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## The Use of Financial Risks Insurance to Launder Financial Resources in Ukraine

*The article analyzes the most common use of illegal schemes of financial risks insurance in order to minimize the tax burden and the legalization of incomes. The first method of using pseudo insurance for financial security since 1230 is described in the first part.*

*The essence of credit insurance and financial risks is clearly described in the second part. The schemes that are in the insurance of Ukraine are described in the third part. They allow withdraw the funds from the country and providing them with legal origin in European countries. There is a specific subcategory under of financial risk insurance in the insurance market, together with the classic types of insurance. However, the modern schemes of fictitious transactions which involve insurance companies, remove it allow to minimize the size of the object taxation or to conceal the real source of income.*

**Keywords:** insurance company, insurance financial risks, scheme transactions, tax burden, capital export

### Introduction

In the conditions of instability of economy of Ukraine, jumps of rate insurance and reinsurance partly effectuate assigned on it the socio-economic function.

The use of insurance of financial risks for providing of financial stability for reservation property, caused by disparity of an existent mechanism of provision insurance services and hedging content of financial risks in the whole is rewrite.

There are separate problem aspects of its functioning. Substantial opportunities of insurance market are widely used for realization of scheme operations that are aimed to minimization of business tax, withdrawal from circulation, transaction abroad or receiving of other economic benefits by insurers and others. It activates interest to insurance of financial risks.

## 1. The first manifestations of the use of insurance

One of the first widely used pseudo-financial transactions began after Pope Gregory IX in 1230 accepted the Bull, it was prohibition of using usury by all Christians as a matter that is not worthy of Christian morality, regardless of it was high or low percentage.<sup>1</sup>

The reaction to this prohibition was inch by inch replacement “Marine loan” with the fictitious agreements of buying and selling. The first mention about such agreement dated in 1234. According to this agreement it looked like the creditor bought subjects which threatened the risk of trip. However, it was accepted that payments delayed to the end of the trip.

Additionally a new agreement was concluded which provided that in case of successful ending of the trip the previous agreement was cancelled without financial outcome to the parties. Payment of the due amount for the payment of the purchase was only in case when the trip was bad and the property that had been bought before was damaged or destroyed. Reward of fictitious buyer but real creditor and insurer by adoption this risk was established additionally and usually was paid in advance.

Such payment of “compensation” in the form of amount determined in advance approached after the actual accident, but not before, as was the case with “Maritime loan”. The same “insurance premium” buyer-insurer received previously in separate quota but it was not in the form of increased interest for the accommodated credit.<sup>2</sup>

It is apparent, the operation of fictitious buying and selling has more significant insurance character than the “Maritime loan”.

Talking about the historical origins of insurance that appeared in close connection with the loan, the credit operations of the Middle Ages, a German scholar of insurance relations Bernhardt Blau gave a neat motto that “credit is the mother of insurance”<sup>3</sup>

V. K Raikher<sup>4</sup> exploring periodization of insurance development, established that its first stage begins around the middle of the 14<sup>th</sup> century that was since the moment of beginning of free-standing commercial insurance in the sphere of merchant seafaring which was separate from the loan.

In the 14<sup>th</sup> century fictitious conditions of buying and selling were used, they were legalized legally by noting and signing of notarial acts, but gradually it is replaced by an agreement of civil law.

The first insurance of credit operations, though, was not related with the sea and was not too effective. The well-known English writer Daniel Defoe (1660 - 1731), known to us as the author of the adventure novel “Robinson Crusoe”. In his paper “An Essay upon Proekts” (1697) he mentioned the mortgage insurance as a form of credit insurance he worked some time with it personally, worked as a head of the insurance company. His essay in which he had written about the project of a number of economic reforms, he addressed it to the English king William III, who treated him with high confidence.

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1. Pierze S., 1989, *O niektórych związkach religii z gospodarką*, Religia i ekonomia, Warszawa Instytut Wydawniczy PAX, s. 176
  2. Lazowski J., 1948 *Wstęp do nauki o ubezpieczeniach*, Warszawa, PZU.
  3. Blau B., 1927, *Bedeutung der Sachlebensversicherung für den Realkredit*, Assekuranz-Jahrbuch, Band 46, Wien und Leipzig: Compassverlag, s. 68.
  4. Raikher V., 1947, *Socio-Historical Types of insurance*, Publishing House of the USSR Academy of Sciences

He proposed to realize the insurance coverage of insolvent borrowers by their life insurance. However, it did not reach the expected success in the insurance business and it did not improve its financial situation, he even quite sharp expressed his dissatisfaction with little interest of his countrymen in such insurance.

