

Brief memorandum

Tallinn, 16 November 2007

The aim of this brief memorandum is to provide an overview of the different possibilities of forms of business entity for operating as the non-life insurer in Estonia, Latvia and Lithuania (the Baltics). Also, the brief memorandum includes an assessment on the best possibility to enter the Baltic market, company's structure and organisation of potential sales structure.

I SUMMARY

The recommended method for entering the Baltic market is the establishing of one insurance company which sets up the branches in other Baltic countries and in other target markets.

The organisational structure of the insurer to be established greatly depends on the chosen method and form of entering the insurance market.

The sales channels of the insurer to be established should be equally both the broker companies as well as its own sales and service network to be established, considering thereby the rapidly developing possibilities of mediation through Internet in the Baltic countries.

II FORMS OF OPERATION OF THE BALTIC INSURERS

1. The non-life insurers operating in the whole Baltics are ERGO (owner German ERGO insurance group), Seesam (owner Finnish banking group OKO), IF (owner Finnish insurance group IF), Parekss (owner Norwegian insurer Gjensidige), BTA (owner Latvian insurer BTA) and Codan (owner Royal & Sun Alliance, insurer of Great Britain).
2. ERGO, IF and Seesam are different companies in all Baltic states.
3. The parent company of Parekss is in Latvia, the branch is in Estonia and the subsidiary in Lithuania.
4. Codan is the branch of the Danish insurance company in Estonia. The subsidiaries of the Danish insurance company are operating in Latvia and Lithuania.
5. The parent company of BTA is in Latvia, the branch is operating in Estonia and Lithuania has a subsidiary.
6. The organisational differences are mainly due to the previous mergers and accessions.

III POSSIBLE FORMS OF BUSINESS ENTITY FOR OVER-BALTIC OPERATIONS

Republic of Estonia

7. In the Republic of Estonia the non-life insurer can be established foremost as a public limited company or the European company (*Societas Europaea*).

8. The share capital of the non-life insurer should be at least 3,000,000 EUR (if required to deal also with traffic insurance, in case of operating with the specific types of insurance the requirement of share capital is 2,000,000 euros).
9. In the Republic of Estonia the branch of the foreign insurer can deal with the insurance activities. Also, the insurer of the European Union can operate in Estonia within the cross-border insurance activities.
10. The foundation of the public limited company takes about 3-4 days in the Republic of Estonia (from the submission of the application at the notary up to making an entry in the Commercial Registry). The decision on the issue of the licences of activity is made by the Financial Supervision Authority within three months. The decision-making procedure is clear and concrete.

Republic of Latvia

11. In the Republic of Latvia the non-life insurer can be established foremost as a public limited company or the European company (*Societas Europaea*).
12. Also, the branch of the foreign insurer can operate in the Republic of Latvia and the insurer of the European Union within the cross-border insurance activities.
13. The requirement of the share capital in the Republic of Latvia is currently 500,000 LVL (about 712,000 EUR) which should be increased up to 1,000,000 LVL within the next 5 years (about 1,425,000 EUR).
14. The foundation of the public limited company in the Republic of Latvia takes more than a month plus about 1 week for the registration in the Commercial Registry. The obtaining of the activity licences takes minimum 3 months.

Republic of Lithuania

15. In the Republic of Lithuania the non-life insurer can establish public stock companies, closed stock companies and European companies (*Societas Europaea*).
16. The branch of the foreign insurer can operate in the Republic of Lithuania and the insurer of the European Union within the cross-border insurance activities.
17. The requirement of the share capital in the Republic of Lithuania is 1,000,000 EUR.
18. The foundation of the public limited company in the Republic of Lithuania takes about 2-3 weeks. The obtaining of the activity licences takes up to 6 months.

