



ESTONIA

**REVIEW OF
THE INSURANCE SYSTEM**



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

This review of Estonia by the Working Party of Governmental Experts on Insurance is part of a series of reviews of national policies undertaken for the OECD Insurance and Private Pensions Committee (IPPC). It was prepared as part of the process of Estonia's accession to OECD membership.

The OECD Council decided to open accession discussions with Estonia on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Estonia to become a Member of the Organisation on 10 May 2010. After completion of its internal procedures, Estonia became an OECD Member on 9 December 2010.

The IPPC was requested to examine Estonia's position with respect to core principles related to insurance and private pensions systems. The examinations were carried out by the Working Party of Governmental Experts on Insurance (WPGEI) and Working Party on Private Pensions (WPPP). The present report was finalised on the basis of information available in December 2009. It is released on the responsibility of the Secretary General of the OECD.

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This document has been prepared as part of the OECD's work in relation to Estonia's application for OECD membership. In accordance with the Accession Roadmap adopted by the Council for Estonia (C(2007)101/FINAL), which sets the terms, conditions and process for accession to OECD Membership. The Insurance and Private Pensions Committee (IPPC) has been asked to examine the ability and the willingness of Estonia to assume the obligations of membership in the fields of insurance and private pensions. The Working Party of Governmental Experts on Insurance (WPGEI) will form its views on Estonia's commitment to the following core insurance principles:

- ensuring sound prudential regulation of insurance and reinsurance markets and protecting the rights of policy holders and beneficiaries, and
- relaxation of restrictions on cross-border trade, investment and establishment in insurance services as required under the OECD Codes of Liberalisation.

This document has been prepared by the Secretariat to support the second examination of Estonia's position on 2 December 2009. The Secretariat carried out a mission on 3-6 of May 2009, and received written submissions in response to the IPPC accession questionnaire and follow-up questions from the Secretariat [DAF/AS/ACS(2009)2/ADD2]. In response to the Chair's letter sent on 31 July 2009 [DAF/AS/ACS(2009)2/ADD4], Estonia followed-up with responses [DAF/AS/ACS(2009)2/ADD5].

The current document contains:

- an executive summary,
- a brief description of the Estonian insurance sector,
- an assessment of market access issues and an assessment of the compliance of Estonian laws, regulations and policies against OECD Codes of Liberalisation,¹ and,
- an assessment of the compliance on Estonia laws, regulations and policies against other insurance-related OECD instruments.

Document DAF/AS/ACS(2009)2/ADD1 presents the extracts from Estonia's Initial Memorandum and submissions regarding Estonia's position against OECD instruments on insurance.

It is meant to provide the basis for a discussion of the Estonian insurance market, regulation and supervision to assist the WPGEI forming its views on the current state of the Estonia insurance sector and to highlight those aspects of the system that could be strengthened or improved, with a specific focus on the regulatory framework.

The Investment Committee reviewed Estonia's proposed position against the OECD's Codes of Liberalisation on 24 March 2009. The Chair of the Investment Committee subsequently sent a letter to Estonia identifying a number of areas where Estonia's proposed position under the instruments should be improved, including matters concerning insurance.² The reply of Estonia to the letter of the chair of the Investment Committee has also been received.³ The Investment Committee carried out its second review of Estonia on 5 October 2009.

¹ This chapter integrates the work that has been conducted so far by the Investment Committee on insurance issues.

² The Investment Committee's report on Estonia is DAF/INV/ACS(2009)2/REV1, and the Chair's letter is contained and distributed in DAF/INV/ACS/M(2009)2.

³ The letter from Estonia to the Investment Committee is DAF/AS/ACS(2009)2/ADD3.

EXECUTIVE SUMMARY

Policies of Estonia with regard to the roadmap principles in insurance

1. Overview of the insurance market

The insurance sector accounts for 5.5% of GDP in terms of assets, while the total gross premiums of Estonian insurance companies were EUR 360 million in 2007 with a penetration of 2.36%, and density of USD 368. Estonia's insurance sector is a young market, having only been established when Estonia became **independent from the Soviet Union in 1991**. Estonia has achieved a feat of developing from scratch an insurance market based on market principles. Estonia has been improving the regulatory structure of its insurance system which has been assisted **by its accession to the European Union in 2004**.

The Estonian insurance sector is small in terms of assets of the overall financial system and compared to other OECD countries. The banking system has a large importance in the financial system but it is expected that assets of the insurance sector will grow substantially when pension savings that are accumulated in the mandatory second pillar of the pension system are released to buy annuities from life companies.

The insurance market of Estonia is open to new entrants, whether domestic or foreign, and is **dominated by foreign-owned insurance companies**, with a strong presence of Nordic companies. Growth in the insurance market has been driven mainly by the compulsory motor third party liability line, land vehicle and property insurance supported by credit guarantee schemes, but the life insurance sector is also growing as a result of developments in unit-linked and pension-related products. The insurance market is characterised by:

- strong and stable performance of **motor insurance**;
- **being part of a broader Baltic market which is developing rapidly**; and
- a growing market in **pension-related products**.

The **pension system is closely related to the life insurance sector**. Contributions to pillar II of the pension system are invested in special funds, and the lump sums accumulated must be used to purchase an annuity contract from a life insurer at the payout phase. This will boost the life insurance market as first payouts commence in 2009. In voluntary pension saving products (pillar III of the pension system), life insurers participate both the accumulation phase and the payout phase.

The market has experienced diverse sales channels with **bancassurance** fast becoming the main distribution network for life products. **Internet-based sales** are also being offered and are becoming a popular mode of purchasing retail insurance contracts.

The assessment of Estonia against the Insurance Core Principles (ICP) of the International Association of Insurance Supervisors (IAIS) was carried out in 2000 as part of the Financial Sector Assessment Programme (FSAP) which assessed Estonia as broadly observant to all ICPs. Since this, Estonia has restructured its regulator, passed new insurance legislation and joined the EU which would improve its position against ICPs further.

2. Preliminary conclusions

Prudential framework of the insurance market

While Estonia has adopted all EU directives related to insurance services, there remain some issues with implementation. Legislation takes into account all directives, but the industry would benefit if Financial Supervision Authority (FSA) provides **greater guidance on implementation** of legislation. The resources of the FSA dedicated to the insurance supervision are limited.

Estonia passed the Act on Conciliation Procedure in November 2009 which establishes a general framework for conciliation procedures in Estonia. Estonia is committed to the commencement of a Financial Sector Conciliation Body in 2013.

The Insurance Activities Act was enacted in 2005 and the insurance system is being developed. Further, the payout phase of pillar II of the pension system has just begun, which would involve life insurers via their business in annuities.

The prudential framework will face an important phase when the Solvency II framework is brought into operation in 2013. Thus:

- Estonia should raise the maximum monetary penalty for financial sector wrong doing, and establishing a system of sanctions with more gradations. Necessary legislative changes should be considered, including amendments to its Penal Code.
- Estonia should move more quickly to establish the Financial Sector Conciliation Body and ensure it commences operations in an orderly and effective manner.
- Estonia would benefit from reviewing the legislation under which the FSA operates in order to strengthen its powers and transparency, and enhance its resources dedicated to insurance supervision. Special consideration should be given to enhancing the risk-based aspects of supervision.

Market access and Codes of Liberalisation

Estonia has a liberal regime for direct investment by foreign insurers, which can establish as a subsidiary or branch in Estonia. In fact, Estonia will have the most liberal insurance regimes of the OECD member countries. Foreign insurers benefit from national treatment, *i.e.*, they are treated in the same manner as insurance entities controlled by domestic investors.

Estonia's insurance system is dominated by foreign-owned insurers both in the life and non-life sector. In the life sector, all five life insurers are ultimately owned by foreign insurers, mainly based in Nordic countries. In the non-life sector, all insurers have a significant proportion of capital from foreigners, with the majority owned by Nordic banks.

Branching is permissible for non-EEA branches based on prudential requirements that are less burdensome than for subsidiaries. EEA insurers can operate as a branch or engage in cross-border insurance transactions on the basis of the "single passport" system in Estonia.

Cross-border transactions by non-EEA insurers are currently not permitted. However, as a result of its accession review by the OECD, Estonia is in the process of amending its legislation to allow non-EEA insurers to provide insurance services. Insurers from OECD member countries will be able to provide cross-border contracts so long as Estonia can ascertain the soundness of the insurer and ensure consumer protection. Cross-border providers are required to submit the same documents as branches, but are not subject to financial requirements in Estonia.

Cross-border reinsurance services are allowed by Estonia.

Regarding private pensions, legislation is pending to eliminate the requirement of established presence in Estonia and allow cross-border provision of services in private pensions.

Estonia's position with regard to the insurance and private pension provisions of the Codes of Liberalisation of Current Invisible Operations (CLCIO) is not its final position. Currently, tax deductions are permitted to residents of Estonia if they buy a life insurance or private pension product cross-border from EEA insurers. The Estonian authorities plan to extend these deductions to products from non-EEA OECD members, based on certain requirements. It is recommended that Estonia formulate these requirements in a manner compatible with the OECD Codes of Liberalisation so that Estonia will not need to lodge a reservation to items D3 (life assurance) or D/8 (private pensions) of the Codes.

Following the Investment Committee's accession reviews (on 24 March 2009 and 5 October 2009) which incorporates the advice from the WPGEI, Estonia has made substantial progress in liberalising its insurance market which reflects its GATS commitments. As a result of the 5 October meeting of the Investment Committee, Estonia is working on a declaration to reaffirm their commitment to continue progress after accession in extending liberalisation to non-European OECD members.

- Estonia should be ready to widen its network of Memoranda of Understanding with OECD member countries to ensure effective cooperation in support of the cross-border provision of insurance services.

Position of Estonia vis-à-vis OECD Legal Instruments

Estonia accepts all OECD instruments. Estonia would benefit from improving some aspects of its insurance regulation and structure to achieve greater coherence with OECD standards in insurance.

Recommendation of the Council on Guidelines for Insurers' Governance [C(2005)45]

Estonia accepts this Recommendation, however, it is not in full compliance.

Estonia's governance requirements follow the requirements of EU directives. However, greater effort should be made to improve qualitative requirements in corporate governance.

- Estonia should issue guidelines specific to insurers so as to ensure full compliance with the Recommendation. In particular, Estonia should issue guidelines with regard to internal reporting and internal control requirements of insurers and the management of these procedures.

Recommendation of the Council on Assessment of Reinsurance Companies [C(98)40]

Estonia accepts this recommendation.

The Insurance Activities Act requires that when initially applying for the activity license, an insurer must submit a scheme of operation to the FSA. The latter scheme shall, among other things, set out the planned amount of reinsurance contracts, as well as the principles of reinsurance regarding each class and subclass of insurance the insurer is anticipating being involved in.

- Estonia should require insurers to assess their reinsurers in accordance with the Recommendation on Assessment of Reinsurance Companies.

Recommendation of the Council on Good Practices for Enhanced Risk Awareness and Education in Insurance Issues [C(2008)22]

Estonia accepts this recommendation.

Various efforts are being made to improve risk awareness and financial education although those specifically focusing on insurance are limited.

- Estonia should consider developing financial educational opportunities through various communication means geared specifically towards insurance.

Recommendation of the Council on the Establishment of a Check-list of Criteria to Define Terrorism for the Purpose of Compensation [C(2004)63/REV2]

Estonia accepts this recommendation.

Estonia uses a definition of terrorism, which generally follows the proposed elements of the Recommendation.

Recommendation of the Council on Good Practices for Insurance Claim Management [C(2004)62]

Estonia accepts this recommendation.

The Insurance Activities Act stipulates that all insurers internally regulate their claim management procedure. Adequacy of the insurer's internal regulation is assessed by the FSA on a regular basis.

Recommendation of the Council concerning a Common Classification of the Classes of Insurance Recognised by the Supervisory Authorities of the Member Countries [C(83)178]

Estonia accepts and complies with this recommendation.

Licensing of insurance is done by classes and subclasses as provided in the Insurance Activities Act and further classified into sub-classes on the basis of a decree of the Minister of Finance.

Recommendation of the Council concerning Institutional Co-Operation between Authorities of Member Countries Responsible for Supervision of Private Insurance [C(79)195]

Estonia accepts and complies with this recommendation.

The FSA Act requires the FSA to co-operate with the supervisory authorities of other countries. The Insurance Activities Act provides specific regulation on effective co-operation in the field of insurance supervision, especially in relation to the supervision of financial conglomerates.

1. INSURANCE SYSTEM OF ESTONIA

1.1 Overview of the insurance sector

The Estonian insurance sector is small in terms of assets of the overall financial system and compared to other OECD countries. The insurance sector accounts for 5.5% of GDP in terms of assets, while the total gross premiums of Estonian insurance companies were EUR 360 million in 2007 with a penetration of 2.36%, and density of USD 368. Currently, the banking system has a large importance in the financial system but it is expected that assets of the insurance sector will grow substantially when pension savings that are accumulated in second pillar are released to buy annuities from life companies. There are no reinsurance undertakings in Estonia.

Table 1. Relative size of various types of financial institutions at end-2007 (% of GDP)

Financial Sector	Basis of calculation	Relative size
Banks	assets	132
Pension funds	net assets	5
Investment funds (except pension funds)	net assets	9
Investment firms	total assets	0.3
Non-life insurance	total assets	2
Life insurance	total assets	3.5

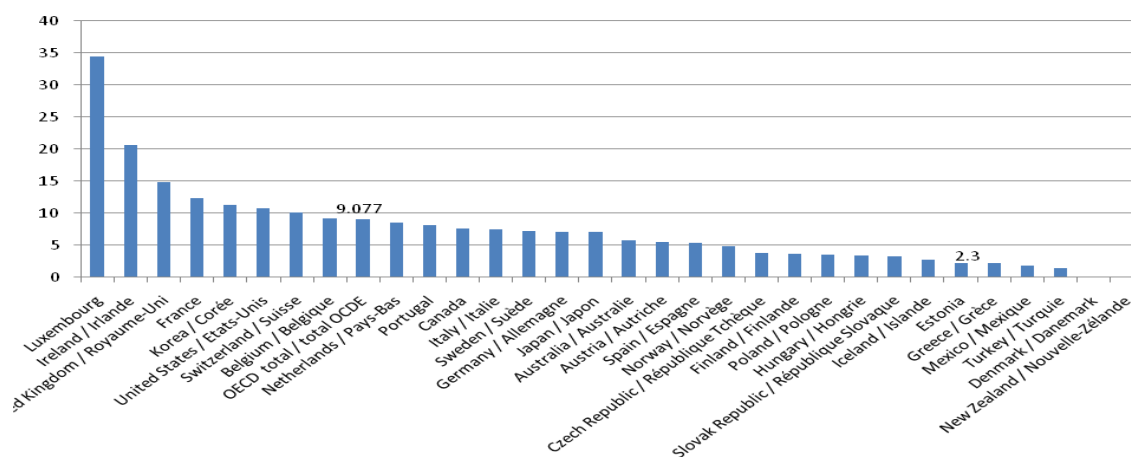
Source: Estonian authorities

Table 2. Gross premiums, penetration and annual growth rate of premiums (million EUR, %)

