supervisory actor being disempowered, the industry is able, without any countervailing power of the state, to remodel the rump supervisory agency according to the requirements of the industry. Relying on the acceptance theory, this observation could be described as the "acceptance effect". For countries in transition it must be added that on such occasions it seems advisable to "dispatch" skilled personnel to the supervisory body.

III. Consequences of supervision law

1. Acceptance of problem feedback

By comparison with the ideal regulatory agency in the reference model, the Russian supervisory body for insurance does not seem able in any respect to meet the aims of "public interest". From this total deviation from the assumptions of the reference model we can only conclude that the Russian law on supervision does not fit the model as far as the consequences of regulation are concerned. However, this assessment is perhaps over-simple.

The assessment may be the result of the superimposition of different problems which are not necessarily associated with the subject of our study. We can only decide if this is so by attempting to differentiate among various problem settings. We must therefore distinguish between the *transition-related* and *regulation-related* problems of the supervisory agency in Russia.

The transition-related problems include those which are caused directly by the circumstances in Russia as a transition country: for instance, the state budget deficit (salaries of state employees are not neutral) and the poor statistical basis of the insurance industry (incomplete information). All the problems which can be attributed only indirectly to the surrounding circumstances must be regarded as regulation-related. This supposition should be tested in individual cases.

For reasons of space, two key points will be selected: the structural aspect and the range of regulatory instruments.

2. Structure of the regulatory agency

The consequences of supervision law are indelibly marked by the structure of the Russian supervisory body. This is itself determined by the general juridical framework of Russian administrative and constitutional law, and is also associated with a situation where, on the one hand, there is assumed to be a political vacuum and where on the other hand, conduct is assumed to be selfless.

a) The problem of the hierarchy of norms

The assumption of selfless conduct proceeds, among other things, from the notion that the regulatory agency makes its decisions in a framework set by parliament. However, in the Russian Federation there is a large number of normative settings, which have to be distinguished in the light of constitutional law. They form part of an extensive pyramid of norms, at the top of which is the constitution and the constitutional laws of the Federation. An ordinary federal statute has to comply with these. Both groups are statutes, according to Russian legal theory, and are described as "statutory normative acts". They are followed by what are called "non-statutory normative acts". These instruments are not laws. Their apex is the Presidential normative decree, followed by government decisions.¹²⁰ Below these are the instruments enacted by the ministries. At the bottom of the hierarchy of norms are the acts of the federal authorities, to which the instructions of the supervisory body belonged until mid-1996.

All these norms form part of the pyramid, and are called "legislative acts". Thus laws and non-statutory normative acts are both described as legislation. A non-statutory normative act within this pyramid may not conflict with an act which is superior to it. Moreover, Russian law on the administration is ignorant of statutory reservation and has no delegated legislation. The administration is subject only to a broad principle of legality, whereby, for instance, the administrative acts of the government may not contradict statutes or presidential decrees (article 115 (3) of the Constitution of the Russian Federation). Hence the administration, acting on the basis of any decree, law or the constitution itself, and in order to implement them, may itself enact rules which are generally binding. From this it follows that rational behaviour by an employee of the supervisory body is made quite difficult, since he cannot see where the rules fit together. There is a constant threat of conflict with other non-statutory normative instruments. In fact "legislation" usually means only a formal law, so that non-statutory instruments incorporate the most general rules of the law.

A political vacuum cannot be anticipated in these circumstances. The substructure of rules in the supervision system is dominated by "soft", non-statutory normative instruments. "Hard" formal law is the exception. Since the government and the President may enact rules without statutory reservation and without express authority "in order to implement the constitution", parliamentary sanction would be almost pointless.

From the constitutional law perspective, it can be seen that it is easy for the government and the President to exert political pressure on the supervisory body, since the structure of the body is not clearly safeguarded, either as regards its position or as regards its funding. This factor is not a by-product of transition; it springs from

a defective statutory basis for the structure of the regulatory agency, and can therefore be seen as regulation-related.

b) The problem of the state budget

With the question of funding a further aspect of the structure of the regulatory agency has to be considered. Practice shows that all the activities of the supervisory body suffer from considerable shortages in terms of finance and personnel. For example, discussions with the St Petersburg inspectorate showed that most inspectorates are on the verge of self-liquidation. Telephone bills and rental contracts for business premises can no longer be paid. Current contracts may have to be terminated. In order to save money, senior staff are obliged to do their own typing as well as various types of maintenance work. This problem is however only an indirect consequence of the institutional problem of the state budget. As long as the supervisory body, through the Regulation on Supervision, remains tied to the deficit in the state budget, this situation will persist. Consequently, funding can be regarded as a regulation-related problem of the reference model.

3. Instruments of regulation

In Russian law, the supervisory body has essentially only two sanctions it can use: licensing and the application for liquidation. The orders it makes seem to be only a preliminary procedure to the licensing sanction. Thus market entry and ongoing supervision are dominated by the licence issue. Where licensing affects the insurance companies themselves, an application for liquidation affects the legal person who in practice will usually have lost the right to operate. Only the licence to operate can be granted or withheld by the supervisory body. Liquidation has to be ordered by the court of arbitration, and enforced under general procedural law. Both measures are outside the competence of the supervisory body, and are time-consuming. Moreover, the liquidation procedure only makes sense if the legal person continues to operate despite the licence being revoked. Ultimately, therefore, only the licensing process is effective as a sanction in regulating the insurance market.