IV FORMS OF OPERATION IN THE BALTICS

19. In entering the Baltic market, the enterer can choose:
 - Foundation of the branch in all Baltic republics **(A)**,
 - Provision of service within the cross-border insurance activities **(B)**,
 - Foundation of the public limited companies in all Baltic countries **(C)**
 - Foundation of the public limited company in one Baltic state, which in its turn opens the branches in the remaining two states **(D)**.
20. The possibilities to start as the European company (*Societas Europaea*) are limited, as the regulation no. 2157/2001 of the Council of the European Union stipulates four possibilities for the foundation of the European company:
 - merger of the public limited company of two memberstates,
 - the foundation of holding SE by the public limited company of two memberstates,

- the foundation of the subsidiary SE by the business entity of two memberstates,
- reorganisation of the public limited company into SE, provided it has had a subsidiary in another memberstate at least within two years.

Also, the already founded SE can also establish SE as the subsidiary. Thus the brief memorandum is not handling the European company (*Societas Europaea*) as the suitable possibility for entering the Baltic non-life insurance market.

A Foundation of the branches in all Baltic countries

21. The enterer to the Baltic insurance market can establish separate branches of the parent company in all three countries.
22. The advantage is the fact that there is no need to pay in the minimum capital required in different countries.
23. The disadvantage of the given variant is the relative complicity of organising the unified management and the higher number of management for the parent company. The minus of the given variant is the dispersion of the responsibility of the management. The problem could be the matters related to the limits of competence of the management and the delay of decision-making processes.
24. The decision-making process is slow and is not able to respond to the fast changes at the Baltic insurance market.
25. The Baltics can be handled as the related economic environment and thus the common management model should be used. The positive samples of using the common management model can be found in the Baltics in banking as well as in insurance sector.

B Provision of service within the cross-border insurance activities

26. The advantage of the provision of service within the cross-border insurance activities is the saving of expenses, as no need exists to pay the minimum share capital in different countries.
27. The matters related to the limits of competence of the management and the delay of decision-making processes can become problematic. In case of this variant as well as operating through the branch the contact with the local market and brokers is weaker in practice.
28. The complicated tax issues might arise in establishing the local representations in providing the service within the cross-border insurance activities.
29. The mentioned variant is not recommended for starting the activities, no positive examples exist in non-life insurance.
30. As known, the Financial Supervision Authority is not supporting this solution in the longer perspective, at least presently.

C Foundation of the public limited companies in all Baltic countries

31. According to the samples of ERGO and Seesam insurance groups the advantage of operating separate companies in each Baltic state is the more thorough and exact supervision, as in this case the activities of the company are controlled by the supervisory board according to the two-level management model who act directly in accordance with the guidelines of the owner.

32. The disadvantage of the given variant is the fact that the payment of minimum share capital required in all three states should be carried out for the establishing of three companies.
33. In the viewpoint of the owner quite different companies with different management methods and forms will be established which are hard to follow by the founder.

D Foundation of the public limited company in one state and foundation of the branches in other states

34. The advantage of the variant is the one-time payment of share capital.
35. The advantage of the variant is also the company's good contact with the local market and sales structure and flexible product development.
36. Also, the advantage of the variant is the common and clear management structure, the deciding competence is clear and the decision-making process fast.
37. The given variant is the most optimum for entering the Baltic insurance market in our opinion.

V WHICH BALTIC STATE SHOULD BE PREFERRED AS THE HEAD OFFICE

38. If considering that the most optimum method to enter the Baltic non-life insurance market is the foundation of the insurer in one country which establishes the branches in two other countries, the question arises in which state the insurer should be established.
39. The fact that this is a logistically well located state speaks for the benefit of the Republic of Latvia (between Estonia and Lithuania).
40. The Estonian business culture in the Baltics is most similar to the Scandinavian business culture. The Lithuanian business culture is most comparable with the Polish and the Latvian one with the Russian business culture. The Estonian insurance market is most advanced and developed.
41. The fact that this is the largest Baltic state speaks for the benefit of Lithuania.
42. The disadvantages of the Republic of Latvia and the Republic of Lithuania could be considerably bigger bureaucracy, worse indicators of corruption and worse payment terms as compared to the Republic of Estonia.
43. The advantages of the Republic of Estonia are: flexible business environment, small bureaucracy, fast management. The business entities can handle most issues through Internet. The Estonian financial intermediation market and business environment are most developed in the Baltics and the most European one. Thus the corporate management of many financial intermediaries and other business entities operating in the whole Baltics proceeds from Estonia.
44. The Scandinavian major banks Swedbank and SEB have entered the Baltic market through the Republic of Estonia. In the business practice Estonia is a common starting-point for entering the Baltics, Scandinavian or Russian and Ukrainian markets.
45. Currently the business income to be reinvested is exempt from income tax in the Republic of Estonia, i.e. the Estonian business entity pays the income tax only from the profit allocated. The exemption is valid up to the year 2009. The exemption up