Year	Life sector			Non-life sector			Total	
	Premiums	Penetration (%)	Growth rate (%)	Premiums	Penetration (%)	Growth rate (%)	Premiums	Penetration (%)
2007	122.3	0.80	23.7	238.0	1.56	11.160	360.3	2.36
2006	98.9	0.75	17.9	200.0	1.53	11.1	298.8	2.28
2005	80.8	0.73	52.8	172.4	1.55	9.5	253.2	2.28
2004	51.5	0.53	39.3	151.2	1.57	11.7	202.8	2.10
2003	37.0	0.43	28.4	131.4	1.51	18.1	168.4	1.94
2002	28.5	0.73		109.8				

Source: Estonian authorities

Figure 1. Penetration of insurance in OECD member countries (gross premiums/GDP, %)



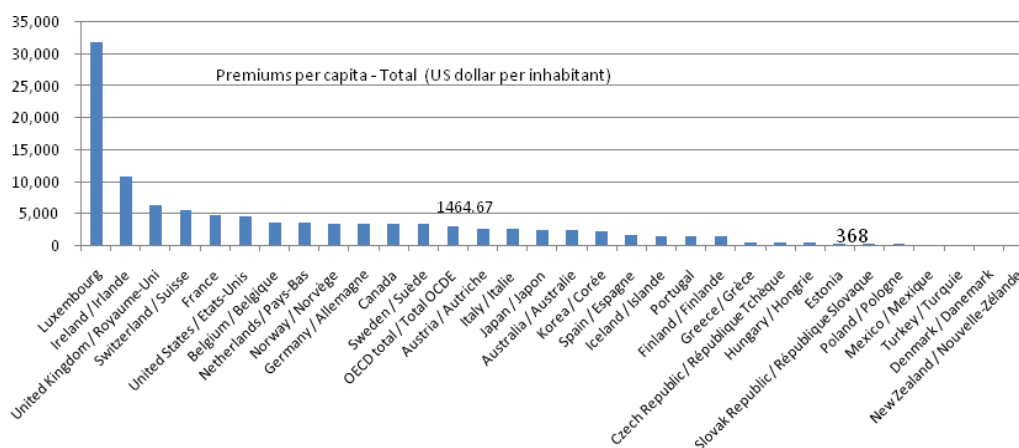
Source: OECD and Estonian authorities

Table 3. Density (Gross premium/capita, US dollar)

Year	Life sector	Non-life sector	Total
2007	125	243	368
2006	101	204	305
2005	82	175	257
2004	52	153	205
2003	37	133	170

Source : Estonian authorities

Figure 2. Density of insurance in OECD member countries



Source : OECD and Estonian authorities

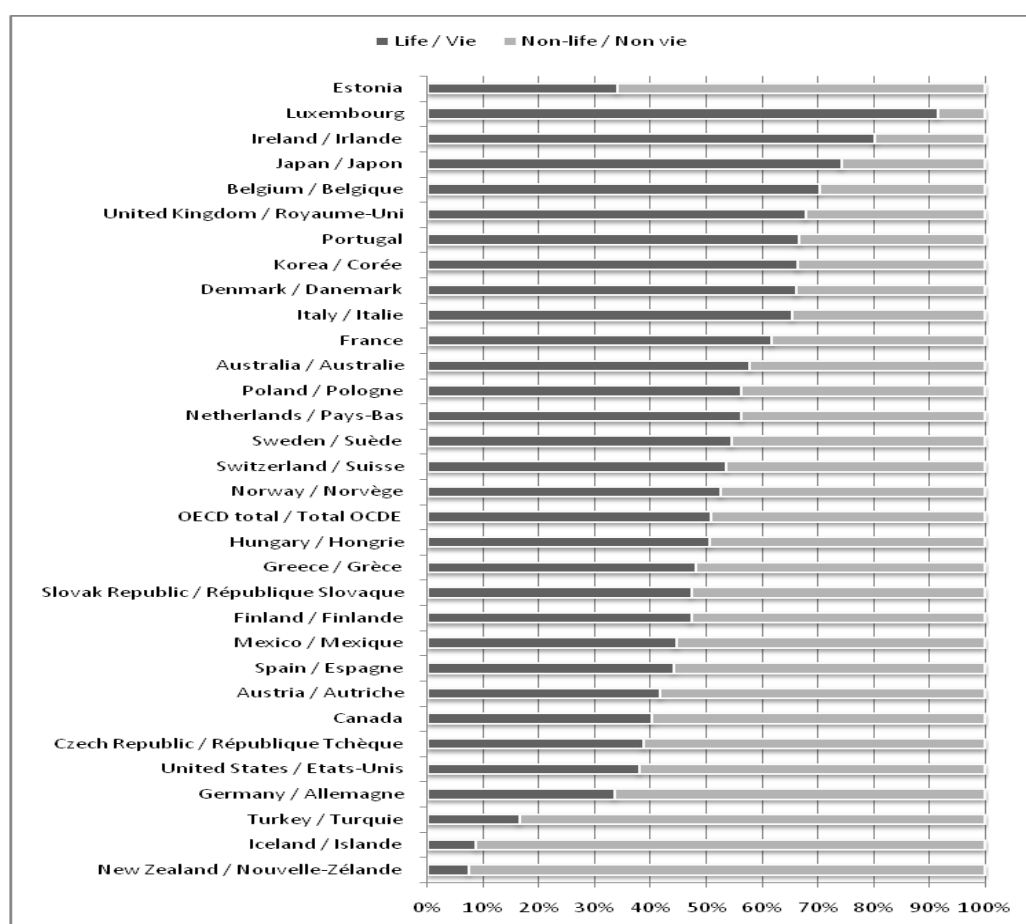
Table 4. Assets in the life and non-life sectors (Million EUR)

Year	Life sector		Non-life sector	
	Total assets	No. of companies	Total assets	No. of companies
2007	359.3	5	315.4	8
2006	336.3	5	263.6	8
2005	237.5	5	205.7	6
2004	149.6	5	154.9	7
2003	105.8	5	121.2	7

Source : Estonian authorities

In the insurance market, 66.1% of the business is generated from the non-life sector. However, this represents a growth in the life insurance market since 1997 when non-life insurance dominated the market by having 88.1% of insurance business. Group life, annuities, occupational accident and disease insurance are still underdeveloped in Estonia, and may become the source of growth for the insurance sector in coming years.

Figure 3. Life and non-life insurance proportion (2007)



Source : OECD and Estonian authorities

The number of people employed in the insurance sector is small reflecting the size of the industry. The life sector is small in terms of employment it generates, and the growth of employees

has been modest. Because of compulsory insurance and motor insurance, the non-life sector employs a greater number of people and has been slowly growing. There was a jump in the number of employees from 2006 to 2007, due to the reorganization of two life insurers to European companies, resulting in the inclusion of employees from the Latvian and Lithuanian offices.

Table 5. Number of employees in the insurance sector

Year	Life sector	Non-Life sector
2007	427	1.180
2006	248	1.161
2005	241	1.163
2004	228	1.216
2003	219	1.239

Source : Estonian authorities

The gross loss ratio of insurance companies was 63.8% in 2007, from 57.8% in 2006. The loss ratio has improved in the non-life sector, especially in the motor TPL sector. The improvement in loss statistics was large enough to compensate lower growth and competition pressure in the non-life sector.

The combined ratio⁴ of non-life companies has increased incrementally in 2007. However, overall combined ratios remain below 100% and good profitability of the insurance industry is evident. The gross combined ratio was 86.5% in 2007, higher than the figures for 2006. This is the result of weak motor TPL insurance performance in 2007.

The life sector has experienced large losses from investments in recent years. The introduction of higher capital charges in 2007 and the global crisis has exacerbated the claims payment of life insurers. The equity market downturn has affected the unit-linked policies severely, with many contracts being cancelled due to the short term losses incurred.

Table 6. Loss and combined ratio of non-life insurers (%)

Year	Gross loss ratio	Gross combined ratio	Net combined ratio
2007	63.8	86.5	89.6
2006	57.8	81.9	85.6
2005	64.9	88.8	87.1
2004	53.2	77.4	83.2
2003	63.2	88.6	90.5
2002	61.6	90.7	96.3

Source : Estonian authorities

Through the years, the total net profit of non-life insurers has remained relatively high and the ROE (return on equity) has stayed above 18%. In 2007, four out of five life insurance companies earned profit, with a total net profit of 8 million EUR, which was a decrease of 21.5% in comparison with 2006 with an ROE of 17.9%. The average investment yield was a bit higher than the average guaranteed technical interest rate. The total net profit for non-life insurance companies was 27 million EUR in 2007.

⁴ Combined ratio = $\frac{\text{Incurred losses} + \text{Expenses}}{\text{Earned premium}}$

Table 7. Return on equity (%)

Year	Life sector	Non-life sector	Total
2007	17.0	18.3	17.9
2006	24.9	23.7	24.0
2005	36.3	32.7	33.6
2004	31.3	35.5	34.5
2003	24.3	23.4	23.6
2002	7.5	7.1	7.2

Source : Estonian authorities

For life insurance companies, nearly half of the assets are placed in bonds. Until 2008, life insurers had nearly half of their assets in equity holding which has decreased substantially in the last two years. As for non-life companies, their assets are held in a more conservative portfolio, with a large proportion invested in bonds and deposits. Investments are mainly European based. Reinsurance is carried out abroad as there is no reinsurer based in Estonia.

All insurance companies fulfilled the solvency requirements in 2007. At the end of 2007 the available solvency margin exceeded required solvency margin by 3.0 times in life insurance business. The average solvency margin of non-life insurance companies exceeded 3.3 times the required solvency margin at the end of 2007. The capital surplus is on an upward trend because insurers prefer to reserve profits instead of paying out dividends which is subject to the profit distribution tax.

Table 8. Total capital surplus (million EUR) and its percentage to policyholder liabilities (%)

Year	Life sector		Non-life sector	
	Owners' equity	% of policyholders' liabilities	Owners' equity	% of policyholders' liabilities
2007	57.9	31	160.1	118.9
2006	44.2	30	134.3	120.7
2005	31.6	26	99.4	105.6
2004	21.1	22	70.8	97.9
2003	18.1	25	49.0	85.1

Source : Estonian authorities

Table 9. Capital adequacy of insurers (Million EUR)

Year	Life companies			Non-Life		
	Calculated solvency margin	Own funds	Surplus (%)	Calculated solvency margin	Own funds	Surplus (%)
2007	18.7	55.8	299	47.1	156.6	333
2006	8.6	35.9	417	33.7	129.9	385
2005	7.1	23.3	329	24.5	91.1	372
2004	6.2	13.5	217	20.8	45.7	219
2003	5.1	12.6	249	15.8	35.2	222
2002	4.7	12.6	267	14.1	31.6	224

Source : Estonian authorities

1.2 Evolution of the insurance industry

The financial sector reforms during the last 15 years have been directed at legal harmonisation with the EU *acquis*, enhancing competition and preserving stability in an environment in which domestic and foreign financial service providers can freely compete.

The growth of the life insurance market was hindered by bankruptcies and transfer of ownership of insurers in 1999. Two newcomers entered the market that year in 1999, Sampo Elukindlustus and Ühispanga Elukindlustus, of which the latter merged with Leks Elukindlustus by the end of the year. Polaris Elu and AB Elukindlustus became bankrupt which had serious effects on the acquisition of new business and cancellation of old ones. Bankruptcy proceedings were initiated by the Insurance Supervisory Authority for Polaris Elu and AB Elukindlustus and their large insurance portfolios were transferred to Seesam Elukindlustus. The bankruptcies were caused by inappropriate management decisions of the insurers which were affected by the bankruptcy of two smaller banks. The situation was exacerbated by weakness of the Estonian Insurance Law (1992), which did not grant sufficient authority to the Insurance Supervisory Authority to intervene in insurers having problems. Specifically, the Insurance Supervisory Authority did not have power to prevent the inappropriate acquisition of majority holding or inappropriate investment of technical provisions.⁵

Growth was quickly restored due to the cession of insurance portfolios of bankrupt insurers to other insurers, the performance of more effective supervision over the insurers and the active sale of policies with tax benefit since 2000.

Since 2004 the growth of the life sector has been due mainly to the sales of unit-linked business, where the policyholder carries all the investment risk. Initially, unit-linked life insurance were popular because of tax benefits received if the contract was held for 12 years. However, the current driving force for unit-linked business is the policyholders' expectations of market developments. The market for unit-linked life policies experienced a year-on-year decrease of 48% by the end of 2008. It is unlikely that unit-linked business will shrink further, impacting the scale of the life sector in general.

The sales of insurance contracts, such as supplementary funded pensions⁶ with tax benefits, has been decreasing in recent years, but the events in the global stock market are likely to increase the popularity of supplementary pension funds as an alternative investment opportunity. The total assets of pension funds registered in Estonia exceeded 0,8 billion EUR at the end of 2007; the volume of mandatory pension funds and voluntary pension funds increased annually by 48% and 45% respectively in 2007.

Further, contributions to pillar II of the pension system are invested in special funds, and the lump sums accumulated must be used to purchase an annuity contract from a life insurer at the payout phase.⁷ Undoubtedly, this will boost the insurance market and the first payouts are commencing in 2009.

⁵ For more details on the bankruptcies and subsequent regulatory actions, see 2.10.1 Regulatory action.

⁶ The supplementary funded pension is the III pillar of the pension system which is a voluntary saving product sold by insurance companies and voluntary pension funds. See section 1.5 Relationship of insurance with the pension system for an overview of the pension system.

⁷ Pillar II of the pension system is a mandatory pension fund in which employers deduct 2% of gross salaries of employees and transfer them to the Tax and Customs Board. See section 1.5 Relationship of insurance with the pension system.

The global financial and economic crises have considerably increased the risks facing Estonia's economy in 2009. The real estate and construction sectors that had been overheating in recent years experienced a large decline in output in the second half of 2008.

The life insurance sector has suffered the largest losses in the financial system as a result of the larger allocation of assets to equity markets, which have undergone marked decline. While the losses suffered on the securities portfolios of life insurers significantly depleted their capital reserves, the FSA assessed that insurance undertakings has sufficient capital to withstand this loss and many companies in the sector had already re-balanced their investment portfolios towards less volatile instruments. Other non-bank intermediaries, including fund managers, non-life insurance and investment companies, remain well-capitalised and the main impact of the crisis will be on their income base as demand for their services declines during the economic downturn.

Because the majority of the life insurance market is owned by Swedish banks, the agreement entered between the Bank of Estonia and Riksbank (Swedish central bank) has implications in safeguarding the insurance market.⁸ Any liquidity or capital support from Riksbank would improve the stability of the banking sector, which would in turn assist in maintaining the financial stability of the insurance sector because a large segment of the insurance market is owned by Swedish banks.

The importance of foreign non-life insurance branches has increased; their market share by premiums in 2007 was 6%, increasing to 13% in the first half of 2009. Branches have been able to provide cheaper contracts in non-life, especially motor TPL, resulting in its significant growth.

Further, the relative importance of non-residents in the share capital of Estonian insurers had been growing significantly during the 1998-2000 period. The direct holding of non-residents in share capital of non-life insurers are now 72-75%.

1.3 Products in the insurance sector

The non-life insurance market remained dominated by insurance classes related to motor vehicles. The volume of land vehicle insurance and motor TPL insurance premiums formed 2/3 of the non-life market. Property insurance was the third largest insurance class. Shares of other classes of insurance remain between 1-3%. For example credit, suretyship and legal expenses insurance are not always fully recognised in Estonia. In recent years, growth in the insurance for individuals was facilitated by the low level of interest rate for loans and leasing, and easy access to loans, as well as an overall increase in private consumption. Growth in the domestic market for corporates was lower, as they can use foreign companies through local brokerage firms or branches of foreign companies.