## 2. Insurance features of financial and credit risk

M. S. Klapkiv in his monograph “Insurance of financial risks” thoroughly studied the question of financial risks.<sup>5</sup>

The author noted that according to the understanding of the content and sphere of business and finance, in economic specialist literature offers a variety of approaches to the definition of business risk and financial risk in its structure.

In wide conception, the financial risks are risks which are characterized by the probability of loss of financial resources (funds) in business. In a narrow conception, it is a part of the commercial risk associated with the probability of financial losses in resulting operations in financial and credit and exchange sphere.

Insurance of financial risks in the structure of the industry market of Ukraine still occupies a small part, approximately 14%.

It is negative for this type of insurance, some companies use financial risks as an additional means of financing, for example, they insure such projects, which are expensive, shifting all risks to the insurance company; realizing different “financial structure “ through this branch of insurance industry in order to tax optimization, transfer funds in cash, etc.

Insurance companies in response establish high level of deductible (from 8 to 15% of the sum insured), high insurance rates (average rate set at 5.7% and higher depending on the risks and insurance term), determine the specific insurance conditions. The credit risks are risks that arise in commercial banks with the realization of active operations. The credit risk expresses when borrower does not return the credit and does not pay interests for its using, it happens very often.

Classification of credit risk is more detailed. It provides risk of general insolvency and risks of default of certain types of credits: export, consumer, mortgage, agricultural, etc. One insurance disadvantage of credit risk is that the insurer does not have direct legal relationship with the bank creditor, they cooperate indirectly. The practice shows that the borrower often does not fulfill the terms of the contract or deliberately break the terms of their fulfillment it gives opportunity for bank to refuse the insurer in paying insurance indemnity.

Therefore, it is necessary to develop common conditions of the credit insurance that would include the most essential rules of each type of insurance.

Law of Ukraine “About insurance” foresees one kind of facultative insurance of credit risk “Credit insurance” (including borrower’s liability for unpaid credit).

However, there is necessity in insurance and other financial risks, which is agree with the development specialization of financial insurance, increased levels of financial culture of enterprises and banks in the area of risk management. Soon we can predict the expansion of range services

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5. Klapkiv M., 2002, *Insurance of financial risks*, Ternopil, Economic thought

on account of the insurance exchange risk, insurance losses related to the suspension of production, income insurance and other offers innovative insurance products.

Insurance companies are subjects of primary financial monitoring in prevention and counteraction to legalization (laundering) of incomes from crime or terrorist financing. In case with reinsurance by insurance company to bank institution on funds worth over 150,000 USD one-time payment and payment of insurance financial recompense through cash banking institution for the same amount, these transactions are subject to financial monitoring according to the Law of Ukraine "About prevention and counteraction to legalization (laundering) of incomes from crime or financing of terrorism".

### 3. The schemes of using the services of insurance companies to optimize financial flows

We want to consider the most widespread illegal schemes of insurance companies to optimize financial flows that take place in Ukraine.

In spite of numerous attempts to proceed insurance companies on the general tax system in Ukraine insurers pay 3% of gross premiums, while other market participant pay – 18% of profits.

In order to reduce the tax burden the insurance company conclude sham contracts for insurance of some financial or property risks, which permit to reduce the tax base for insurer income as costs for acquiring insurance policies pass to the structure of gross costs from the main operations. Then the insurance company reinsures risks in fictitious company for what it receives bonus of 7.8% of the premium. In addition, the amount of premiums were transmitted into reinsurance reduces the tax base for the insurer.

As a result, the insurer pays 18% instead of 10% tax (7–8% rewards + 3% tax on gross premiums of the insurer). According to experts, every year Ukrainian business through the use of fictitious insurance operations reserve on paying taxes 1.5 bln. UAH. It should be noted that there is nothing illegal in tax optimization of the enterprise, as all seek to minimize costs.<sup>6</sup>

It is noticeable that the number of banks and insurance companies are much more than Ukraine needs. It is enough 40 or 50 insurance companies. Now there are about 450 such companies. Theoretically, such amount of financial companies, plus credit unions so Ukraine should compete with Switzerland. The insurance companies are link to minimize taxes.

Sometimes the money is removed from the country by using the insurance company, and they are returned later as foreign investment.

Concluding sham insurance contract is the easiest way. Insurance expenses attribute as gross and do not pay income tax. And the insurance company reinsures risks in foreign companies, withdraw funds, for instance in Monaco. For example, "State Food and Grain Corporation of Ukraine" has signed an urgent insurance contract, lasting 12 hours on handling grain from rail to ship for \$ 170 million. Such contracts and the absurdity of insurance coverage and complete mismatch sum insured and risk received publicity with the change of government. It does not have any impact on the insurance companies that provided the service.