D. Normative analysis of Russian supervision law

I. Market failure on the Russian market

1. The problem of the ceteris-paribus assumption

The ceteris-paribus assumption does not really hold up for Russia as a transition country. Because institutions, such as the capital market, are wanting there is a basic problem in considering market failure. Under what circumstances can the insurance market in Russia function at all? For as long as the data remain constant, economic theory can confine itself to examining economic variables, and thus limit itself to the way markets function. But as we can see, in the case of countries in transition the institutions become the focus of interest when considering the functioning of markets.

Consequently, the normative theory of law cannot successfully choose between alternative courses of action by the legislature, if the institutional preconditions do not

exist because of transition factors. In this case it seems necessary to fall back on a method which can explain the conditions for the emergence of the necessary institutions. This is dealt with by the so-called modern economics of institutions. However, their line of research is outside the scope of our study.

2nd Equivalence hypothesis

A somewhat unsatisfactory result here is that the normative economic theory of law can hardly be applied in a rational manner to countries in transition. But is it possible by using a slightly different approach to achieve valid results, using the normative economic theory?

It is conceivable, for instance, that valid conclusions can be drawn via a straightforward *ceteris-paribus* assumption. Thus if the contra-factual framework conditions are assumed and market failure is tested following normative theories, the defects which call for regulation can perhaps be identified. Here a fresh problem arises: can such a "divisive" examination be productive? For it is possible that the framework conditions and the causes of market failure interact with each other, so that they cannot be defined through an altered approach. There is also an answer in the form of institutional economics, which attempts to explain the manner of functioning of institutional arrangements and how they develop.¹²¹ But this lies outside the methodical scope of our study.

In order to discern the effects in a highly abstract neoclassical welfare model, a normative study seems nevertheless to be viable, since the defect which it shows up is open to examination. This procedure can be described as the *equivalence hypothesis*.

This assumes that if market failure occurs in a given transition situation with *ceteris-paribus* and an existing supervisory organ, there will always be a certain flaw in the regulation. This flaw is equivalent to the flaw in regulation which is present in the assumed transition situation without *ceteris-paribus* and the presence of a supervisory organ when the same market failure occurs. At this time, however, it is not possible to make any pronouncement about the nature of the need for regulation. Rather, the comparison with different hypothetical regulation options must be tested until market success can be identified.

3. Market failure situations

We first have to see what situations of market failure there are. If market failure can be found under a particular constellation for one kind of market failure situation, for reasons of space no other constellation for this situation will be examined.

From the perspective of our study, only two forms of market failure are to be considered. These show external effects with domino effects, and growing gains of scale with ruinous competition.

a) The domino effect

The domino effect can be shown to exist on the Russian insurance market. The insurers have no reliable statistics on the pattern of accidents. They are mainly reliant on data from their own businesses or from friendly companies. The insurers' association has no infrastructure to deal with this task. Another complication is that there are considerable regional differences in the pattern of accidents to be anticipated. Environmental risks in the northern region are different in kind from those in Moscow or on the Caspian Sea. This brings an advantage to companies which have large quantities of information at their disposal about accident trends. Naturally, the former monopoly insurers have the advantage here. The result is considerable distortions of competition, which lead to a non-existence problem.

If we assume *ceteris-paribus*, where regulation exists market failure will occur, since the supervisory body has no means of compensating the service gap, i.e., equalising the information asymmetry. The same result occurs in the absence of the *ceteris-paribus* assumption. Thus the lack of statistics means in these market conditions that regulation is needed.

b) Increasing gains of scale

Increasing gains of scale can also be identified. The under-capitalised insurers subscribe risks which in their amount and frequency cannot be borne by the poor capital cover. There is the danger that capacity will be overstretched in order to compensate for insufficient capital cover through current premium receipts. According to reports from the supervisory body, many insurers meet their obligations only from current receipts. In order to meet the requirements of the supervisory body for the portfolio to be balanced, the insurers pass on heavier risks to reinsurers, or are obliged to join together in insurance pools. The latter will not be very effective, since the country's insurers are mainly under-capitalised. On top of this, the lack of skills and experience on the part of company management results in the actual scale of the risk being underestimated. Assistance from service providers is available to only a limited extent on the Russian market. Moreover, there are marked regional discrepancies in the services on offer (e.g. Moscow and Novosibirsk). If the companies engage in competition under these conditions, instability cannot be avoided. Here are synergies to the domino effects. Insolvency threatens and does occur, thus eliminating balanced competition.

The same observation applies when the equivalence hypothesis is followed. If we take the *ceteris-paribus* assumption, it does not affect the under-capitalisation and the willingness of the insurers to overstretch their capacity. Both aspects would feature even without the *ceteris-paribus* assumption, since they both have a micro-economic character. Hence regulation is needed in order to prevent insolvency.