⁸ Eesti Pank entered into a precautionary arrangement with the central bank of Sweden which primarily guarantees liquidity to Estonia under the currency board agreement, 27 February 2009. <http://www.eestipank.info/pub/en/press/Press/pressiteated/pt2009/_02/pt0227>.

Table 10. Dominant products in non-life market (%)

Year	Land vehicle	Motor TPL	Property insurance
2007	41.6	27.4	22.5
2006	39.7	28.8	22.6
2005	38.3	29.6	22.4
2004	37.8	29.1	22.5
2003	36.4	30.1	22.4
2002	34.4	29.6	22.6

Source : Estonian authorities

Table 11. Dominant products in life market (%)

Year	Unit-linked assurance	life	Endowment assurance	Annuities
2007	65.3		24.8	4.5
2006	58.9		30.3	5.9
2005	51.9		36.3	7.0
2004	33.6		49.1	10.8
2003	14.0		64.5	14.1
2002	11.0		61.0	19.5

Source : Estonian authorities

In non-life insurance, the most important lines of business are motor TPL and land vehicles insurance. Motor TPL is compulsory insurance, and land vehicle insurance is the most important line of business because of the common practice of financing the purchase of the vehicle, by lease or loan, with an obligation to insure the vehicle.

The life sector is dominated by unit-linked products but data of 2008 is likely to indicate a downturn in the unit-linked market.

1.4 Institutional players

In 2007, eight non-life insurance companies, five life insurance companies and the Estonian Traffic Insurance Fund,⁹ which provides cross-border insurance and reinsurance, were operating in the insurance market. There are also six branches of EEA insurance undertakings. A total of 272 providers of non-life insurance and 64 providers of life insurance have been registered as providers of EU cross-border services in Estonia.

At the moment, there are no state-owned insurance companies and the majority of Estonian insurance companies belong to international, mainly Nordic, financial groups. To increase the competitiveness on the European Union financial market that opened since May 2004, some groups

⁹ The Estonian Traffic Insurance Fund is not an active reinsurer, but has concluded re-insurance contracts during earlier periods of the insurance market, and there remain outstanding reinsurance obligations. The Fund does not fully qualify as an insurer for the purposes of the Insurance Activities Act. However, the Fund still fulfils certain functions inherent to an insurer, such as insurance contracts for third country based vehicles entering into Estonian territory. The Fund also acts as information centre as required by the EU Motor Third Party Liability Directives. The Fund pays compensation to victims of traffic accidents on certain occasions, most notably, when accident were caused by uninsured or unidentified vehicle or where there is a cross-border link related to the accident, i.e. the accident has been caused through the use of foreign-based vehicle.

have been making arrangements that affect Estonian insurance companies (for example, a united management board for Baltic insurance companies in which board members are the same for all Baltic countries resulting in reduction of fixed costs for boards).

An insurance undertaking shall be founded as a public limited company or a European company unless otherwise provided by law; for example, the Motor Third Party Liability Insurance Act stipulates Traffic Insurance Fund (Eesti Liikluskindlustuse Fond MTÜ) to be a not-for-profit association. Mutuals are not permitted in Estonia, and none of the insurance companies are listed.

Six branches of European non-life insurance undertakings have been established in Estonia. Two are headquartered in Latvia, one each in Finland, Denmark, Ireland and Britain. None of the branches is headquartered outside the EU.

Estonian insurance companies are expanding their activities into other Baltic countries. Since 2007, two Estonian life insurance companies have written business with their branches in Latvia and Lithuania. In 2008, the FSA received two applications to merge Baltic companies from these two life insurers, and one application to establish a branch in Latvia.

Table 12. Insurance undertakings and their share of the insurance market in 2007

Licensed Life			
	Market share	Part of a conglomerate	Foreign capital
Swedbank Elukindlustus AS	45.2	Yes	Yes
SEB Elu- ja Pensionikindlustus AS	29.5	Yes	Yes
SE Sampo Life Insurance Baltic	15.3	No	Yes
Seesam Life Insurance Vienna Insurance Group SE	5.8	No	Yes
Ergo Elukindlustuse AS	4.2	No	Yes

Licensed Non-life			
	Market share	Part of a conglomerate	Foreign capital
If Eesti Kindlustus AS	31.2	No	Yes
Ergo Kindlustuse AS	23.5	No	Yes
Seesam Rahvusvaheline Kindlustuse AS	13.9	No	Yes
Swedbank Varakindlustus AS	9.5	Yes	Yes
Salva Kindlustuse AS	9.1	No	No
Inges Kindlustus AS	2.9	No	No
QBE Kindlustuse AS	3.8	No	Yes
D.A.S Õigusabikulude Kindlustuse AS	0.0	No	Yes

Source : Estonian authorities

Insurance branches		
	Market share	Part of a conglomerate
QBE Insurance (Europe) Limited Estonia Branch	0,0	Yes
AAS Gjensidige Baltic Estonia Branch	2.6	Yes
BTA apdrošinašanas akciju sabieriba Estonia Branch	2.3	Yes
Codan Forsikring A/S Estonia Branch	0.2	Yes
Euler Hermes Kreditversicherungs-Aktiengesellschaft Estonia Branch	0.8	Yes
Fennia Mutual Insurance Company Estonia Branch	0.4	Yes

Source: Estonian authorities NB. The branch of Fennia Mutual Insurance Company will transfer their Estonian portfolio to the If Eesti Kindlustus in mid 2009 and will close its insurance business in Estonia.

The Herfindahl index for the insurance market of Estonia is high, indicating to a highly concentrated market.¹⁰ The concentration of the life sector is especially high since there are fewer firms operating in the market compared to the non-life market.

Table 13. Herfindahl index of the insurance market¹¹

Life	3200
Non-life	2100
Total	1400

Source : Estonian authorities

The insurance market of Estonia has a relatively short history, where the private insurance market has been established within a short period, and with the insurance law being enacted only in 1992. The high concentration of the insurance market can be explained by the limited history of the insurance market and small size of the general economy.

Table 14. Market concentration: market share of largest players (%)

Year	Life sector			Non-life sector		
	Biggest life insurers	2 biggest life insurers	3 biggest life insurers	Biggest non-life insurers	2 biggest non-life insurers	3 biggest non-life insurers
2007	45.2	74.7	90.0	33.3	58.3	73.1
2006	40.6	66.8	88.5	36.1	62.3	80.9
2005	48.0	74.4	87.3	39.2	65.7	82.5
2004	46.6	71.7	82.1	41.4	67.5	81.7
2003	42.8	68.2	80.9	37.7	65.3	79.2
2002	44.0	66.3	82.5	36.1	61.7	78.6

Source : Estonian authorities

The market has had new entrants and exits which means that the competition regime is robust. Because the ROE of firms is relatively high, the Estonian market would be an attractive market, especially for EU insurance undertakings. The lack of domestically owned insurers may be explained by the lack of economies of scale that a domestic insurer may have. As an indicator of the competitive and liberal regime, Swedbank's non-life insurance entity entered the market in 2006 but has been able to carve out 15% of the non-life market within this relatively short timeframe through diverse distribution channels.

On the other hand, Swedbank's life entity has more than 45% of the life market. The Estonian Competition Act defines a dominant position as "if an undertaking or accounts for at least 40 per cent of the turnover in the market." The Competition Act further requires that those with a dominant position do not abuse their position. Thus, the selling and marketing tactics of insurers which appear to have a dominant position should be carefully monitored.

In the 1990s, there were a number of insurer failings due to weaknesses of the then Insurance Law (1992) which did not give sufficient powers to the Insurance Inspectorate to prevent unsuitable

¹⁰ A Herfindahl index above 1800 is considered to be high concentration according to the US Department of Justice. <<http://www.usdoj.gov/atr/public/testimony/hhi.htm>>

¹¹ The Herfindahl index for non-life insurance and total insurance market do not take into account operations by branches of foreign non-life insurers.

ownership of insurers or intervene in the investment of technical provisions. The prevalence of bad management where owners were abusing their position and using company finances for personal purposes also accounted for their weaknesses. The Ministry of Finance (MOF) decided to withdraw their licenses and have their insurance portfolios taken over to ensure better management and safeguarding of policyholders' benefits. The Insurance Activities Act was subsequently enacted overhauling the Insurance Law and granting greater power to the supervisor to intervene for the safety and soundness of the insurance system.

1.4.2 Public sector's role in insurance

There are no state-owned insurance undertakings in Estonia. Non-marketable credit insurance is not provided by private undertakings in Estonia but can be obtained from a state owned foundation KredEx ja Eksporti Garantimise Sihtasutus KredEx (The Credit and Export Guarantee Fund) which is not considered an insurance undertaking by the Insurance Activities Act.

KredEx was founded in 2001 to improve the financing of small enterprises, to decrease export-related credit risks, enable people to build or renovate their homes and promote energy efficiency in Estonia. KredEx provides business loan guarantees, housing loan guarantees and export guarantees. Business loan guarantees are meant for small and medium-sized enterprises that are just beginning their business or cannot secure a bank loan. Export guarantee insures export related credit risks, enabling exporters to provide better payment conditions for foreign buyers and enter new markets. KredEx is currently providing services to large enterprises also.

1.4.3 Foreign penetration

Three of the five life companies are subsidiaries of foreign insurance groups. The remaining two companies are owned by Estonian banks that are directly controlled by Swedish investors. There are no branches in life market.

Of eight non-life insurers, there are five subsidiaries of foreign insurance groups, two local independent companies, 1 insurer owned by a bank that is directly controlled by Swedish investors and 6 branches of foreign insurance companies. The market share of the foreign branches in non-life business was about 13% in 2009; the market share of local independent companies (not including the bank owned company) was about 13% by gross premiums in 2007. For branches the most important insurance classes are motor TPL and land vehicles insurance.

Through shareholdings, all life insurers and most non-life insurers are owned by foreign companies. The shares of Nordic and German capital are largest. The financial system is majority held by Nordic banks.¹²

¹² See Box 1 Strengths and vulnerabilities of a small insurance system.

Table 15. Shareholders of insurance undertakings

Life insurance company	Main shareholders	Shareholder of main shareholder (if there is one)
Swedbank Elukindlustus AS	Swedbank AS (Estonia, 100%)	Subsidiary of Swedbank (Sweden);
SEB Elu- ja Pensionikindlustus AS	SEB Pank AS (Estonia, 100%)	Subsidiary of Skandinaviska Enskilda Banken AB Clients (Sweden);
SE Sampo Life Insurance Baltic	Vakuutusosakeyhtiö Henki-Sampo (Finland, 100%)	
Ergo Elukindlustuse AS	Ergo International Aktiengesel (Germany, 100%)	
Seesam Life Insurance Vienna Insurance Group SE	WIENER STÄDTISCHE Versicherung AG Vienna Insurance Group (Austria, 100%)	

Non-life insurance company	Main shareholders	Shareholder of main shareholder (if there is one)
Swedbank Varakindlustus AS	Swedbank AS (Estonia, 100%)	Subsidiary of Swedbank (Sweden)
If Eesti Kindlustus AS	If Skadeförsäkring Holding AB (Publ) (Sweden, 100%)	Subsidiary of Sampo Bank (Finland)
Inges Kindlustus AS	Unix-V OÜ (Estonia, 55%), Ingosur B.V (Russia, 25%), and Voldemar Vaino (Estonia, 16%)	
Ergo Kindlustuse AS	Ergo International Aktiengesel (Germany)	
Salva Kindlustuse AS	ING Luxembourg S.A. (Luxembourg, 45%) and Tiit Pahapill (Estonia, 45%)	
Seesam Rahvusvaheline Kindlustuse AS	Pohjola Bank Plc (Finland, 100%)	
D.A.S Õigusabikulude Kindlustuse AS	D.A.S Deutscher Automobil Schutz Allgemeine Rechtsschutz-Versicherungs AG (Germany, 100%)	

Source : Estonian authorities

1.5 Relationship of insurance with the pension system

The life insurance sector has an important role in the Estonian pension system. Life insurers take part in both the accumulation and payout phase of the pension system. The pension system in Estonia comprises three pillars: I) the state pension, II) the mandatory funded pension, and III) the supplementary funded pension. State pension insurance (I pillar) is based on pay-as-you-go financing and covers three social risks: old age, permanent incapacity for work and loss of a provider.

The II pillar, the mandatory funded pension scheme, was launched in 2002, based on a full pre-financing principle and to cover the risk of old age. Pillar II is a funded pension in which a working person saves by paying 2% of the gross salary to the pension fund. In addition the state adds 4% out of the current social tax that is paid by the employee to the pension fund. Pension funds are administered by private pension fund companies, and are in essence an individual savings scheme, where the ultimate pension benefits will depend on total contributions over the working career and investment return of the pension fund. Contributions to mandatory pension fund are withheld by the employer from wages and other remuneration to those born after 1983 and contribution is mandatory.

Upon retirement, the pillar II mandatory funded pension is paid out through the mandatory purchase of an annuity. However, programmed withdrawals and lump sum payments are available depending on the accumulated amount. In 2009, the payout phase of the mandatory funded pension started with life insurers providing the annuities. However, due to the limited number of years since commencement of pillar II, lump sum withdrawal along with the programmed withdrawals are the main forms of payout so far (43.7% have been lump sum withdrawals and 54.2% programmed withdrawals).

Pillar III, the supplementary funded pension, was made available in 1998. The supplementary funded pension pillar is based on a pre-financing principle and is offered through voluntary pension funds and life insurance companies. The State encourages participation in the supplementary scheme with tax incentives.

1.6 Compulsory insurance

All compulsory insurance lines are based on relevant EU directives. Compulsory motor third party liability (MTPL) insurance was introduced in 1993.

Compulsory insurance is required for the professional liability of insurance intermediaries. Other compulsory professional liability insurance are as follows:

- Bankruptcy trustees.
- Public notaries.
- Members of the Bar Association.
- Bailiffs.
- Authorized public accountants.

There are compulsory lines of non-life insurance for entrepreneurs acting in risk-related industries, such as railway undertakings, aviation undertakings, shipping undertakings, undertakings acting as electrical contractors, and undertakings handling explosives.

Estonian was taking steps to introduce compulsory insurance against accidents at work and occupational diseases. Preparations for legislation was taking place with a view of implementation in 2011, but this has been put on hold for the time being.

Providers of the compulsory motor TPL are non-life insurance undertakings. In 2007, the gross premiums of motor TPL was 64 million EUR. Providers of compulsory professional indemnity insurance are non-life insurance undertakings. In 2007 non-life insurance undertakings accumulated 4.7 million EUR in general liability insurance gross premiums.

1.7 Distribution channels

Insurance intermediaries are divided into insurance brokers and insurance agents. Insurance brokerage is mediation in the interests of the policyholder or, in the case of reinsurance, in the interest of an insurance undertaking. An insurance agent represents one or several insurance undertakings or reinsurance undertakings on the basis of an authorisation. Representation of several insurance undertakings or reinsurance undertakings is permitted only on the condition that their insurance contracts are not competing. Insurance contracts are not competing if different classes or subclasses of insurance are contracted.