to the mentioned time results from the fact that the European Union offered the period of transition up to the end of 2008 for Estonia to take the income tax act into full compliance with the directive at the accession negotiations. The Estonian government currently processes the new development plan to continue also after 2009 with the income tax exemption for the business income to be reinvested.

46. At the same time it could be discussed about that the legal address is for example in Estonia, but the physical head office (management, product development etc) still e.g. in Latvia.

VI ABOUT POTENTIAL STRUCTURE

47. The organisational structure of the insurer is determined by the chosen method of entering the insurance market and the logic of location of the head-office-branches.
48. If the public limited company will be established as a preference in Estonia and the branches, the management structure could be the following.
49. The supervisory board is intelligibly unified and this plans the activities of the public limited company and organises the management of the public limited company and carries out supervision over the activities of the management board. The supervisory board discloses the results of the control to the general meeting. The supervisory board has for example three members, if the articles of association stipulate no higher number of members.
50. The creating of the next management level – management board – is more complicated. 6-member management board can be recommended, where in each country 2 members of the management board are constantly residing in each state and are responsible for the activities. The members of the management board are chosen for a specified term for up to three years, if no other date has been stipulated in the articles of association. The articles of association could not stipulate that the term of office of the member of the management board is longer than five years.
51. The next level is established by the persons working on the basis of the employment contract. The given level consists of the departments (insurance department, loss adjustment department, sales department, accounting department, legal department, personnel department, internal control department, actuary etc.)
52. The Estonian law is not stipulating the right of employees to choose or appoint the representatives to the management board and/or supervision council.
53. In case the insurance company is established in Estonia, the registration of the branch in Latvia takes over one month and in Lithuania about two months.

VII SALES STRUCTURE

54. According to the statistics of the Estonian Insurance Brokers Association¹ the Estonian insurance brokers mediated the non-life insurance payments in 2006 in amount of ca 1,600,000,000 EEK (ca 105,000,000 EUR).

¹ <http://www.ekml.ee/index.php3?sisu=statistika>

55. On the basis of the data of the Financial Supervision Authority² the Estonian non-life insurers collected the insurance premiums in 2006 in amount of ca 3,100,000,000 EEK (ca 200,000,000 EUR).
56. Thus the insurance brokers mediate approximately half of the non-life insurance payments.
57. The conclusion of the insurance contracts through the insurance brokers is currently the annually increasing trend. At the same time in the longer perspective this is not so sure – the share of individuals-policyholders increases and the brokers are not willing to deal with them. Thus the creating of its own sales network is though more capital-using, but the activity guaranteeing the stable development.
58. The similar trends can be detected also in the Republics of Latvia and Lithuania. At the same time the number of insurance premiums mediated by the insurance brokers is currently in the given states smaller than in the Republic of Estonia.
59. The last enterers (Codan, Parekss, BTA) to the Estonian insurance market have focused on the insurance brokers and sales through Internet. Pursuant to starting the activities, though, they started to establish their own sales network. The competitive advantage in the Baltics is the good service level with good product choice and IT support.
60. The main products in non-life insurance: means of transport (traffic insurance, hull insurance), property insurance of private and legal persons. The insurance of work accidents and occupational disease and health insurance have great future. Also, the development of different types of liability insurance has an outstanding potential. The environmental risks are a separate topic.
61. The estimate in growth of non-life insurance: 2-3 times compared to the insurance market/GPD with the penetration of the so-called old EU states.

² http://www.fi.ee/failid/kind_st_2006m12_es.pdf