II. The need for regulation

1. A comparison of theories

According to the view taken here, there are two contrasting efficiency-oriented theories for the Russian insurance market. Since they depart from different basic positions, we will distinguish here between the advocacy and the entrepreneurial theories.

There are basic objections to the entrepreneurial theory, springing from the framework conditions in Russia as a country in transition. If competition takes place as a guarantee of allocation efficiency in the distribution of resources, it follows that premium fixing, the spreading of risk and business and investment policy in Russia should also make it possible to achieve market success even if the framework conditions are not fulfilled. This is not likely to happen. Certainly, capital investment could be taken away from the functions of the supervisory body. But because the government and the President have the power to make rules, this is unlikely to be successful. Regulation does not take place via a regulatory organ, but via "soft" norms set by the government with a view to achieving general economic policy goals. The government's decisions on investment policy for insurance companies show why, against the background of the government's debt moratorium in autumn 1998, the arguments of entrepreneurial theory are quite without substance for Russia. Moreover, the Russian capital market offers no secure opportunities for a sound capital investment policy. It is doubtful whether the government will accept the outflow of capital to foreign capital markets. In addition, the capital ingathering function of insurance in Russia seems to be disturbed. The calculation of premiums offers no assistance. The inter-relationship of capital, subscribed risk and premium calculation will always, in Russia, work to the disfavour of premiums. The consequence is likely to be high premiums for relatively low risks. Given the choice, a rational insurer will steer clear of entire types of insurance. This outcome would disrupt private welfare insurance, with the result that gaps will occur in cover.

The entrepreneurial theory is therefore rejected as far as Russia is concerned.

2. Alternative courses of action

The yardstick for ascertaining alternative courses of action is the equivalence hypothesis. The basis for the argument is the advocacy theory. This will be discussed in terms of key points, and will be confined to a conceivable constellation of factors.

a) Capital investment rules

Increasing gains of scale are caused in Russia both by under-capitalisation and by insecure capital investments. A general requirement for investing tied property is that the asset values must be secure, profitable and liquid. Care must be taken to achieve an appropriate mix and spread of the investment risk. These requirements do not fulfil the previous investment requirements for Russian insurance companies. Specific investment rules are found only on the level of non-statutory normative instruments. In addition, there are also instruments which are not enacted by the supervisory body itself. Moreover, insurance companies are forbidden by paragraph 2.2 of the Reserves Order to make investments not permitted by the Order. This is especially problematic, as according to paragraph 2.6 of the Reserves Order insurers are bound to place 10-20 per cent of their deposits in state securities, which are neither

secure nor liquid and thus offer only the semblance of profitability. Since it cannot be expected that the state will give funding guarantees if state securities become illiquid, statutory regulation of the capital investment rules is necessary, in order to avoid growing gains of scale. It seems advisable here to prohibit especially those security investments which bear notably high interest.¹²²

b) Qualifications sought from management personnel

A serious capital investment policy calls for experience in the appraisal of risk and legal intentions for the investments made, since otherwise it will be impossible to avoid an exacerbation of the capitalisation problem in Russia. Therefore, growing gains of scale can only be headed off if it is ascertained that the senior staff of the insurance company is able to prove that it meets these requirements. There are no rules to this effect. Article 32 (1 a)) merely specifies that the management staff must be made known, not that it should have minimal qualifications. This interpretation corresponds to the practice of the supervisory body. It therefore seems appropriate to add a rule governing the qualifications and prior careers of the senior staff.

c) Statistics

It is questionable whether the information asymmetries on the Russian insurance market can be corrected by making it obligatory for the industry to produce annual figures. Article 30(4a) of the Law on Insurance gives the supervisory body wide powers to obtain information "in the performance of its functions". This can be interpreted to mean that there is a corresponding obligation on the part of the insurers to provide it. In fact, the supervisory body calls for the information to be supplied every three months.

Yet this rule does not suffice to make the supervisory body responsible for keeping statistics of accidents. The statistics kept by the supervisory body are maintained only for internal administrative purposes, and only extracts are published. These statistics must be accompanied by a right on the part of the industry to obtain information, in order to remove the information asymmetries. If the supervisory body collects information through the inspectorates, the insurers would obtain the same information under the same terms about accidents. One problem here is the question of data protection and the additional demands on staff.

d) Preventing insolvency

The supervisory body could be given powers to avert insolvency, in order to avoid market failure caused by growing gains of scale. This idea is associated with the *calculation argument*. The regulatory instrument of asset transfer seems appropriate here. These provisions would fail. The existing rule of the insolvency law bears upon insolvencies which have already occurred.

The rule of the insolvency law offers the option of protection only when instability has already occurred, and is confined to the receipt of assets following an insolvency. However, prevention of insolvency would require a monitoring capacity on the part of the regulatory agency itself, in order to protect the assets ahead of time when

instability threatens in the form of insolvency. The transfer of assets should be understood as a special form of takeover of an insurer by another, this being done under state control to regulate the possibility of complete or partial takeover of the assets without the consent of the insurance customer. A transfer of assets can oblige the insurer to whom the assets are transferred to conduct the contracts properly in future. Accordingly, market success will occur again only when assets are transferred.