As of 31 December 2007, there were 22 insurance brokers and 1,131 insurance agents in Estonia, about 600 cross-border insurance brokers, and 1100 cross-border insurance agents who are authorised to provide intermediation services in Estonia.

In life insurance market, the two market leaders' are owned by Estonian banks (which are in turn owned by Swedish banks) and they are using *bancassurance* as a major distribution channel. The former owner of another insurer was a bank and this channel is still used besides developing their own network. Other companies are mainly using their own selling channels. Swedbank established a non-life entity in 2007, but has managed to take over 15% of the non-life market in two years due to the efficacy of *bancassurance* distribution.

For *bancassurance* to take place, banks either refer depositors to insurance products available or make client data available to related insurance companies. The rapid expansion of *bancassurance* in Estonia is of some concern in terms of whether good data protection of clients is taking place. The Data Protection Act, Insurance Activities Act and Credit Institutions Act prohibit client information from being provided to third party unless consent is given by the client. The Estonian authorities may consider ensuring that client data is not being provided to third parties without explicit consent from the client.

A relatively recent development has been the provision of services through e-broker systems in which 27% of retail contracts are now being agreed. Many insurers are in the midst of developing internet based sales channels to accomplish direct sales.

Insurance intermediaries, whether they are agents or brokers, are subject to certain requirements. As most contracts are sold through these channels, it is critical that intermediaries are able to raise awareness of risks and explain the coverage of contracts. The current regime is considered insufficient by most parties, and the need for a qualification or accreditation of intermediaries is urged.

Insurance mediation regulation is based on the EU insurance mediation directive (2002/92/EU). Insurance intermediaries (brokers and agents) are among other things subject to:

- registration (only an intermediary entered in the list of intermediaries may act as an intermediary);
- fit and proper requirements, including qualification requirements; and
- requirements to the contractual terms and conditions (as stipulated in the Insurance Activities Act and specified in FSA Guidelines on General Requirements to Insurance Mediation).

According to the insurance mediation directive, EU Member States may adopt stricter provisions regarding the information requirements. Estonia requires the following additional information compared to the insurance mediation directive:

- an insurance intermediary shall present the conditions of the insurance pre-contract, including the size of premiums, and the restrictions and exclusions relating to the contract;
- an insurance intermediary shall inform the customer of compensation in the event of an insured event;
- an insurance intermediary shall disclose the intermediary fee for the mediated insurance contract; and

- an insurance broker shall advise the customer on any other issue relating to the insurance contract.

Insurance intermediaries are subject to qualification requirements. The process for obtaining the required training is not regulated, but there is a requirement that the training should ensure that an intermediary is able to comply with the requirements at all times.

Training of insurance agents is provided by the insurance undertaking whom the agent represents. An insurance undertaking can delist its insurance agent if the agent has not undertaken the required training.

Insurance brokers use different methods to ensure their training is sufficient. Training is provided by brokers as well as insurance undertakings. The FSA may deregister an insurance broker if the insurance broker has violated the requirement of training.

1.8 Reinsurer

Reinsurance is principally provided by the group reinsurer or shareholder insurance firm of insurance undertakings in Estonia or by foreign reinsurer, such as Munich Re or Swiss Re, providing cross-border reinsurance transactions. The local insurance firms that do not have any foreign affiliation receive much training and consultation opportunities from the major foreign reinsurers, Munich Re and Swiss Re, to ensure that their insurance underwriting is done with good risk management.

Principles vary from company to company, but in general, each insurance undertaking sets a minimum rating requirement for accepting a reinsurance partner.

FSA may demand additional deductions from the available solvency margin of an insurance undertaking carrying out reinsurance with a foreign reinsurer, if according to the opinion of FSA:

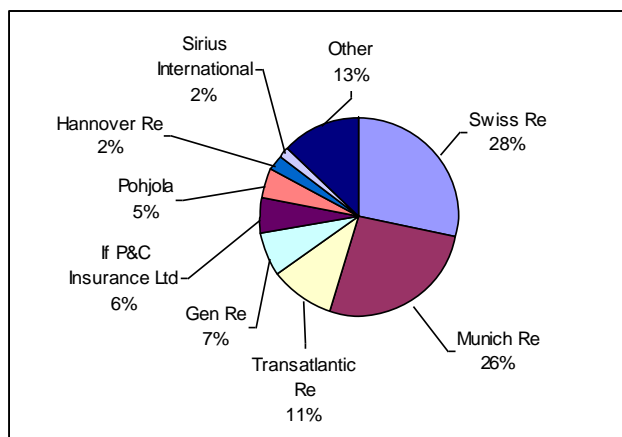
- 1) the legislation or supervisory authority of the home country of the reinsurance undertaking does not ensure the provision of sufficient supervision, including consolidated supervision, over the reinsurance undertaking; bankruptcy or liquidation proceedings have been initiated against the reinsurance undertaking; the supervisory authority has imposed significant sanctions on the reinsurance undertaking; or the quality of reinsurance has significantly deteriorated in comparison with the previous financial year; or
- 2) risks are not transferred on the basis of the reinsurance contract or the transferred risk is insignificant considering the volume of the reinsurance contract.

Table 16. Reinsurance ceded (percentage of insurance ceded to reinsurers)

	Non-life insurance	Life insurance	Total
2008	11.6	1.7	8.3
2007	14.0	1.1	8.5
2006	14.6	1.3	10.1
2005	17.3	1.3	12.1
2004	26.9	2.2	20.4
2003	33.9	2.0	26.5
2002	35.9	2.2	28.0

Source : Estonian authorities NB. Data of Estonian insurance companies branches (in Latvia and Lithuania) is included.

Figure 4. Market shares of reinsurers based on non-life insurance premiums ceded, 2008



Source: Estonian authorities

1.9 Insurance associations

The Estonian Insurance Association (EKSL) is a non-profit organisation which protects the interests of insurance industry. Membership is not limited to life and non-life companies but branch offices can also apply for membership. Out of 18 market players 13 are members of EKSL. EKSL is a member of the European insurance associations central organisation Comité Européen des Assurances (CEA) and a member of the Estonian Employers Association.

The objective of EKSL are to:

- represent the insurers interests in relations with the state and other parties;
- propose changes to the legislative acts which have connection to insurance activities;
- participate in surveys, statistics and publications related to the insurance activities; and
- organise professional training and education for insurance professionals and general insurance training to the other parties.

EKSL has issued a guideline “Good Practice of Insurers”. This guideline mostly regulates communication and contractual relations between insurers and their clients. The guideline is of a more general character and compliance is not monitored by the FSA.

The Estonian Insurance Brokers Association (EKML) was founded in 2000 by 12 broker firms in Estonia. EKML is a member of The European Federation of Insurance Intermediaries, and there are 14 members in the association representing 95% of the broker market.

EKML’s primary objective is to promote an Estonian regulatory environment in which insurance brokers can prosper, ensure fair competition, an adequate level of consumer protection and a sound insurance market.

1.10 Risks of the insurance sector

The financial crisis has had a sharp negative impact on life insurers. While investment returns have deteriorated, premiums income has decreased and many policyholders are surrendering their contracts. Life insurance undertakings whose portfolio are mainly unit-linked products are more

affected but they have restructured their investment portfolios, increasing the share of less riskier instruments and life insurer remain generally well capitalised.

The financial crisis has had an indirect impact on non-life insurance undertakings. As financial institutions require tougher conditions and requirements for loans, the demand for non-life insurance products has shrunk.

The coverage of natural disasters depends on the insurance contract. In practice, there are few policyholders who opt to include coverage of natural disasters as such events are uncommon in Estonia.

The number of options available for pricing and valuation of liabilities may complicate the payout of mandatory (pillar II) pension commencing in 2009. Historically, technical provisions have been calculated by using mathematical formulas and fixed interest rates. However, technical provisions of mandatory pension insurance must be accounted by fair value and a risk free interest rate curve has to be used. The concept of fair value of insurance liabilities is new to the market and not all companies are technically prepared. Further, some aspects related to the technical provision, such as profit sharing and investment limits, are yet to be specified by guidelines or regulations.

- Large-scale risks

The most significant recent event in the Estonian insurance market has been the storm on 9 January 2005, which caused flooding that resulted in large-scale damages. Total damages were estimated at 11.8 million EUR.

There has been one man-made disaster in April 2007 after Government decided to move the monument of a Bronze Soldier which caused numerous gatherings at the grave site, several of these meetings being hostile. The riot caused an estimated damage of around 1,6 million euros. Taking into consideration the sensitivities to the event, the government proposed to cover direct damages caused to third parties. The decision was provided for all damages regardless of whether or not there was a related insurance arrangement.

There has been some concern over the uncertainty of coverage of insurance contracts in the face of floods and storms. The lack of clear coverage terms is considered the primary reason for this uncertainty, although the expectation that the state would compensate for such large scale risks also seems to have exasperated the confusion. The Supreme Court ruled that the lack of clarity of terms caused the confusion and that insurers would need to compensate.

In the aftermath of this incident, the FSA issued “General requirements to insurance contracts” to protect policyholders from unclear drafting of insurance contracts. The general requirements provide greater clarity to the extent and conditions of insurance contracts.

A contract must accurately and clearly define an insured event and insured risks. Insured events and insured risks must be defined, as far as possible, through positive features and not negative features. Where exclusions are used, the contract must include an exhausting and final list of exclusions. The exclusions must be clear and logical, and comprehensive next to the respective positive definition of an insured event or insured risks. Exclusions must be reasonable, taking into account the objective of an insurance contract. The use of hidden exclusions is prohibited.

An insurance policy must include all insured risks covered by the insurance contract, together with an exact reference to the clause of the contract (terms and conditions) where exclusions are listed.

Definition of an insured risk presented on the policy must correspond to the content of insured risk. It must not be misleading in respect of the actual extent of insurance cover. If a specific insurance contract does not cover an insured risk defined in standard conditions that are applied to the insurance relationship, this exclusion must be mentioned also on the insurance policy.

There are no state-sponsored or industry-sponsored insurance/compensation schemes that provide insurance coverage/financial compensation against natural and man-made disaster events.

Estonian insurance industry is unwilling to cover agricultural risks, and there is no compulsory insurance for such risks. However, the Minister of Agriculture allows up to 80% of insurance premiums on certain agriculture risks to be compensated by the Estonian Agricultural Registers and Information Board. The risks that are covered are: 1) 80% of premiums for losses caused by adverse climatic events which can be assimilated to natural disasters; and 2) 50 % of premiums, losses caused by climatic events and/or losses caused by animal or plant diseases or pest infestations.

Box 1. Strengths and vulnerabilities of a small insurance system

Estonia's economy is small in terms of GDP and the insurance system is small within its financial system. The insurance system was growing until 2007, gross premiums were EUR 360 million in 2007, but it is one of the smaller insurance systems in the EU.

Estonia's insurance system is largely owned by foreign insurers which originate in Sweden, Finland, Germany, and Austria. This is especially true for the life sector in which all insurers are foreign owned. Two of the large life insurers, are owned by Swedish banks, which constitutes 74.7% of the life market. In the non-life sector, Finnish ownership extends to 45.1%, German ownership is 23.5%, and Swedish ownership is 9.5%. The two non-life insurers which are majority owned by Estonian interests, which have a marketshare of 12% together, have a large shareholding by Luxembourgian and Russian corporates. The aforementioned refers to subsidiaries of foreign owners, while Estonia has six branches in non-life which together hold 6.3% of the non-life market.

While the insurance system of Estonia has benefited from the large foreign presence providing insurance services to Estonians which might have otherwise not been readily available, the large presence exposes Estonia to unique vulnerabilities. For example, capitalisation of the insurers will be dependent on the holding company which may be exposed to different economic climates or interests than those of the subsidiary or branch.

Another factor which may affect the insurance system of Estonia is the large shareholding by banks. In the life sector, the two largest insurers are owned by banks, which are Swedish, making up 74.7% of the life market. In the non-life sector, 54.6% is owned by banks. Due to the development of financial conglomerates, this is not a unique situation, but the financial condition of the parent company would have an impact on the affiliated insurance company and contagion risk of banks may impact related insurers. Another specific issue is the growth of *bancassurance* which has led many banks to establish insurance companies. This development must be accompanied by the protection of client information, ensuing that consent of the client is acquired if necessary.

Small economies tend not to have a large number of financial institutions due to the lack of economies of scales this will have. Concerns for competitiveness will sometimes influence governments of small economies, leading them to encourage merger of financial institutions that would limit the number of institutions. In the case of Estonia, ROE is high at 17.9% for the life sector, and 18.3% for the non-life sector. In terms of the Herfindahl index, the life sector and non-life sector have a high index of 3200, and 2100 respectively.

2. SUPERVISORY AND REGULATORY STRUCTURE

Following Estonia's membership to the EU, Estonia has harmonised its legal system with EU, thereby upgrading its insurance system significantly. There are some areas in which the regulators may consider improving implementation and improving the guidance to legislation, but overall, regulation has led an open and orderly marketplace. Despite the relatively young insurance market, the market has developed and the regulator has adapted well to the challenges posed by the market and its *acquis* to the EU.

Estonian insurance regulation takes many cues from the Finnish regulatory approach, maintaining conservatism to safeguard the technical provisions of insurers. There remain some issues in the area of insurance intermediaries fit and proper rules together with qualification criteria, and means of consumer protection.

Preparation for Solvency II is well ahead with a good participation in QISs. Consultation is being held between the market and the regulator to ensure that implementation of Solvency II will be orderly and insurers will have sufficient capital for the transition.

2.1 Policy and regulatory initiatives

Table 17. Recent regulatory initiatives

1991	Estonian independence
1992	Insurance Act enacted, enforced in 1993
	Estonian Insurance Inspectorate established
	MTPL Guarantee Fund established
1993	Introduction of compulsory motor TPL
1998	Pillar III of pension system, voluntary retirement saving commences
2001	Financial Supervisory Authority (FSA) commences operation
	Mandatory second pillar of pension system was introduced, and insurers authorised to pay annuities to scheme participants.
2005	New Insurance Activities Act enacted to harmonise with EU legislation
2009	Payout of pillar II of pension system starts

Source: OECD Secretariat

Table 18. Planned regulatory reforms

Scheduled date	Planned area of change	Effect on insurance market
No date	Introduction of compulsory insurance for liability insurance	Insurance against accidents at work and occupational diseases to be taken out with insurance companies.
No date	Health insurance system	To give more weight to private health insurance coverage for occupational health or complimentary coverage.
2013	Solvency II	Harmonisation with EU directives, and functioning of supervision.
2011	Act on motor TPL insurance	To harmonise motor TPL insurance with civil law.

Source: OECD Secretariat

2.2 Legal framework

The central act for the insurance market and insurance industry is the *Insurance Activities Act*. Most legislation, including the Insurance Activities Act, are based on EU requirements. The *Insurance Activities Act* contains important rules on insurance, such as:

- requirements concerning the establishment and licensing of the insurers;
- the bases for cross-border activities for the foreign insurers in Estonia;
- the bases for Estonian insurers' cross-border activities;
- requirements concerning the insurers' governance;
- solvency requirements;
- regulation of and requirements for insurance intermediation (brokers and agents);
- rights and obligations of the FSA concerning the supervision of insurers and branches of Estonian insurers established in other countries and branches of third-country insurers in Estonia.