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6. Boyko A., Roenko V., 2015, *Evaluation criteria scope of insurance companies in circuit operations*, Financial space, № 1 (17), p. 50–54.

For example, the percentage of net insurance payments in financial risks insurance on Jan 31, 2014 is 2.1%. The amount of insurance premiums is 2 019.1 million. UAH, the level of benefits are 41.6 million. UAH.<sup>7</sup>

However, experience shows that insurers often use insurance not for their own interests but in order to receive additional income.

First, the financial risks are classified in a different way according to it this risk category includes almost all possible enterprising (economic and financial) risks.

Secondly, each structure that operates in the market has opportunity to minimize tax payments until the legislation allows.

The most widespread scheme related to the legalization of income from the use of reinsurance, are as follows: signing fictitious insurance contract, the insurance company reinsures its risks in non-resident company. Than money placed outside Ukraine and are concentrated in the accounts of offshore companies.

There is an interesting scheme of legalization income through non-cash transfer of funds in cash using fictitious securities. That is, the insurer pays funds to the insurance company in the form of insurance payments, after that the insurance company invests part of funds in no liquid securities of the issuer, which transfers funds as financial help to another economic agent and then funds withdrawn in cash.

A striking example of withdraw money is the tender using for insurance state enterprises. According to tender “Kharkivoblenergo” drew up two agreements with TDV “Big Insurance Company” for the insurance services which amount 99.91 million UAH. Alternative proposals with the same insurance coverage from existing insurance companies worth much less. For example, the proposal PJSC “Insurance Company” City “ costs 7.85 million. UAH. The company tender winner does not execute even the minimum requirements as regulator for insurance companies – doesn't have own internet site.<sup>8</sup>

Captive insurance companies actively function in Ukraine and in other countries. The Bank concludes contract of credit insurance with captive insurance company to optimize its credit portfolio. The essence of fictitious insurance is reduced to such a scheme. A round amount of unrepaid credits is on returns to bank in order to reserves will not be increased, therefore bank concludes insurance agreement and according to it, insurance case begins. As a result, the bank receives an insurance payment and according to this it allows to transfer the risks on the insurance company.

## Conclusions

There is a specific subcategory under of financial risk insurance in the insurance market, together with the classic types of insurance.

However, the modern scheme of fictitious transactions which involve insurance companies, allow to minimize the size of the object taxation or to conceal the real source of income. Only the change

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7. Site of «The National Commission for State Regulation of Financial Services Markets» Retrieved from <http://nfp.gov.ua/> [in Ukrainian]

8. Site of journal «Our money» Retrieved from <http://nashigroshi.org/2016/01/17/harkivoblenerhozaplatyt-fiktyvnij-firmi-100-miljoniv-za-strahuvannya/> [in Ukrainian].

in tax legislation, reduction the number of insurance companies, about 400 such companies that are registered in Ukraine, may reduce the urgent of this problem.

In the conditions of financial and economic crisis, the problems general instability using of financial risk insurance for doubtful transactions are urgent.

The use of captive insurance is because of its efficiency for financial economic groups.

They keep such incomes. The gaps in the legislation and the lack of regulation are less important. The following study of this subject should be aimed at the complex approach to extirpation of this phenomenon, which in our opinion may include: transition to new business standards, improving the modern legislation, and more notional monitoring of its abidance, the growth of non-financial requirements for insurance companies, treatment to the development of potential opportunities of the insurance market.

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## Ubezpieczenia finansowe jako narzędzia prania pieniędzy na Ukrainie

*W artykule, dokonano analizy zastosowania ubezpieczeń finansowych w celu minimalizacji obciążeń podatkowych i legalizacji dochodów. W pierwszej części artykułu przedstawiono pierwsze, użyte jeszcze w roku 1230, pseudo-ubezpieczenie którego celem było zabezpieczenie dochodu. Druga część artykułu przybliżyła pojęcie ubezpieczeń kredytu i ryzyk finansowych. Część trzecia pracy jest poświęcona analizie zastosowań ubezpieczeń finansowych na rynku ukraińskim, dla ich eksportu z Ukrainy i legalizacji w krajach europejskich. Przedstawiono także schematy fikcyjnych operacji na rynku ubezpieczeniowym, które pozwalają minimalizować wysokość podstawy opodatkowania lub ukryć rzeczywiste źródła pochodzenia środków finansowych.*

**Słowa kluczowe:** zakłady ubezpieczeń, ubezpieczenia ryzyka finansowego, pranie pieniędzy, obciążenie podatkowe, eksport kapitału.

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