A rule of this kind also seems to be required in view of the special situation which will arise from January 2000, since many companies will not comply with minimum capitalisation; secondly, the question of the state of the assets concerned following the revocation of a licence has not been regulated, either positively or negatively.

c) Repressive avoidance of insolvency

From the above follows, as well as prevention of insolvency, the question of handling the assets once insolvency has occurred. Although the case in issue here is a case of insolvency which has already taken place, consumer protection should be treated from the viewpoint of "repressive" avoidance of insolvency, since even the departure of market participants will have indirect effects on the functioning of markets. This follows from the *security argument* of the advocacy theory: if it is no longer possible to avoid an insolvency, the assets of the insurance company must be secured in such a way that confidence in the insurance industry is maintained. To some extent, this combats the outcome of increasing gains of scale.

Article 145 (3) of the Law on Insolvency is not a rule of supervision law, but of the procedural law on insolvency. It depends on an application for (repressive) compulsory administration of a company. There is no such right of application for the supervisory body. The supervisory body has no power to decide on the transfer of assets. It seems therefore desirable to introduce a qualified right of application for the supervisory body. In addition, it should not be the sole prerogative of the court to judge whether an insurer has fulfilled the requirements of the proper conduct of business. It is therefore suggested that the transfer of assets by auction (cf. Article 145 (1) together with article 86 of the Law on Insolvency) should be made dependent on a power of consent by the supervisory body, since insolvency procedures and supervision pursue different aims and the aim of the insolvency procedure, irrespective of whether debtor or creditor protection is sought, does not in any case coincide with the aim of preserving confidence in the insurance industry.

3. Proposals for reform

The following reform proposals are therefore put forward for Russian supervision law:

- introducing the transfer of assets
- statutory regulation of capital investment rules
- minimum requirements for senior personnel
- a duty on all insurers to report on accidents
- a right of information for insurance companies concerning accident statistics.

All the reform proposals, because of the structure of norms in the Russian Federation, should be incorporated in a federal law on supervision and framed in detail.

The Law on Insolvency should also be supplemented to include the insolvency of insurance companies:

- a right of application for the supervisory body to institute insolvency proceedings
- approval by the supervisory body when assets are transferred in the context of insolvency proceedings.

E. Summary

I. Boundaries to the economic theory of law

1. The problem of the framework conditions

In spite of the assumed macro-economic model framework, there is a special problem arising from the framework conditions of Russia as a transition country. In the centrepoint of the problem is the question of institutions. These include capital markets and insurance companies on the one hand, and courts, liability law etc. on the other. These phenomena are outside the neoclassical approach and are added to the data. The constancy of institutional framework conditions which is required for the ceteris-paribus condition does not exist in Russia as a transition country. However, the research approach chosen here, that of the economic theory of law, relies on the neoclassical approach and is therefore limited when it comes to explaining these phenomena. Hence the micro-economics of a country in transition can only to a limited extent be treated as institutionally neutral.

2. A combined solution

The examination of these institutions is the subject of the so-called modern institutional economics. In the long term, a viable study of the law of the transition countries with the methods of economics will only promise success if the approach of modern institutional economics is combined with that of economic theory.

3. The minimal approach

However, economic theory can seek to achieve limited results, even if it applies only its own line of research. This can serve to create awareness of the complex regulation requirements of a country in transition.

II. A positive analysis

1. Problem feedback

Under Russian law, the regulatory agency departs in all respects from the reference model. A reason for this may be that transition-related and regulation-related

problems are different. Both causes act together and bring about a problem feedback which is peculiar to transition situations.

2. A facet of regulation

Existing regulation law suffers from the structural weaknesses of the regulatory agency. The decisive factors lie to some extent outside supervision law and are transition-related.

In licensing, the Russian regulatory agency has only one significant instrument of regulation. This means that the supervisory body can only react to a very limited extent to market developments. Licence sanctions can only have a limited impact in bringing about constructive behaviour on the part of the insurer, as he can only be indirectly compelled to comply with the directions of the supervisory body.

III. Normative analysis

1. Equivalence hypothesis

Under transition circumstances, market failure cannot be attributed solely to the classical market failure situations. However, a minimal approach via an equivalence hypothesis may produce verifiable results.

We find that under a given transition situation, with *ceteris-paribus* and an existing supervisory body, where market failure occurs there will be a certain flaw in regulation. This flaw is equivalent to the flaw in regulation which occurs on the assumption of the same transition situation in the case of the same market failure, but without *ceteris-paribus* and with the supervisory agency. But at this point in time nothing can be said with certainty about the nature of the need for regulation. Rather, a comparative study must be made of different hypothetical regulation options, until market success can be shown to occur.

2. The advocacy solution

The entrepreneurial theory cannot be successfully applied to Russia; this is why preference is given to the advocacy theory.

With this theory, market failure can be shown to occur, using the equivalence hypothesis, as a result of external effects and growing gains of scale on the Russian market.