The *Commercial Code* and the *General Part of Civil Code Act*, especially the Commercial Code, are important from the point of view of insurers' governance. Insurance companies must be incorporated as limited liability companies, and rules applicable to insurers such as establishment, board composition, governance, winding-up are in the Code.

The *Guarantee Fund Act* is primarily concerned with the guarantee towards mandatory funded pension savings¹³ provided by insurers. There are four separate sub-funds in the Guarantee Fund–Deposit Guarantee Sectoral Fund, Investor Protection Sectoral Fund, Pension Protection Sectoral Fund and Annuity Protection Sectoral Fund. The two latter sub-funds are related to the pension industry. Pension fund asset managers make contributions to the Pension Protection Sectoral Fund and insurers contracting statutory funded pension annuities must pay premiums to Annuity Protection Sectoral Fund. The assets of the Guarantee Fund's sub-funds are to be used in case of insolvency of insurers or pension management companies, in order to protect the financial interests of policyholders or unit-holders.

The MOF is responsible for the overall financial policy as well as the drafting of legislation of the financial sector. The MOF can issue secondary legislation that is binding on implementation of legislation. These regulations have been mainly related to reporting of insurers and classification of insurance.

¹³ The statutory funded pension is pillar II of the pension system in Estonia.

The FSA can issue *guidelines* which are not legally binding, and are part of the discretionary power of the FSA. Guidelines are issued when legislation is not sufficiently specific or clear, and acts as an interpretation of the legislative acts. Thus, in cases supervised entities do not comply or explain why they cannot comply, it is considered possible to get a court injunction to have the interpretation made by the FSA approved as official. The FSA has five guidelines dealing directly with insurance activities (general requirements to insurance contracts, life insurance policies—disclosure of information to policyholders, unit-linked life insurance policies—components, underlying assets and disclosure policy to policyholders, reporting by actuaries, and the guideline imposing the requirements related to insurance intermediation).

2.3 Objectives

The objectives of financial supervision are stipulated in the FSA Act as:

- to enhance the stability, reliability, transparency and efficiency of the financial sector;
- to reduce systemic risks;
- to prevent abuse of the financial sector for criminal purposes,
- to protect the interests of clients and investors by safeguarding their financial resources; and
- to support the stability of the Estonian monetary system.

The FSA conducts supervision for the purpose of these objectives in the name of the state and is independent in the conduct of financial supervision. The functions of the FSA in this respect are to:

- monitor and analyse the compliance of supervised entities with the requirements of financial soundness and own funds, and other obligations prescribed by the relevant legislation;
- guide and direct entities to ensure sound and prudent management;
- take measures prescribed by legislation to protect the interest of policyholders and investors;
- apply penalties based on the procedure prescribed by Acts;
- propose amendments and legislation of Acts concerning the financial sector and related supervision, and participate in drafting legislation;
- co-operate with international organizations, foreign financial supervisory authorities and other foreign authorities and persons; and
- perform the other functions arising from the acts such as the Guarantee Fund Act, the Money Laundering and Terrorist Financing Prevention Act, the International Sanctions Act.

2.4 Governance and accountability of FSA

The FSA is a public agency, with autonomous powers and a separate budget. Its competence, rights and obligations are stipulated in the FSA Act, as well as in other financial sector related acts.

2.4.1 Governance structure

The FSA has a bicameral board system, with a supervisory and management board. The supervisory board is responsible for monitoring the management of FSA such as approving the

operating strategy and budget of the FSA. The management board manages and organises the activities of FSA. The management board is responsible for all obligations and exercises of the FSA that are not assigned to the supervisory board.

According to the FSA Act, the Minister of Finance is the *ex officio* chairman of the supervisory board of the FSA. His/her authorities, as the chair, include organising the activities and administration of the supervisory board. Membership of the Supervisory Board otherwise comprises the governor of the Bank of Estonia, two members appointed by the government, and two members appointed by the Supervisory Board of the Bank of Estonia.

The Management Board consists of four members, who are responsible for functional areas. The Management Board of the FSA is based primarily on a consensus decision making, although some cases are decided by majority voting. Members of the Management Board are elected by the Supervisory Board, with a term of three years for members and four years for the chairman, with a possibility of re-election. Management Board members cannot generally be dismissed during their term.

Independence of the FSA is ensured by its budgetary independence from government or other interests. The FSA budget is not dependent on the State Budget, but covered from compulsory payments made by the supervised entities, administrative fees and other sources. Insurance companies are required to pay one percent of the highest amount of minimum own funds required, and an amount dependent of their volume of business.

The FSA is divided into the divisions of responsibility:

- Business Conduct Supervision Division
- Market Supervision and Enforcement Division
- Prudential Supervision Division
- Prudential Policy and Financial Reporting Division
- Legal Department
- Administrative Services Department
- Internal Audit
- Public Relations.

As FSA is a unified supervisor, supervision of insurance is carried out functionally within the FSA. The number employed at FSA is 65. The exact number of experts involved in insurance supervision is difficult to ascertain as prudential supervision is risk-based and not sector-based, but prudential supervision is performed by 5 full-time specialists. In addition there are 5 specialists involved in insurance supervision, (lawyers, IT auditors, reporting and regulation specialists), but who are also involved in the supervision of other areas. The Business Conduct Supervision Division deals with the quality of service of all supervised entities.

Estonia would benefit from reviewing the legislation under which the FSA operates in order to strengthen its powers and transparency, and enhance its resources dedicated to insurance supervision. Special consideration should be given to enhancing the risk-based aspects of supervision.

2.4.2 Accountability

The accountability of FSA is achieved through an annual report approved by the supervisory board submitted to the Parliament. The Parliament will hear the report of the chairman of the management board of the FSA, following the procedure prescribed by the Riigikogu (Parliament) Rules of Procedure Act. The annual report of the FSA must comprise: the management report, the statement of revenue and expenditure, and the auditor's report.

The FSA is obliged to issue an annual yearbook that contains the annual report of the FSA approved by the supervisory board, a list of the advisory guidelines issued by the FSA with the explanations about the guidelines, and a summary report of the activities of the subjects of financial supervision during the previous calendar year.

Most of the decisions of the management board (exception for those containing confidential information about the supervised entities, and information on the personal fees of management board), must be published in the FSA's official website. The FSA must also publish in its webpage: guidelines it has adopted; provision by Estonian legislation for discretionary measure of the EU which are to be decided by the Member States; and the methods and general criteria used in supervisory activities are based on the guidelines of the Committee on European Insurance and Occupational Pensions (CEIOPS).

2.5 Compliance with international standards of supervision

The assessment of Estonia against the Insurance Core Principles (ICP) of the IAIS was carried out in 2000 as part of the Financial Sector Assessment Programme (FSAP) which assessed Estonia as broadly observant to all ICPs. Since 2000, Estonia has restructured its regulator, passed new insurance legislation and joined the EU which would improve its position against ICPs further.

2.6 Licensing and ongoing requirements

Prudential supervision is risk-based, focusing on the major risks in insurance (underwriting risk) as well as cross-sectoral risks (market and credit risks). Supervisory practices (methods and frequency) take into account the systemic importance of the supervised entity or of a particular business line, size, complexity and scale of business. Risk-based supervision will become increasingly employed when implementation of Solvency II takes place, and Estonia has been preparing for this process.

In order to engage in insurance or reinsurance activities, authorisation from the FSA is necessary. Any undertaking which establishes its head office in Estonia and wishes to engage in insurance or reinsurance activities requires authorisation from the FSA. Activities can only be carried out in the class(es) or subclass(es) of insurance which a license has been issued. Existing, authorised insurance or reinsurance undertaking can apply for an extension of its business to another class of insurance. In case of motor TPL insurance, the insurer must become a member of the respective Guarantee Fund.

The minimum share capital of an insurance undertaking is 3.2 million euros if the insurance undertaking has the right to engage in reinsurance activities, life insurance, or the following classes of non-life insurance:

- motor vehicle liability, including motor TPL insurance;
- aircraft liability insurance;
- liability for ships;
- general liability insurance;

- credit insurance; and
- surety-ship insurance.

If an insurance undertaking has the right to engage only in classes of non-life insurance which are not specified above, the minimum share capital of the insurance undertaking is 2.2 million euros. The minimum share capital of a captive reinsurance undertaking is 1.1 million euros.

2.6.1 Fit and proper tests

The fit and proper test of management of insurance undertaking, *inter alia* members of the management and supervisory boards, is applicable not only to domestic insurers, which includes subsidiaries of foreign insurers, but also to managers of branches of insurers headquartered in third countries.

First, managers must have the appropriate degree of education, knowledge, experience, as well as a flawless business reputation.

Second, the manager of an insurance undertaking must not be a person:

- who has previously caused, through activity or inactivity, insolvency of an insurance undertaking or of other financial sector undertaking;
- who have been punished for an economic offence, official misconduct or offence against property or offence against public trust and information concerning the punishment has not been expunged from the punishment register pursuant to the Punishment Register Act;
- who has been subjected to a prohibition on business;
- whose earlier activities as managers of a company during the previous five years have shown that they are not capable of organising the management of a company such that the interests of the policyholders, insured persons and beneficiaries are sufficiently protected.

Managers are required to act with due diligence and in compliance with all the requirements, having in mind the best interests of the undertaking, of the policyholders and beneficiaries.

2.6.2 Branch licensing

An EEA insurance entity with a insurance license from its home country may engage in insurance activities in Estonia on the basis of the activity licence issued in its home country by establishing a branch or engaging in cross-border insurance activities.

For a non-EEA insurer to establish a branch in Estonia, it is required to apply for a corresponding authorisation from the FSA. Non-EEA insurance undertakings are currently not able to engage in cross-border insurance activities in Estonia but will be permitted when the ongoing legislative changes are made to reflect the reservations made by Estonia to the Codes of Liberalisation. Non-EEA reinsurance undertakings have a right to engage in cross-border reinsurance activities in Estonia.¹⁴

¹⁴ Further details on market access is described in section 3. MARKET LIBERALISATION IN INSURANCE.

2.6.3 Shareholding of insurance companies

A qualifying shareholding¹⁵ (shareholding in excess of 10, 20, 33 or 50 per cent) may be held by:

- persons who are able to ensure the sound and prudent management of the (re)insurance undertaking,
- those with owners and business connections, if they exist, that are transparent and do not prevent efficient supervision, and
- those who do not prevent the FSA from obtaining information by reasons related to the legislation of their home country.

A person who intends to acquire a qualifying holding or to increase a qualifying holding so that the proportion of the share capital or votes represented by shares in a (re)insurance undertaking held by the person would exceed 20, 33 or 50 per cent, or to conduct a transaction which would result in the (re)insurance undertaking becoming a controlled company, is required to give advance notice to the FSA.

A person who intends to transfer shares which would result in the person losing a qualifying holding in the (re)insurance undertaking to below the 20, 33 or 50 per cent threshold, or when the person surrenders control over the (re)insurance undertaking, shall promptly notify the FSA of such intent.

The FSA can prohibit the acquisition, increase to a qualifying holding, or making the insurance undertaking a controlled company if such transaction is contradictory to the principles of sound and prudent management of the insurance undertaking.

2.7 Capital and surplus requirements

There are no localisation requirements for assets covering technical provisions as the respective EU directives permit the relaxation of the rules on localisation. The financial instruments that can be used as assets covering technical provisions are limited. There are also quantitative restrictions on investment of assets covering technical provisions. An insurance undertaking is required to invest assets covering technical provisions corresponding to the commitments arising from insurance contracts in the same currency that the commitment was assumed, unless:

- 1) the assets covering technical provisions corresponding to the commitments assumed in such currency is equal to up to 7 per cent of the assets covering technical provisions expressed in other currencies;
- 2) the assets covering technical provisions corresponding to the commitments assumed in such currency is equal to up to 20 per cent of all the commitments of the insurance undertaking expressed in the same currency;
- 3) the assets covering technical provisions corresponding to the commitments assumed in Estonian kroons or Member State's currency is invested in euros;
- 4) the commitment arises from a unit-linked life assurance contract.

¹⁵ .A qualifying holding means any direct or indirect holding in the share capital of a company which represents 10 per cent or more of the share capital of the company, of all rights related thereto or of the voting rights in the company or which makes it possible to exercise a significant influence over the management of the company in which that holding subsists.

Insurance undertakings are required to make quarterly reporting based on IFRS accounting to the FSA.

Every (re)insurance undertaking is required to maintain an adequate available solvency margin to ensure that the (re)insurance undertaking is capable of meeting the obligations arising from (re)insurance contracts at all times. The total amount of the assets included in the available solvency margin of an (re)insurance undertaking shall not be at any time less than the minimum solvency margin or the required solvency margin, and/or the adjusted solvency margin.

For non-life insurance, the required solvency margin can be calculated based on either gross premiums or gross claims. If based on gross premiums, the required solvency margin is calculated by using the higher of gross written premiums, or gross earned premiums of a financial year, multiplied by the factor 0.18 for an amount extending up to 50 million euros, and by the factor 0.16 for an amount in excess of 50 million euros. However:

- For aircraft liability insurance, liability for ships and general liability insurance, the gross written premiums, or gross earned premiums of the previous financial year shall be increased by 50 per cent before calculation.
- For short-term accident insurance or sickness insurance, the gross written premiums, or gross earned premiums of the previous financial year shall be divided by three before calculation.

If the non-life insurer calculates its required solvency margin by its gross claims, the amount of gross claims of the last three financial years shall be divided by three and multiplied by the factor 0.26 for an amount extending up to 35 million euros, and by the factor 0.23 for an amount in excess of 50 million euros. However:

- For aircraft liability insurance, liability for ships and general liability insurance, the gross written premiums, or gross earned premiums of the previous financial year shall be increased by 50 per cent before calculation.
- For short-term accident insurance or sickness insurance, the gross written premiums, or gross earned premiums of the previous financial year shall be divided by three before calculation.

The required solvency margin of life insurers is dependent on the lines of its business. For term and whole life assurance, endowment assurance, birth assurance and marriage assurance, and annuities, the required available solvency margin is calculated by adding the following:¹⁶

- the mathematical provisions relating to direct business and reinsurance acceptances gross of reinsurance cessions shall be multiplied by 0.04, for the last financial year;
- for policies of which the capital at risk is not a negative figure, such capital underwritten by the assurance undertaking shall be multiplied by 0.003.

For administration of pension schemes, the following calculation shall be made:

- for policies with a term of up to three years on which the capital at risk is not a negative figure, the capital shall be multiplied by 0.001;

¹⁶ Capital at risk is the amount of premiums to be paid in the event of an insured event occurring.

- for policies with a term of three to five years on which the capital at risk is not a negative figure, such capital shall be multiplied by 0.0015.

For tontines, capital is multiplied by 0.01.

For unit-linked life assurance, required solvency margin is calculated by adding the following:

- if the insurance undertaking bears an investment risk, a multiple of 0.04 of technical provisions;
- if the insurance undertaking bears no investment risk but the allocation to cover management expenses is fixed for a period exceeding five years, a multiple of 0.01 of technical provisions;
- if the insurance undertaking bears no investment risk and the allocation to cover management expenses is not fixed for a period exceeding five years, a multiple of 0.25 of the last financial year's net administrative expenses pertaining to such business;
- if the insurance undertaking covers a death risk, a multiple of 0.003 of capital.

Estonia will implement Solvency II when the implementation date is agreed in the EU. Most insurers have been taking part in the QIS4 (quantitative impact study), and the FSA will seek higher participation for subsequent QISs. The QISs have resulted in significantly higher capital requirements than of the current regime. Because Estonia has a profit distribution tax instead of an income tax, corporates tend to reserve profits rather than payout dividends which would be taxed. Therefore, most insurers are well capitalised, and the FSA does not foresee problems achieving Solvency II capital requirements. Further, due to Estonia's insurance system being dominated by foreign insurers, preparation by the parent companies has been taking place well in advance. For QIS5, all Estonian insurers are scheduled to take part.

2.8 Investment regulations

The Insurance Activities Act sets out the parameters of the investment regulations. There are requirements for matching of currencies and types of assets that may cover technical provisions. There are also maximum percentage of technical provisions which can be invested in a type of asset. Other considerations that are required are for the safety and security of proceeds, and liquidity of the insurance undertaking.

The same principles apply for reinsurers although the specifics of investment regulation differ between insurers and reinsurers. For reinsurers there is no asset classification requirement but some currency rules and quantitative requirements apply.

The currency requirements indicated above in section 2.7 apply. The following restrictions apply only to insurers, concerning assets covering technical provisions:

- 1) a bond, convertible security or other tradable debt obligation issued which are issued or fully guaranteed by Contracting States, members of the OECD, states which are participants of the International Monetary Fund's (IMF) General Agreements to Borrow (GAB) (hereinafter Zone A states), or central banks of Zone A states;
- 2) securities as specified in the Securities Market Act which are traded on a regulated securities market;
- 3) loans secured by mortgages entered in the land register in the first ranking or by guarantees of credit institutions registered in a Zone A state;

- 4) debenture loans granted to credit institutions or other insurance undertakings on the presumption that the credit institution or insurance undertaking is registered in a Zone A state;
- 5) share in investment fund which is located in a zone A state;
- 6) immovables or structures except for those parts of immovables or structures used by the insurance undertaking;
- 7) deposits with ceding undertakings and claims against ceding undertakings;
- 8) claims against policyholders and insurance intermediaries which are not older than ninety days and which arise from insurance or reinsurance activities;
- 9) demand deposits and fixed-term deposits in a Zone A state.

Asset limits covering technical provisions must following the below restrictions:

One immovable or structure or several structures which can be considered to be one structure due to their immediate vicinity	Up to 10 per cent of the total amount of technical provisions together with the reinsurance undertaking's share but not more than 15 per cent in immovables and structures in total.
Securities of one issuer or in loans secured by one borrower	Up to 5 per cent of the total amount of technical provisions together with the reinsurance undertaking's share and in an amount of up to 10 per cent, provided that neither the proportion of securities nor the proportion of secured loans in assets covering technical provisions in an amount of exceeds 40 per cent of the total amount of technical provisions together with the reinsurance undertaking's share.
One debenture loan	Up to 1 per cent of the total amount of technical provisions together with the reinsurance undertaking's share and in an amount of up to 5 per cent of the total amount of technical provisions together with the reinsurance undertaking's share in debenture loans in total.
Demand deposits	3 per cent of the total amount of technical provisions together with the reinsurance undertaking's share.
Securities not traded on a regulated securities market and which can be sold within a short period of time, and in shares of investment funds that are not UCITS	Up to 10 per cent of the total amount of technical provisions together with the reinsurance undertaking's share.

Further, the FSA has the right to prohibit an insurance undertaking from concluding a transaction which may result in the assets covering technical provisions of the insurance undertaking not complying with the requirements of the Insurance Activities Act. The restrictions specified here do not apply to the underlying assets connected to unit linked life assurance contracts, where the insurance undertaking has no obligation arising from the insurance contract to bear the investment risk.

Investment restrictions do not apply to assets corresponding to unit-linked life insurance products. However, in order to ensure policyholder protection, the FSA issued the guideline "Unit-linked life assurance policies—component, underlying assets and disclosure to policyholders." The objective of the guideline is to define minimum requirements of unit-linked products, and disclosure policy.

2.9 Group-wide supervision

The Insurance Activities Act stipulates the conditions in which supplementary supervision over consolidation group and supervision over financial conglomerates needs to be carried out on insurance companies in accordance with the EU directives on the supplementary supervision of insurance undertakings in an insurance group and on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial groups. According to the Act, Swedbank Elukindlustus AS, Swedank Varakindlustus AS and SEB Elu- ja Pensionikindlustus AS are financial conglomerates.

Supplementary supervision of financial conglomerates are carried out by the disclosure and verification of information, intra-group transactions, adjusted solvency margin and the amount of assets included in adjusted solvency margin.

When an insurance undertaking is part of an international group in the EU, the FSA and counterpart supervisory authority will decide on who is to be the lead regulator (home supervisor) of the financial conglomerate. The FSA is not the lead regulator for any of its insurance companies that are part of a conglomerate.

2.10 Early intervention and winding-up/insolvency

2.10.1 Regulatory action

The FSA has the discretion to take regulatory action when a insurance undertaking fails to comply or inappropriately comply with the Insurance Activities Act or another administrative acts. The FSA can fine insurers to the upper limit of 50,000 EEK (or 3000 EUR). However, this fine is recognised to be too low, and this limit has been raised to 0.5 million EEK (or 30,000 EUR).

Estonia has noted that the maximum criminal offence is 250 million EEK, whereas financial sector related offences are likely to be administrative offences with a maximum penalty of 0.5 million EEK. Wrong doing by financial institution are usually classified as an administrative or civil penalty, so therefore, the maximum penalty for administrative offences needs to be reviewed in Estonia, not the criminal penalty.

Estonia should raise the maximum monetary penalty for financial sector wrong doing higher, and introduce a system of sanctions with more gradations.¹⁷ Necessary legislative changes should be considered, including amendments to its Penal Code.

2.10.2 Early intervention

An insurance undertaking shall calculate its technical provisions to reflect its commitments arising from insurance contracts as can be reasonably foreseen. If an insurance undertaking violates the requirements established for calculating technical provisions or if, in the opinion of the FSA, the amount of the technical provisions is not adequate, the FSA has the right to prohibit the insurance undertaking from carrying out transactions or performing acts related to the funds of the undertaking or to restrict the volume thereof.

¹⁷ For example, in Finland, corporates can be penalised for an amount of EUR 500 to no more than EUR 200,000, not, exceeding 10% of turnover in the financial year preceding imposition of the penalty payment. Penalty payment for a natural person shall amount to no less than EUR 100 and to no more than EUR 10,000.

If the available solvency margin is below the required solvency margin, the insurance undertaking is required to promptly submit a recovery plan to the FSA. If the available solvency margin is reduced to below one-third of the required solvency margin or below the minimum solvency margin, the insurance undertaking shall promptly submit an extraordinary recovery plan to the FSA to restore the available solvency margin to at least one-third of the required solvency margin, but not below the rate of the minimum solvency margin, within three months.

If the FSA considers the financial position of an insurance undertaking to be deteriorating regardless of a recovery plan or extraordinary recovery plan submitted, the FSA has the right to prohibit, by a precept, the insurance undertaking from carrying out transactions or performing acts related to the funds of the undertaking or to restrict its volume. For EU undertakings, the FSA can also notify the supervisory authorities of the EU Contracting States where the insurance undertaking has established a branch or is engaged in cross-border insurance activities.

If the interests of policyholders, insured persons or beneficiaries are threatened due to the deterioration of the financial position of an insurance undertaking, the FSA may establish, based on the recovery plan or extraordinary recovery plan, a required solvency margin with respect to the insurance undertaking higher than the required solvency margin calculated on the basis of the Insurance Activities Act.

The FSA can establish a special regime for the recovery of an Estonian insurance undertaking. The special regime is used when an Estonian insurer, an Estonian insurer's EEA branch, or a third country insurer's Estonian branch is likely to experience solvency problems due to its financial position or in the opinion of the FSA. If an insurance undertaking fails to perform its obligations to a policyholder, insured person, beneficiary or other entitled person in a timely manner or in compliance with the requirements due to its financial position, the FSA will establish the special regime. The FSA shall make a decision on the basis of activity reports, information and documentation submitted by a special regime trustee on whether the insurance undertaking is able to resume its activities or it is necessary to revoke its activity licence in part or in full, to reorganise its activities or to file a bankruptcy petition with respect of an Estonian insurance undertaking.

2.10.3 Winding-up procedure

Bankruptcy proceedings against insurance undertakings can only be initiated through a petition filed by the FSA or by liquidators in the course of liquidation proceedings. The FSA will file a bankruptcy petition when the assets of the insurance undertaking are insufficient to satisfy all claims of creditors or to cover technical provisions.

Insurance claims are given seniority over other claims, and even if claims arising from insurance contracts are not submitted to the trustee in bankruptcy during the prescribed term, they shall be deemed protected on the basis of the documentation of the insurance undertaking. Claims on life insurance contracts shall be satisfied to the extent there are technical provisions corresponding to the contract. Claims on non-life insurance contracts' shall be satisfied to the extent insurance indemnity payable on the insurance contract to the insured risk remains. Insurance contracts terminate on the date of a bankruptcy order.

In the 1990s, there were a number of insurer failings due to weaknesses of the then Insurance Law (1992) which did not give sufficient powers to the Insurance Inspectorate to prevent unsuitable ownership of insurers or intervene in the investment of technical provisions. The prevalence of bad management where owners were abusing their position and using company finances for personal purposes also accounted for their weaknesses. The Ministry of Finance (MOF) decided to withdraw

their licenses and have their insurance portfolios taken over to ensure better management and safeguarding of policyholders' benefits. The Insurance Activities Act was subsequently enacted overhauling the Insurance Law and granting greater power to the supervisor to intervene for the safety and soundness of the insurance system.

2.11 Guarantee fund

There are no general policyholder protection funds. A guarantee fund exists for motor TPL policyholders and compulsory funded pension annuities (pension contracts).

As the payout for compulsory funded pension started in 2009, the Annuity Protection Sectoral Fund was established to guarantee pension payments from life insurers, supporting the transfer of a pension contract's insurance portfolio from one life insurer to another. The FSA decides whether the Sectoral Fund needs to be activated in the bankruptcy of a life insurer. The funds can be used to support the transfer of pension contracts' portfolio if the assets covering technical provisions corresponding to the pension contracts do not exceed the pension contracts' liabilities and an activity licence is likely to be revoked from the life insurer, a special regime will be established or a bankruptcy order will be issued for the life insurance undertaking. The obligations arising from the pension contracts is guaranteed for monthly pension payments up to the amount of the national pension and 90% of value for parts that exceed the national pension. The Annuity Protection Sectoral Fund is financed by life insurers who are providers of pension contracts and is *ex post* financed.

The Traffic Insurance Fund can take over motor TPL insurance contracts concluded by bankrupt insurers although there are restrictive terms imposed on the takeover. The insured event (traffic accident) must have already taken place, and then the Fund will pay compensation directly to the injured party instead of the policyholder. Therefore, the primary task of the Fund is the protection of the injured party, not the protection of the policyholder. Takeover by the Fund is voluntary and will not take place if the takeover is deemed financially too burdensome. The Fund can only be accessed in cases of bankruptcy of the insurer and not in the stages of early intervention.

2.12 Complaint-handling and consultation process

The FSA does not have the power to settle complaints, and can only provide an independent opinion on a situation, or can commence supervisory proceedings according to the respective legislation to ensure transparency and credibility of the financial market as well as the appropriateness of internal controls of a financial service provider. Market participants generally take into account the opinions of the FSA when resolving consumer disputes. The survey on consumer complaints allows the FSA to have an overview of main disputes and their frequency.

2.12.1 Survey of complaints

Table 19. Number of complaints to the FSA in 2007 and 2008

Area of service	2007	2008
Land vehicles insurance	17	9
Property insurance	13	10
Motor TPL insurance	10	13
Travel insurance	8	3
Investment services	8	59
Life insurance	6	4
Pension insurance (annuities)	1	12
Civil liability insurance	1	3

Source : Estonian authorities

When comparing 2007 data with 2006, there has been an increase in insurance-related disputes. Complaints related to insurance services have doubled in comparison with 2006. The FSA received a total of 82 applications, of which 56 were related to insurance services in 2007. Most of the applications were related to voluntary land vehicles insurance and property insurance (mostly home insurance). The main reason for disputes in the insurance sector was due to the interpretation of terms and conditions and customers with a limited understanding of rights and obligations before entering into the insurance contract.

2.12.2 Consultative mechanisms with industry and other stakeholders.

In general, consulting stakeholders when drafting legislation and preparing policy documents is not mandatory under Estonian law. A governmental decree of 1999 on preparation of legal acts provides that the explanatory memoranda of draft laws should include the opinions of NGOs and interest groups. In practice, such consultation takes place prior to the amendment of laws, either directly or through the Central Union of Employers and the Chamber of Commerce.

There have been several initiatives to improve the current system of consultations. For example, in 2005, representatives of the public sector and NGOs developed a “Code of Good Practice on Consultation” describing the key principles that support active and meaningful participation of NGOs in developing laws, regulations and policies. However, the recommendations of the study and the Code have yet to be put in practice.

Regulatory impact assessment is a relatively new feature in the country’s policy-making and reforms are under way to improve the system. An expert working group and an inter-ministerial commission (including representatives from two universities, one think-tank, the Parliament and the Statistics Office) were set up in 2007 to this end. Preliminary proposals have already been discussed in the working group and are expected to be adopted by the Government in the near future. These proposals include developing impact assessment check-lists and guidance material.

In the insurance market, market players are consulted on draft legislation and guidelines of the FSA mainly through the Estonian Insurance Association or other interested parties. The FSA is consulted on legislation related to the financial sector as stipulated in the FSA Act. There appears to be good communication between the MOF and the FSA, and between the FSA and market players. Insurers were well aware of planned regulatory changes, and the MOF and FSA were aware of concerns that had been raised by the market.

2.12.3 Appeal processes and judicial review

The Administrative Procedure Act obliges all administrative authorities, including the FSA, to offer the counterpart of a regulatory action an opportunity of commenting on the action in written, verbal or any other suitable form. Before taking measures which may affect the rights of a participant, the affected party must be able to provide their opinion and objections.

2.12.4 Dispute settlement

Financial services related complaints are handled in cooperation with the Estonian Consumer Protection Board¹⁸ and the FSA. Complaints related to financial services that the Consumer Protection Board receives are forwarded to the FSA.

Insurance policyholders can attempt the use of mediation for claim settlement, but mediation results are not binding on insurers, and allows the insurer to reject the proceedings at any point. If an insurance consumer were to have a problem with its claim, the only ultimate avenue to contest would be through court system. Motor TPL claims have the possibility of being brought to the small claims court which is free for the consumer. However, all other claims have to be brought to the court system proper at great expense. This would not be a practical solution for insurance contracts which are small in amount, and for individual policyholders that will not have the resources for proper representation.

Although there is no general alternative dispute resolution scheme for insurance claims, there is a special dispute resolution scheme for Motor TPL insurance under Estonian Traffic Insurance Fund since 2004, which deals with more than 150 cases annually.

Estonia has been discussing the possibilities of establishing a Financial Sector Conciliation Body for the past few years. The Act on Conciliation Procedure was passed in November 2009 which establishes a general framework for conciliation procedures in Estonia. The necessary stages for this to be adopted to the financial sector would be the following:

- 1) Reaching consensus between the MOF, FSA, and market participants on framework principles by the end of 2010.
- 2) Drafting necessary legislation, and resolving practical issues (financing, office, and staff etc) by end of 2011.
- 3) The Financial Conciliation Body to commence operations before the end of 2012.