3. A programme of legal policy

On the Russian market there is a need of regulation for supervision law. The existing rules are inadequate, as the forms of market failure which have been identified cannot be avoided. The existing rules of Russian supervision law need supplementing. For instance, using the yardstick of the equivalence hypothesis and the normative theory of regulation, a choice can be made between different courses of action. However,

there should be no doubt that if the proposals were adopted there would be a minor revolution in Russian administrative law: it would be the first time that a federal administrative organ would be tied to a statutory reservation concerning administrative action - even if only through a simple law.

1. A lawyer and former long-term expert adviser to the *Comité Européen des Assurances Training Task Force* for the TACIS project "*Insurance Training II*" in St. Petersburg and Moscow.

² On the demonopolisation process, see *M. Weyer* "Private insurance law in Russia - an overview", *Versicherungswirtschaft* Heft 1 1995, p. 38.

³ At present (15 August 1999) there is only an unofficial draft of the regulatory proposal, and the official version is awaited. The future programme of work of 16.2.1999 of the Expert Committee for Insurance Matters of the Committee for the Budget, Taxation, Banking and Finance of the lower house of parliament (the *Staatsduma*) includes the preparation of an official draft. On the present state of the law, see the translation in "*Handbuch Wirtschaft und Recht in Osteuropa*", Vol. 3, RUS 580; for a translation and introduction see *M. Weyer* "Russian Federation: the law on insurance", in *Wirtschaft und Recht in Osteuropa*, Vol 5 1995, pp. 185-189.

⁴ This problem overlaps to some extent with the doctrine of lawmaking, which offers a method for separating out the various aspects of the question about the need for framing rules, but does not itself answer the question of the need for a rule, focussing instead on clarifying the aims of the exercise. See e.g. *L. Treder* "Methoden und Technik der Rechtsanwendung" Heidelberg 1998, p. 182.

⁵ See *M. Weyer* "Das russische Privatversicherungsrecht - Ein Überblick", p. 38 et seq.

⁶ *H. Eidenmüller* "Effizienz als Rechtsprinzip", *Studien in den Grenzbereichen der Wirtschafts- und Sozialwissenschaften*, Vol. 90, 2nd edition, Tübingen 1998, p. 58; *Ch. Kirchner* "Ökonomische Analyse des Rechts", Berlin-New York 1997, p. 5.

⁷ *H. Eidenmüller*, "Effizienz als Rechtsprinzip", p. 58.

⁸ *R.A. Posner* "Economic Analysis of Law", Boston, Toronto, 2nd edition 1977, quoted from *H.D. Assmann/Ch. Kirchner/E. Schanze* "Ökonomische Analyse des Rechts", Tübingen 1993, pp. 79-98, esp. p. 92.

⁹ See *H. Eidenmüller*, "Effizienz als Rechtsprinzip", p. 58.

¹⁰ *H. Eidenmüller* "Effizienz als Rechtsprinzip", p. 58.

¹¹ *W. Heinrichsmeyer/O. Gans/I. Evers* "Einführung in die Volkswirtschaftslehre" Stuttgart, 6th edition 1985, p. 38 et seq.

¹² *R.A. Posner* "Economic Analysis of Law", New York, 5th edition 1998, p. 13 et seq.

¹³ *R.A. Posner* "Economic Analysis of Law", 5th edition, p. 16.

¹⁴ See *R.A. Posner* "A Reply to some recent criticisms of the Efficiency Theory of the Common Law" in: *9 Hofstra Law Review* 181, p. 775 ff.

¹⁵ *H.B. Schäfer/C. Ott* "Lehrbuch der ökonomischen Analyse des Zivilrechts", Berlin et al. 1995, p. 5 et seq.

¹⁶ *Ch. Kirchner* "Ökonomische Theorie des Rechts", p. 23.

¹⁷ This is also the view of *R. Schmidt* in *E.R. Pröls* "Versicherungsaufsichtsgesetze", 11th edition, Munich 1996, note 114.

¹⁸ *H. Eidenmüller*, "Effizienz als Rechtsprinzip", p. 10.

¹⁹ *J. Müller/I. Vogelsang* "Staatliche Regulierung. Regulated industries in den USA und Gemeinwohlbildung in wettbewerblichen Ausnahmebereichen in der Bundesrepublik Deutschland", series *Wirtschaftsrecht und Wirtschaftspolitik*, vol. 56, Baden-Baden 1979, 1st edition, p. 31.

²⁰ *Ch. Kirchner* "Ökonomische Theorie des Rechts", p. 24; it is worth mentioning here that the well-known Russian businessman *Berezhovsky* seriously suggested, during the Russian financial and government crisis of autumn 1998, that an oligarchic dictatorship of this sort should be set up, with himself taking part to solve the problems.

²¹ *R.A. Posner* "Economic Analysis of Law", 5th edition, p. 14 et seq.

²² *R.A. Posner* "Economic Analysis of Law", 5th edition, p. 15.

²³ *H. Eidenmüller* "Effizienz als Rechtsprinzip", p. 51.

²⁴ See *H. Eidenmüller* "Effizienz als Rechtsprinzip", p. 191.

²⁵ *H. Eidenmüller* "Effizienz als Rechtsprinzip", p. 192.

²⁶ *H. Eidenmüller*, "Effizienz als Rechtsprinzip", p. 273.

²⁷ *H. Biermann/E. Einig/F. Hesse* "System Transformation: Logik und Theorie sowie Darstellung am Beispiel der muslimisch beeinflussten GUD-Republiken", Munich, Vienna 1996, p. 72.

- ²⁸ H. Biermann/E. Einig/F. Hesse "System Transformation", p. 86.
- ²⁹ H. Biermann/E. Einig/F. Hesse "System Transformation", p. 86.
- ³⁰ Deregulierungskommission/Unabhängige Expertenkommission zum Abbau marktwidriger Regulierungen "Marktöffnung und Wettbewerb", Stuttgart 1991, p. 1 (2).
- ³¹ W. Strassel, "Externe Effekte auf Versicherungsmärkten: Eine allokatorentheoretische Begründung staatlicher Regulierung", Schriften zur angewandten Wirtschaftsforschung, Vol. 54, Tübingen 1988, p. 2.
- ³² Deregulierungskommission, p. 1 (4).
- ³³ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 35.
- ³⁴ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 35 et seq. and footnote 13.
- ³⁵ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 101 et seq.
- ³⁶ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 102 et seq.
- ³⁷ G.W. Hilton, "The Basic Behavior of Regulatory Commissions" in: The American Economic Review 1972, Vol. 62 no. 3, p. 47 et seq.
- ³⁸ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 109 et seq.
- ³⁹ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 111.
- ⁴⁰ See the examples in J. Müller/I. Vogelsang "Staatliche Regulierung", p. 111.
- ⁴¹ G.J. Stigler "The Theory of Economic Regulation" in The Bell Journal of Economics (and Management Science) 1971, Vol. 2 no. 1, p. 4 et seq.
- ⁴² J. Müller/I. Vogelsang "Staatliche Regulierung", p. 113.
- ⁴³ R.A. Posner "The Social Costs of Monopoly and Regulation" in Journal of Political Economy 1975, Vol. 83, p. 807 et seq.
- ⁴⁴ A. Downs "An Economic Theory of Political Action in a Democracy" in Journal of Political Economy 1957, vol. 65, p. 141.
- ⁴⁵ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 118.
- ⁴⁶ C.B. Blankart "Zur ökonomischen Theorie der Bürokratie" in Public Finance 1975, vol. 30 no. 2, p. 174 et seq.
- ⁴⁷ See G. Wolters "Wettbewerb auf dem Versicherungsmarkt", Europäische Hochschulschriften, series V, Volks- und Betriebswirtschaft vol. 1745, Frankfurt am Main et al. 1995, p. 40.
- ⁴⁸ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 40.
- ⁴⁹ See M. Fritsch/T. Wein/H.J. Ewers "Marktversagen und Wirtschaftspolitik" Munich 1993, p. 15.
- ⁵⁰ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 43.
- ⁵¹ Deregulierungskommission, p. 2 (5).
- ⁵² J. Müller/I. Vogelsang "Staatliche Regulierung", p. 47.
- ⁵³ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 54.
- ⁵⁴ R. Marris "A Model of the Managerial Enterprise" in The Quarterly Journal of Economics, 1963, vol. 77, no. 2, p. 186 et seq.
- ⁵⁵ J. Finsinger "Eine positive Theorie der Regulierung, entwickelt am Beispiel der Geschichte des Kraftverkehrsversicherungsmarktes" in: Ansprüche, Eigentums- und Verfügungsrechte. Workshop of the Association for Economic and Social Sciences, Basle 1983, Berlin 1984, p. 470 et seq.
- ⁵⁶ C. Blankart/T. Wein "Deregulierung der Versicherungswirtschaft. Gutachten erstattet für den Bundesminister für Wirtschaft im Auftrag der Deregulierungskommission", Berlin 1989, p. 3.
- ⁵⁷ The expert opinion does not cite any source.
- ⁵⁸ C. Blankart/T. Wein "Deregulierung der Versicherungswirtschaft", p. 4.
- ⁵⁹ C. Blankart/T. Wein "Deregulierung der Versicherungswirtschaft", p. 4.
- ⁶⁰ H. Kotsch "Grössenvorteile von Versicherungsunternehmen und Versicherungsaufsicht", Karlsruhe 1991, p. 28.
- ⁶¹ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 44.
- ⁶² G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 44: "Information asymmetry" is understood here as a blanket term for moral hazard and adverse selection; cf. Deregulierungskommission, p. 16 et seq. There is a different view in e.g. W. Strassel "Externe Effekte auf Versicherungsmärkten", p. 5. To simplify, both G. Wolters and W. Strassel argue that for insurance markets, there is no difference of outcome between the separate and simultaneous consideration of adverse selection and moral hazard. See G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 107 and W. Strassel "Externe Effekte auf Versicherungsmärkten", p. 194.
- ⁶³ C.B. Blankart/J. Finsinger "Staatliche Aufsicht und Preiszyklen in der Motorfahrzeug-Haftpflichtversicherung", Discussion Papers IIMV/Structural Policy - IIM/Industrial Policy Wissenschaftszentrum Berlin 1981, IIM/IP 81-27, p. 4.