Estonia should ensure the establishment of the Financial Sector Conciliation Body takes place and commences its operations in an orderly and effective manner.

¹⁸ The Consumer Protection Board is a national authority with the task of protecting consumers rights, to represent their interests, and to develop and implement consumer policy in accordance with the provisions of the UN Guidelines, of the Consumer Protection Act and of European Union consumer policy. The Consumer Complaints Committee is an independent institution, which operates at the Estonian Consumer Protection Board and settles disputes between consumers and traders. The Committee functions as the alternative dispute resolution (ADR), with competence to settle disputes arising from contracts between consumers and traders if the parties have not been able to settle the disputes by agreement and if the value of the disputed goods or services is at least 300 EEKs (20 euros).

2.13 Role of Actuary

According to the Insurance Activities Act, every insurance company must have an appointed actuary in place. There are legal requirements for the person being an appointed actuary, including on education, qualification and experience. The regulatory oversight of the insurance business including actuarial activities is performed by the FSA. There is no direct link between the legal requirements of actuaries and the qualified member status of the actuaries professional body, although they coincide in general. The FSA must be informed of the appointed actuary as well as how these persons meet the requirements. An actuary cannot be employed by more than two companies (including insurance companies, banks, investment funds etc) which do not belong in the same financial group.

The professional body of Estonian actuaries, Eesti Aktuaaride Liit, was founded in 1999 and is a full member in International Actuarial Association (IAA) since 2001 and a full member in Groupe Consultatif since 2004. It has currently 7 fully qualified members and 20 associate and student members. Eesti Aktuaaride Liit has qualification rules for full members, Educational Syllabus, Code of Conduct and Disciplinary Process. Eesti Aktuaaride Liit has a Code of Conduct for members. Being a Full Member of IAA, the Eesti Aktuaaride Liit suggests its members to follow the technical standards set by IAA or the standards of any other full member association of IAA which are applicable to Estonia.

2.14 Taxation

In Estonia, tax treatment of entities does not depend on the field of activity. All resident, legal persons and non-residents with a permanent establishment in Estonia are treated in the same way and are liable to tax when they distribute profits. Insurers are not liable to tax on the basis of premiums or payouts, or technical reserves.

2.14.1 Taxation of profit distributions

Instead of the classical income tax system, income taxation has shifted from earning profits to the distribution of profits. Instead of taxing the profit of resident legal persons and registered permanent establishments upon accrual, the profit distribution, as well as transactions treated as hidden distribution of profits, are taxed. Corporate entities are exempt from income tax on undistributed profits, regardless of whether these are reinvested or merely retained.

All distributions, both actual and deemed, including dividends and other profit distributions such as fringe benefits, gifts, donations and representation expenses, expenses and payments not related to business will be subject to income tax at the grossed-up rate of 21/79 of the amount of taxable payment.

The resident legal person carrying out profit distribution has to pay income tax at the rate of 21% (in 2009), which is calculated as 21/79 of the amount of profits distributed. As of 1 January 2009, withholding income tax on dividends payable to non-residents was abolished.

Income tax is charged on all dividends and other profit distributions received by a resident natural person from a foreign legal person in monetary or non-monetary form unless income tax has been paid on the share of profit on the basis of which the dividends are paid or if income tax has been withheld on the dividends in a foreign state.

The taxation of liquidation proceeds and payments made in case of reduction of share capital or redemption or return of shares is taxed at the corporate level as of January 2009. If in 2008 such

payments were subject to tax as capital gains at the level of the recipient, as a result of the amendments, they are taxable at the level of the company making such payments similarly to dividends and other profit distributions.

2.14.2 Taxation of insurance indemnities

As a general rule, indemnities of life and non-life insurance are not taxed. Income tax is also not charged on the surrender value payable upon termination of a life insurance contract. There are two exceptions stipulated by the law:

- Income tax is charged on amounts paid to a policyholder or beneficiary under a life insurance contract with an investment risk, from which the insurance premiums paid by the policyholder have been deducted. Such amounts are subject to taxation if they are paid within twelve years as of the entry into the insurance contract.
- Income tax is charged on an insurance indemnity paid in a case where the insured event occurred under non-life insurance conditions, and if the taxpayer has deducted the insurance premiums related to such insured event. The acquisition cost of the insured assets, or the depreciation of fixed assets are applied to determine taxation based on sale of property in the Income Tax Law.

3. MARKET LIBERALISATION IN INSURANCE

In principle, Estonian law is not discriminative towards foreign investors which are treated on a national treatment basis. However, the Restrictions on Acquisition of Immovable Property Act imposes restrictions on the acquisition of immovable property by non-residents (natural persons as well as corporate bodies) in border zones and in Estonia's islands (except the four largest ones).

The investors/shareholders' rights are regulated and protected under the Commercial Code. Article 272 of the Commercial Code explicitly states that the shareholders shall be treated equally under equal circumstances.

3.1 Establishment of foreign insurers

The requirements for foreign investors to gain market access are the same as for local investors. If a foreign investor would like to establish an insurance undertaking in Estonia, they have to follow the authorization procedure stipulated in the Insurance Activities Act.¹⁹ A foreign investor can also obtain market access by acquiring a qualifying holding in an insurance undertaking.²⁰ Foreign insurers can establish a presence in Estonia through:

- i) *de novo* establishment of a branch;
- ii) *de novo* establishment using the single passport system of the EU; or
- iii) acquisition of qualified shareholding of a domestic insurer.

There are language requirements – as a rule, all documents to be submitted to the FSA or the Estonian Commercial Register, must be filed in Estonian.

The timeframe for considering authorisation applications are:

- Domestic insurers (including subsidiaries of foreign insurers): three months, and in case additional information is required, no later than six months after the initial application.
- Branches of third country insurers: the same as domestic insurers.
- Branches of EU insurers: immediately after receiving approval from the home country's supervisory authority, or, alternatively, two months after the notification proceedings have been complete.
- Engagement in cross-border insurance activities: for EU-headquartered insurers only, immediately after notification is completed.

¹⁹ For requirements on obtaining authorisation, see section 2.6 Licensing and ongoing requirements.

²⁰ For rules regarding acquisition of shareholdings, see section 2.6.3 Shareholding of insurance companies.

3.1.1 Establishing a branch of a non-EEA country insurer

In order to establish a branch in Estonia, a non-EEA insurance undertaking is required to apply for authorisation from the FSA. The applicant is required to provide information on the planned scope of insurance activity and the director of the branch, and audited annual reports of the insurance undertaking for the past three financial years; a scheme of operations of the branch, confirmation by the guarantee fund that the branch will become a member of the guarantee fund if engaging in motor TPL, and a certificate from an Estonian credit institution certifying that the person who applies for authorisation for founding a branch has deposited at least 25 per cent of the minimum solvency margin provided in the Insurance Activities Act.

In addition, non-EEA insurance undertakings are required to provide the following from the financial supervision authority of their home country to the FSA: permission to open a branch in Estonia; confirmation of the home country supervisor to the effect that the insurance undertaking holds a valid activity licence in its home country and that it pursues its activities in a correct manner and in accordance with public interest; and information on the amount of available solvency margin and the solvency of the insurance undertaking, and the requirements of the home country for the formation of technical provisions and assets covering technical provisions.

In terms of financial requirements, third country foreign insurance undertaking branches are required to:²¹

- i) possess assets in EU Contracting States of an amount equal to at least the amount prescribed in respect to the required solvency margin;
- ii) possess assets in Estonia of an amount equal to at least one half of the amount required in respect of minimum solvency margin including a deposit that is at least 25 per cent of the minimum solvency margin;²²
- iii) calculate the required solvency margin pursuant to the Insurance Activities Act on the basis of insurance contracts concluded in Estonia and to comply with the requirements provided for the solvency margin in Insurance Activities Act;
- iv) to localise in Estonia the matching assets covering technical provisions related to insurance contracts concluded in Estonia in adherence to the Insurance Activities Act.

A third country insurance undertaking who, in addition to Estonia, has a branch in any other EU Contracting State is entitled to operate under the following preferential conditions which must be requested beforehand by the undertaking and approved by the supervisory authority of the relevant EU Contracting States:

- 1) the required solvency margin is calculated pursuant to the Insurance Activities Act based on the insurance contracts concluded in Estonia and all Contracting States;
- 2) possession of the deposit specified in the Insurance Activities Act is required only if the FSA exercises supervision over the required solvency margin of the Estonian and Contracting State branches of the third country insurance undertaking;
- 3) assets matching the minimum solvency margin may be localised in Estonia or the state where the third country insurance undertaking has established a branch.

²¹ As per Article 82 of the Insurance Activities Act.

²² As per described in section 2.7 Capital and surplus requirements.

The requirement for a deposit does not apply to: Estonian branches of insurance undertakings of the Swiss Confederation who have the right to engage in non-life insurance, Estonian branches of third country insurance undertakings who benefit from the preferential treatment over the required solvency margin as a result of a branch in another EU Contracting State and when supervision of the required solvency margin is not exercised by the FSA.

Branches of a foreign insurer providing non-life or reinsurance of non-life contracts are required to pay 0.05 to 0.5 percent of gross insurance premiums earned by the corresponding branch as supervision fee to the FSA. Branches operating in life insurance or reinsurance of life contracts are obliged to pay 0.02 to 0.25 percent of the sum of assets and gross insurance premiums of the corresponding branch as supervision fee.

3.1.2 Establishment of branch by a EU insurance undertaking

The establishment of branches of EU insurers in another EU member is dictated by the Article 13 of the Directive 73/239/EEC as amended by Art 9 of the Directive 92/49, which stipulates that financial supervision of an insurance undertaking, including that of the business it carries on either through branches or under the freedom to provide services, is the sole responsibility of the home Member State. However, according to Art. 40 of Directive 92/49, in case measures taken by the home country authority prove to be insufficient to terminate a violation, the host country authority will be entitled to take appropriate measures to prevent or penalise further irregularities, including to prevent that undertaking from continuing to conclude new insurance contracts within its territory.

3.1.3 Establishment of branch by a non-EU reinsurer

A non-EU reinsurance undertaking has to deposit at least 25% of the minimum solvency margin provided for in the Insurance Activities Act in an Estonian credit institution to establish a branch in Estonia. An Estonian branch of a non-EU reinsurance undertaking is also required to:

- possess assets in EU Contracting States of an amount equal to at least the amount prescribed for the required solvency margin;
- possess assets in Estonia of an amount equal to at least one half of the amount of minimum solvency margin, including the abovementioned deposit;
- localise in Estonia the assets matching to cover technical provisions related to reinsurance contracts concluded in Estonia.

If the undertaking has a branch in any other EU Contracting State, it is entitled to operate under preferential conditions which must be requested beforehand by the undertaking and approved by the financial supervisory authorities of the relevant EU Contracting States:

- the required solvency margin is calculated based on reinsurance contracts concluded in Estonia and all EU Contracting States;
- possession of the deposit is required only in the case where the FSA exercises supervision over the required solvency margin of the Estonian and EU Contracting State branches of the third country reinsurance undertaking;
- assets matching the minimum solvency margin may be localized in Estonia or the state where the third country reinsurance undertaking has established a branch.

There are no specific provisions in relation to third country reinsurance undertakings. However, the FSA may demand additional deductions from the available solvency margin of an insurance

undertaking to the extent a reinsurance undertaking has a share in the technical provisions, if according to the opinion of the FSA:

- the legislation or the home country supervisor of the reinsurance undertaking does not ensure the provision of sufficient supervision, including consolidated supervision, over the reinsurance undertaking, bankruptcy or liquidation proceedings have been initiated against the reinsurance undertaking, the financial supervision authority of the home country has imposed significant sanctions on the reinsurance undertaking or the quality of reinsurance has significantly deteriorated in comparison with the previous financial year;
- risks are not transferred on the basis of the reinsurance contract or the transferred risk is insignificant considering the volume of the reinsurance contract.

3.1.4 Acquisition of local insurer

There are requirements for the acquisition of a qualified holding of an insurer.²³ However, these regulations do not discriminate on the basis of the origin of the investor, but the FSA must be able, through the law of the home country of the acquirer, to obtain information about the prospective acquirer.

The principles of supervision and co-operation of financial supervision authorities as harmonized by EU insurance directives may not be practiced in third countries. However, if sufficient supervision is exercised over the acquirer, who intends to become a controlling company of an insurance undertaking, and the financial authority of the third country has legal grounds and possibility to co-operate with the FSA, there would not be any obstacles for acquiring qualifying holding.

3.2 Trade Agreements

Estonia is a member of WTO since 1999 and a member of European Union since 2004. Estonia does not have any trade agreements independent from those that have been agreed by the EU.

Under the GATS, Estonia has committed itself not to apply restrictions to any GATS members, including therefore all current OECD Members. However, Estonian laws and regulations include restrictions on most cross-border financial services and on private pension branching by non-EEA residents.

In the Investment Committee held on 24 March 2009, Estonia committed to take steps before OECD accession to remove restrictions on operations by non-EEA OECD residents.²⁴

3.3 Cross-border insurance transactions

EU-headquartered insurers are entitled to engage in cross-border insurance activities in Estonia, without direct presence of the insurer in Estonia. The same possibility of engaging in cross-border activities without direct presence is available to re-insurance and retrocession undertakings from third countries, in addition to the respective undertakings from the EU.

²³ See section 2.6.3 Shareholding of insurance companies for details on qualified shareholding of insurers.

²⁴ This is further discussed in section 4. The Position of Estonia Regarding the OECD Code of Liberalisation of Current Invisible Operations.

Currently, cross-border activities are not available to non-EEA insurance undertakings. Estonia is in the process of amending its Insurance Activities Act and Financial Supervision Authority Act to change its rules for cross-border activities by non-EEA insurance undertakings as a result of its OECD accession review. The amendments are being prepared with requirements that non-EEA insurers be subject to adequate prudential measures in its home country to ensure the protection of customers' interests and market stability. The following are the principles that the legislation would require as a basis for provision of financial services on a cross-border basis by non-EEA providers:²⁵

- proportional prudential requirements are met;
- primary consumer protection (conduct of business) rules are complied with; and
- grounds for effective supervisory co-operation exists.

Estonia is preparing a draft legislation related to cross-border transactions by non-EEA OECD insurers.²⁶ The regime would require that non-EEA service providers be licensed under a system that is similar to branching, but without local financial requirements.

In order to obtain a license for cross-border provision of insurance service, the insurer will have to submit the following data/documents to the FSA:

- the business name and address of the insurer;
- confirmation of the home country's supervisory authority that the applicant is an insurer, with a list of the classes of insurance the insurer is authorized to deal with;
- brief description of the requirements related to the amount and calculation principles of the insurer's own funds, confirmed by the home country's supervisory authority that the insurer is in compliance with those requirements and actually has the funds required. (*Note that no funds have to be transferred to Estonia*);
- audited annual accounts of the insurer for the preceding three years;
- description of the intended cross-border activities in Estonia; and
- in the case the insurer is to conclude MTPL contracts, the insurer must become a member of the Traffic Insurance Fund.