- ⁶⁴ *Deregulierungskommission*, p. 16 no. 47.
- ⁶⁵ C.B. Blankart/J. Finsinger "Staatliche Aufsicht und Preiszyklen in der Motorfahrzeug-Haftpflichtversicherung", p. 4.
- ⁶⁶ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 87.
- ⁶⁷ W. Strassel "Externe Effekte auf Versicherungsmärkten", p.4.
- ⁶⁸ *Deregulierungskommission*, p. 17 no. 48.
- ⁶⁹ Cf. e.g., clause 24 of the Law on Insurance Contracts.
- ⁷⁰ *Deregulierungskommission*, p. 3 no. 9.
- ⁷¹ C.B. Blankart/J. Finsinger "Staatliche Aufsicht und Preiszyklen in der Motorfahrzeug-Haftpflichtversicherung", p.5.
- ⁷² Cf. clause 158 c) of the Law on Insurance Contracts.
- ⁷³ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 63.
- ⁷⁴ See P. Albrecht "Gesetze der grossen Zahlen und Ausgleich im Kollektive - Bemerkungen zu Grundlagen der Versicherungsproduktion" in: Zeitschrift für die gesamte Versicherungswissenschaft 1982, Vol. 71, p. 505.
- ⁷⁵ C.B. Blankart/J. Finsinger "Staatliche Aufsicht und Preiszyklen in der Motorfahrzeug-Haftpflichtversicherung", p. 6.
- ⁷⁶ J. Müller/I. Vogelsang "Staatliche Regulierung", p. 41 et seq.
- ⁷⁷ *Deregulierungskommission*, p.18 no.52.
- ⁷⁸ This description is drawn from the expert opinion of the Deregulation Commission: see *Deregulierungskommission*, p.19 no. 58. The terminology for the arguments is taken from C. Hollenders, who has made a thorough study of the particular features of the insurance industry: C. Hollenders "Die Bereichsausnahme für Versicherungen nach § 102 GWB", Baden-Baden 1985.
- ⁷⁹ G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 253.
- ⁸⁰ See J. Prölss/A. Martin "Versicherungsvertragsgesetz: Kommentar zum VVG und EGVVG sowie Kommentierung wichtiger Versicherungsbedingungen - unter Berücksichtigung österreichischer Rechtsprechung", Munich 1992, 25th edition, p. 21 preliminary note II 1; G. Wolters "Wettbewerb auf dem Versicherungsmarkt", p. 253; *Deregulierungskommission*, p. 17 no. 50.
- ⁸¹ *Deregulierungskommission*, p. 17 no. 50.
- ⁸² Gesamtverband der Deutschen Versicherungswirtschaft (GDV) "Die Deutsche Versicherungswirtschaft - Jahrbuch", Bonn 1985, p. 106.
- ⁸³ R. Eisen/W. Müller/P. Zweifel "Entrepreneurial Insurance. A New Paradigm for Deregulated Markets" in The Geneva Papers on Risk and Insurance 1993, Vol. 18 no. 1, p.49.
- ⁸⁴ The second OECD East-West conference on insurance regulation, in 1997, set out twenty principles, in the form of guidelines, for the countries in transition in eastern and central Europe. Reference is made to them here as an independent outline for regulation in countries in transition. See *OECD Proceedings "Insurance Regulation and Supervision in Economies in Transition - Second East-West Conference on Insurance Systems in Economies in Transition"*, Paris 1997, p. 53 et seq.
- ⁸⁵ R. Schmidt in W. Grosse/H.L. Müller-Lutz/R. Schmidt "Versicherungsenzyklopädie Vol. 3, Rechtslehre des Versicherungswesens, Wiesbaden 1984, p. 11 et seq.
- ⁸⁶ U.D. Kubli "Aufsicht und unternehmerisches Handeln - Die Versicherungsunternehmung im Spannungsfeld von Aufsicht und Marktentwicklung", Schriftenreihe des Instituts für Versicherungswirtschaft an der Hochschule St. Gallen, Vol. 20, St. Gallen 1998, p. 50.
- ⁸⁷ R. Schmidt in E.R. Prölss "Versicherungsaufsichtsgesetz" 11th edition, Munich 1996, preliminary note 110.
- ⁸⁸ R. Schmidt in W. Grosse/H.L. Müller-Lutz/R. Schmidt "Versicherungsenzyklopädie" Vol. 3, Rechtslehre des Versicherungswesens, Wiesbaden 1984, p. 11 et seq.
- ⁸⁹ O.E. Starke in W. Rohrbeck "50 Jahre materielle Versicherungsaufsicht" 1955, Vol. 3, p. 65 et seq.
- ⁹⁰ Y. Kawai "The Reform of Regulatory and Supervisory Systems in Transition Insurance Markets" in: *OECD Proceedings "Insurance Regulation and Supervision in Economies in Transition"*, p. 308.
- ⁹¹ *European Bank for Reconstruction and Development "Transition Report"* London 1995, p. 21 et seq.
- ⁹² See Kieler *Diskussionsbeiträge* "Die wirtschaftliche Lage Russlands. Wirtschaftliche Wende bedenklich verzögert", Institut für Weltwirtschaft Kiel, 12th Report 5/1998, p. 12 et seq. and "Rubel und russische Aktien geben erneut nach" in Handelsblatt of 19.8.98, p.1.
- ⁹³ *Kieler Diskussionsbeiträge* "Die wirtschaftliche Lage Russlands", p. 10.
- ⁹⁴ *Kieler Diskussionsbeiträge* "Die wirtschaftliche Lage Russlands", p. 9.

- ⁹⁵ These remarks owe much to *Y. Kawai* "The Reform of Regulatory and Supervisory Systems in Transition Insurance Markets" in: *OECD Proceedings "Insurance Regulation and Supervision in Economies in Transition"*, p. 313 et seq.
- ⁹⁶ For the founding act of the Goskomstat, see the Government decision in SZ RF (*Legislative Acts of the Russian Federation*) 1994, no. 13 item 1522..
- ⁹⁷ Insofar as rules exist for insurance companies, these are non-statutory normative instruments enacted by the supervisory body. For this concept, see below, C.III. 2.a).
- ⁹⁸ SZ RF (*Legislative Acts of the Russian Federation*) 1998, no. 11, item 1290.
- ⁹⁹ See the Government's development programme for the period 1998-2000 in SZ RF (*Legislative Acts of the Russian Federation*), no. 40, item 4968.
- ¹⁰⁰ For the figures, see *Olga Ruf-Fiedler* "Russia Report 1998 - Insurance market survey with emphasis on life business", Publikation der Schweizer Rückversicherungsgesellschaft 1998, p. 15.
- ¹⁰¹ See para. 5 of the introductory law in VSN DiVS (*Reports of the Proceedings of the People's Deputies of the Russian Federation and of the Supreme Soviet of the RF*) 1993, no. 2 item 57.
- ¹⁰² V.A. Sukhov "Gosudarstvennoye regulirovaniye finansovoi ustoichivosti strakhovshchikov" (*State regulation of the finances of insurers*) Moscow, p. 93.
- ¹⁰³ VSN DiVS (*Reports of the Proceedings of the People's Deputies of the Russian Federation and of the Supreme Soviet of the RF*) 1993, no.2, item 56.
- ¹⁰⁴ SAPIp (*Collected Enactments of the President of the RF and the Government of the RF*) 1993, no. 27, item 2557.
- ¹⁰⁵ Rossiiskiye Vesti (*Russian News*) of 29.6.1994, no. 118.
- ¹⁰⁶ On 22.4.1998 the minimum wage, according to the law of 9.1.97, was 83.49 roubles. Because of the financial crisis in the autumn of 1998, the DM/rouble exchange rate on 12.8.99 was around 1:12.5.
- ¹⁰⁷ See article 3 of the Amendment Law of 31.12.1998 in SZ RF no. 1, item 4.
- ¹⁰⁸ *Olga Ruf - Fiedler* "Russia Report 1998 - Insurance market survey with emphasis on life business", p. 15.
- ¹⁰⁹ Through the Amendment Law of 17.7.99, entry into force of the minimum capitalisation rule was postponed in the short term until 1 January 2000. An initial draft of this law was stopped in March 1999 through a veto of the President of the RF. Since January 1999 the supervisory body had been investigating the annual accounts of Russian insurers for 1998. Up to August 1999, no sanctions are known to have been imposed by the supervisory body for non-compliance with the minimum capital rule.
- ¹¹⁰ Rossiiskiye Vesti (*Russian News*) of 11.1.1996, no. 5.
- ¹¹¹ In Russian there is no conceptual distinction between one kind of reserve and another. The differences need to be brought out, however the Law on Insurance refers only to "reservi" (*reserves*).
- ¹¹² Rossiiskiye Vesti (*Russian News*) of 8.6.1995, no. 105.
- ¹¹³ This rule has been in abeyance for an indefinite period since the financial crisis of autumn 1998.
- ¹¹⁴ Russian administrative law does not distinguish between cancelling and calling in.
- ¹¹⁵ Rossiiskiye Vesti (*Russian News*) of 27.7.1995, no. 139.
- ¹¹⁶ Source: the "Garant" database. The text has not been published.
- ¹¹⁷ SZ RF (*Legislative Acts of the Russian Federation*) 1998, no. 2 item 222.
- ¹¹⁸ See the commentary in the Civil Code, and: *M. Weyer* "Neue Gesetzgebungsentwürfe zum Privatversicherungsrecht" in *Versicherungsrecht* 1996, Vol. 13, p. 557.
- ¹¹⁹ SZ RF (*Legislative Acts of the Russian Federation*) 1992, no. 20 item 1661.
- ¹²⁰ The Order on Supervision was confirmed by a Government decision and put into effect.
- ¹²¹ *R. Richter/E. Furubotn* "Neue Institutionenökonomik. Eine Einführung und kritische Würdigung" *Neue ökonomische Grundrisse*, Tübingen 1996, p. 2.
- ¹²² Here we should mention that the Government has promised returns of 90 per cent and more a year for GKO's. Thus insurers are tending to invest much more than the prescribed percentage in GKO's. It is interesting that after the moratorium in the autumn of 1998, government spokesmen reproached depositors for failing to pursue serious investment goals because of these expected returns, and said they did not deserve any compensation.