As for promotional activities, there are no discriminatory measures imposed on foreign service providers once they have entered the market. The Advertising Act imposes general, non-discriminatory requirements and restrictions on advertising. However, it must be noted that according to the Act, it is not permitted to distribute misleading advertisements, including in terms of availability of the product or service. Therefore, if a service provider that is not authorised to engage in cross-border insurance services in Estonia advertises its services as available, this could be interpreted as misleading.

Whether an insurance contract is cross-border or not depends on the location of the risk being insured. The Insurance Activities Act stipulates that the risk is located in Estonia if the object is in Estonia or entered in a register in Estonia. Also, if the policyholder is habitually resident in Estonia, then the risk is deemed to be located in Estonia. Otherwise, the risk will be considered to be located outside of Estonia.

²⁵ See DAF/AS/ACS(2009)2/ADD3 for the letter from Estonia.

²⁶ .See Room document No 3 for a summary of the licensing framework for cross-border transactions.

4. THE POSITION OF ESTONIA REGARDING THE OECD CODE OF LIBERALISATION OF CURRENT INVISIBLE OPERATIONS

As explained briefly above,²⁷ Estonia's schedule of commitments in its agreement in financial services of the GATS does not have any restrictions on the provision of financial services by WTO member states. In terms of GATS commitments, Estonia's has one of the most liberal commitments in financial services.

As a result of Estonia's accession to the EU, Estonia subscribes to the single passport system for insurers, and which foregoes licensing for EEA insurers already licensed in another EU state. Thus, the reservations which Estonia initially submitted in the context of its Initial Memorandum in the field of insurance and private pensions (items D/2-D/8) were only related to the preferential treatment of EU countries.

However, as a result of the Investment Committee's intervention,²⁸ Estonia committed to take steps, including legislative changes, before accession to the OECD, to remove – in accordance with its obligations under the GATS – restrictions on operations by non-EEA OECD residents.²⁹

Even if legislative changes are not carried out prior to its accession to the OECD, because Estonia's Constitution gives seniority to international agreements over domestic legislation, the Codes of Liberalisation will be applicable domestically as well.

Estonian laws and regulations include restrictions on most cross-border financial services and on private pension branching by non-EEA residents. These restrictions are in conflict with Estonia's commitments under the GATS. Hence, during the accession process, Estonia eliminated, in accordance with its GATS commitments, the draft reservation under item D/8 which required private pension funds to be established in Estonia.

Estonia initially considered lodging reservations for the tax deduction provided to transactions with domestic insurers and to cross-border transactions in life and private pension products with EEA insurers.³⁰ Contrary to their plans during the last review, Estonia is now planning to extend the above tax incentives to clients of providers (branches and cross-border providers) from non-EEA countries as well, on the condition that two criteria are met:

- the service provider has obtained the license (branching or cross-border service provision) to provide services in the Estonian market; and
- for cross-border service providers, a tax agreement exists with the country of the service provider that includes clauses on the exchange of information.

²⁷ Section 3.1.1 Establishing a branch of a non-EEA country insurer.

²⁸ See DAF/INV/ACS(2009)2 at pp. 20-22.

²⁹ Letter from Chair of Investment Committee to Estonia, dated 3 April 2009.

³⁰ See DAF/AS/ACS(2009)2/ADD3.

During the review of the Investment Committee, there was uncertainty among delegates on the practicality of requiring a tax agreement for cross-border transactions in life insurance and private pensions. As a result of subsequent communications with the Estonian authorities, it was confirmed that the need for a tax agreement was for the need to be able to exchange of information with the counterpart tax authority to avoid the possible misuse of the tax incentives' clauses and tax evasion. This is in line with article XIV (c) and (d) of the GATS which lists general exceptions, as well as article 5 of the Codes on controls and formalities which does “not limit the powers of Members to verify the authenticity of transactions and transfers nor to take any measures required to prevent evasion of their laws and regulations”. Accordingly, if the planned change in legislation takes place, Estonia would not need to lodge a reservation in under items D/3 and D/8. Thus, the WPGEI recommends that Estonia formulate these requirements in a manner compatible with the OECD Codes of Liberalisation so that Estonia will not need to lodge a reservation to items D3 (life assurance) or D/8 (private pensions) of the Codes.

To ensure that cross-border transactions carried out in Estonia by non-EEA countries do not inhibit the safety of the insurance system, Estonia should consider developing means to address prudential concerns it may have of non-EEA insurers providing cross-border transactions. Estonia currently has seven Memoranda of Understanding with insurance authorities enabling exchange of information. Exchanging MOUs with all non-EEA OECD countries would assist the exchange of information and address the issue of supervisory adequacy of non-EEA insurers.³¹

Estonia should be ready to widen its network of MOUs with OECD member countries to ensure effective cooperation in support of the liberal cross-border provision of insurance services.

³¹ MOUs related to insurance undertakings have been exchanged with the Finnish Insurance Authority and Financial Services Authority, Danish Financial Supervisory Authority, German Insurance Supervisory Authority, Swiss Insurance Supervisory Authority, Lithuania State Insurance Supervisory Authority, and Latvia State Insurance Supervision Inspectorate.

5. COMPLIANCE OF ESTONIAN REGULATION, POLICIES, AND SUPERVISION WITH OECD LEGAL INSTRUMENTS ON INSURANCE

5.1. Instruments to be examined by IPPC

Key instruments which have specific policy implications requiring an assessment of the candidate country's position through a review by the IPPC and the subsidiary bodies concerned are:

Recommendation of the Council on Guidelines for Insurers' Governance C(2005)45

Recommendation of the Council on Assessment of Reinsurance Companies C(98)40

Recommendation of the Council on Good Practices for Enhanced Risk Awareness and Education in Insurance Issues C(2008)22

5.1.1. Recommendation of the Council on Guidelines for Insurers' Governance

Estonia accepts this recommendation, however, it is not in full compliance.

Estonia's governance requirements follow the requirements of EU directives. However, there is a lack of qualitative information on corporate governance requirements in general. Responsibility related to the internal control of the insurance undertaking is not clear, especially for those besides the supervisory and management board.

The disclosure regime needs to be improved in terms of qualitative and quantitative information that is required. In addition, there does not seem to exist a disclosure mechanism geared towards policyholders. None of the insurers in Estonia are listed, making application of stock exchange rules only voluntary. Disclosure is an area in which Estonia may consider adhering more closely to the recommendation.

Guideline 10 is not applicable, as mutual insurers are not permitted in Estonia. Estonia should issue guidelines specific to insurers so as to ensure full compliance with the Recommendation. In particular, Estonia should issue guidelines with regard to internal reporting and internal control requirements of insurers and the management of these procedures.

Guideline 1. Identification of responsibilities and Guideline 2. Board(s) structure

In Estonia, an insurance company must be established as a public limited liability company and all public limited liability company must have a three-stage governance structure. Insurers have the three levels of governance: shareholders (owners), supervisory board, and management board. The three groups have separate roles and responsibilities, with accountability to its respective group above in the hierarchy (with the exception of shareholders). One cannot sit simultaneously on the supervisory board and management board.

Guideline 3. Functions and responsibilities

According to the Insurance Activities Act, the supervisory board of an insurance undertaking shall ensure, and the management board of an insurance undertaking shall organize the effective operation of internal control mechanisms within the undertaking. The internal control system shall cover all levels and processes of management and operation of an insurance undertaking. In case the insurer is a parent undertaking, then the supervisory board of a parent undertaking must ensure, and the management board of each undertaking belonging to the consolidated group must organize the effective operation of internal control mechanisms within the undertaking belonging to the consolidated group.

Guideline 4. Composition and suitability

The bicameral structure of insurance undertakings ensure that management is monitored. Requirements regarding the election of board members, the number of board members, duration of their authorities, procedure of their appointment are set out in the Commercial Code.

There are *fit and proper* requirements applicable to the managers (along with the shareholders, actuary and auditors) of an insurer foreseen in the Insurance Activities Act – first, the fact of the managers not being in compliance with the *fit and proper* requirements constitutes a cause of refusal to issue the activity license to the insurer. The *fit and proper* requirements include the requirements related to education, knowledge and experience of the managers, as well as their business reputation (including the absence of offences related to bankruptcy, mismanagement, etc).³²

Guideline 5. Accountability

There is a basic rule set out in the Commercial Code that stipulates that the supervisory board of a company is accountable to the general meeting of shareholders, while the management board is accountable to the supervisory board. The supervisory and management board are legally liable to their actions as board members as stipulated in the Insurance Activities Act.

Guideline 8. Internal controls

The Insurance Activities Act states that the supervisory board of an insurer must ensure, and the management board must organise, the effective operation of internal control mechanisms within the undertaking. Also, the supervisory board of an insurance undertaking who is a parent undertaking must ensure, and the management board of each undertaking belonging to the consolidated group organise, the effective operation of internal control mechanisms within the undertaking belonging to the consolidated group.

An independent employee must be appointed to carry out the functions of internal audit control. There are also *fit and proper* requirements foreseen the employee must comply with, as well as the clauses designated for the avoidance of the conflict interests.

Guideline 9. Reporting

The process of internal communication is not regulated in the law. While the Insurance Activities Act stipulates in the context of the reporting to the FSA, no clauses exist on the internal communications of an insurer.

Guideline 11. Disclosure

The Insurance Activities Act sets out the timeframe in which disclosure should be made to the FSA. While the Insurance Activities Act states that the Minister of Finance shall establish, for

³² See section 2.6.1 Fit and proper tests for details of the fit and proper requirements.

insurance undertakings and branches of foreign insurance undertaking the content, format and bases for preparation of reports as well as the procedure and due dates for submission and publication of reports, it is uncertain what qualitative and quantitative information is required.

The Law on Obligations Act sets out requirements of information disclosure to policyholders.

Guideline 12. Redress

In case of breach of their (contractual) rights, the policyholders are entitled to use all regular legal remedies, as foreseen in the Law on Obligations Act against the insurer.

5.1.2. Recommendation of the Council on Assessment of Reinsurance Companies

Estonia accepts this recommendation.

The Insurance Activities Act requires that when initially applying for the activity license, an insurer must submit a scheme of operation to the FSA. The latter scheme shall, among other things, set out the planned amount of reinsurance contracts, as well as the principles of reinsurance regarding each class and subclass of insurance the insurer is anticipating being involved in. Degree of adequacy and sufficiency of the scheme of operations falls under the assessment of the FSA, which can influence the issue or refuse the license. The FSA may demand additional deductions from the available solvency margin of an insurer to the relevant extent, in case the insurer's contractual reinsurer does not meet certain criteria of quality.

In practice, insurers use either the reinsurers approved by their parent undertaking or the top ten reinsurers.

Estonia should require insurers to assess their reinsurers in accordance with the Recommendation on Assessment of Reinsurance Companies.

5.1.3. Recommendation of the Council on Good Practices for Enhanced Risk Awareness and Education in Insurance Issues

Estonia accepts the recommendation. Various efforts are being made to improve risk awareness and financial education although those specifically focusing on insurance may be more limited. The Estonian Government's decree of September 1, 2002 enacts the curriculum for elementary as well as for secondary schools. Secondary school must include lessons on economy with coverage of financial matters. The category of financial matters essentially covers the matters of insurance. However, there have been no special campaigns about insurance.

The FSA created the website www.minuraha.ee (My Money) which includes comprehensive and impartial customer information on financial issues, and a special section dedicated to the insurance matters. The FSA has been holding roadshows to present the risk awareness to consumers.

To improve the clarity of information, the FSA approved the Advisory Guidelines on General Requirements to Insurance Mediation, specifying requirements to insurance brokers and insurance agents pursuant to the Insurance Activities Act in 2007. The main goal of instructions provided in these Guidelines is to direct service providers to identify the insurable interest of policyholders, so that the customer could choose and the insurance intermediary offer the most suitable insurance contract.

Estonia should consider developing financial educational opportunities through various communication means geared specifically towards insurance.

5.2. Instruments to be assessed by the Secretariat

Instruments that are primarily of technical or operational nature, and for which the position of the candidate country will be assessed through a technical review by the Secretariat are:

Recommendation of the Council on the Establishment of a Check-list of Criteria to Define Terrorism for the Purpose of Compensation C(2004)63/REV2

Recommendation of the Council on Good Practices for Insurance Claim Management C(2004)62

Recommendation of the Council concerning a Common Classification of the Classes of Insurance Recognised by the Supervisory Authorities of the Member Countries C(83)178

Recommendation of the Council concerning Institutional Co-Operation between Authorities of Member Countries Responsible for Supervision of Private Insurance C(79)195

5.2.1. Recommendation of the Council on the Establishment of a Check-list of Criteria to Define Terrorism for the Purpose of Compensation

Estonia accepts this recommendation. Terrorism risk is not generally covered except for contracts involving MTPL-related insurance and MTPL-related re-insurance contracts. Generally, the criteria used to define terrorist act are as follows:

- violent act, or a threat to use violence
- harmful to human life, or to tangible or intangible property, or to the infrastructure
- involving the intention to influence government, or any part of the government, or put the public, or part of the public in fear

Estonia uses a definition of terrorism, which generally follows the proposed elements of the Recommendation.

5.2.2. Recommendation of the Council on Good Practices for Insurance Claim Management

Estonia accepts this recommendation. The Insurance Activities Act stipulates that all insurers internally regulate their claim management procedure. Adequacy of the insurer's internal regulation is assessed by the FSA regularly basis.

The Law on Obligations Act stipulates the contractual rights and obligations of the insurer in relation to policyholders and beneficiaries. The insurer's general obligations in relation to the claims handling are the obligation to determine the amount of compensation payable, the obligation to pay the required compensation within reasonable period of time (generally within one month after the insured event), and the insurer's obligation to pay interest in case there was a delay in the payment of compensation.

The regulation of standard terms of the Law on Obligations Act applies to protect the weaker parties to the contracts, for insurance contracts the policyholders and the beneficiaries, from being subjected to unfair contractual terms.

For motor TPL insurance, the Motor Third Party Liability Act foresees more detailed regulation for claims handling procedures as claims are more standardized.

5.2.3. Recommendation of the Council concerning a Common Classification of the Classes of Insurance Recognised by the Supervisory Authorities of the Member Countries

Estonia accepts this recommendation and fully complies with the recommendation. Licensing of insurance is done by classes and subclasses as provided in the Insurance Activities Act and further classified into sub-classes on the basis of a decree of the Minister of Finance. As a general rule, the insurers are licensed to operate either in the field of life insurance or in the field of non-life insurance, but not in both fields. The classification of classes of insurance is based on and is based on the EU Directives 2002/83/EC and 73/239/EEC, on Life and Non-Life Insurance respectively and follows the model list in full.

5.2.4. Recommendation of the Council concerning Institutional Co-Operation between Authorities of Member Countries Responsible for Supervision of Private Insurance

Estonia accepts this recommendation and is in compliance with the recommendation. The FSA Act obliges the FSA to co-operate with the supervisory authorities of other countries. In the field of insurance, the Insurance Activities Act provides for specific regulation targeted to the effective co-operation in the field of insurance supervision especially in relation to the supervision of financial conglomerates. The FSA Act stipulates the legal bases for the exchange of confidential information. The use of information sent from the FSA to other authorities must be solely for supervisory purposes.

Currently, the FSA has seven MOUs with the relevant authorities of six countries.³³ The Supervisory Authority is also a member of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) as well as of the International Association of Insurance Supervisors (IAIS).

³³ See footnote 31 for insurance authorities which Estonia has exchanged MOUs.