The Austrian Insurance Industry in CESEE: Risks and Opportunities from a Financial Stability Point of View

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This study gives an overview of the insurance market in Central, Eastern and Southeastern Europe (CESEE) in general and of the Austrian insurance groups' activities in the region in particular. Moreover, it deals with risk management issues and the challenges arising from the new EU regulatory framework, Solvency II. We identify the main risks and opportunites for insurance groups in this respect: While potential market growth rates and still higher margins represent the main opportunities, there is also evidence of some reputational as well as financial risks. Further, cross-border business activities also pose some challenges for the risk management of internationally active insurance groups. From a macroprudential perspective, the Austrian insurance groups' exposure to CESEE augments the exposure of Austria financial institutions to this region.

JEL classification: G22, F15
Keywords: Central, Eastern and Southeastern Europe, Insurance, Austria

1 Introduction

Central, Eastern and Southeastern Europe (CESEE)[2] has been the key growth market for Austrian banks and insurance companies in recent years. Having put their activities on a broader basis and entered the market fairly early, Austrian businesses established a solid foundation in the region. Austrian banks and insurance companies have benefited from the catching-up process in financial services. However, besides generating positive effects, the expansion to CESEE has also implied risks to financial stability in Austria. The financial crisis has revealed that the sizeable exposure of Austrian financial institutions to the region plays an important role in the assessment of their soundness by other market participants. These assessments have often been rather undifferentiated, not reflecting the heterogeneity of the region and the fundamental economic and financial conditions.

The Osterreichische Nationalbank (OeNB) and the Austrian Financial Market Authority (FMA) have intensified their research and monitoring activities, not only in connection with banks but also as regards insurance companies; in the latter area, the OeNB focuses on aspects related to financial stability. The aim of this study is to shed light on the CESEE insurance markets and the Austrian insurance sectors' exposure to CESEE from a more macroprudential perspective. We identify risks and provide a general assessment. In section 2 we describe the structure and the characteristics of the insurance market in CESEE, in particular with regard to Austrian insurance groups. In section 3 we identify the main risks of the insurance market in CESEE, whereas section 4 focuses on

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[2] *In this study, CESEE includes Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan. Please note that for some of these countries countinuous data series are not available.*

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risk management issues. The impact of the upcoming new EU regulatory framework for insurance companies, Solvency II, on the CESEE business will be addressed in section 5.

2 Overview

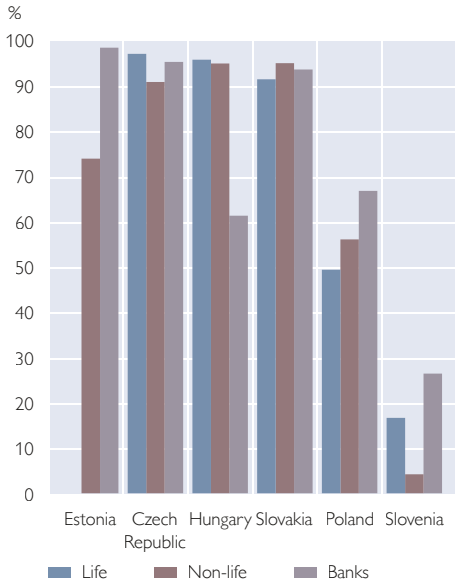
2.1 Structure and Characteristics of the Insurance Market in CESEE

The insurance market in CESEE is relatively young. The privatization of the insurance sector started with the end of the communist regimes more than 20 years ago. The process of privatization and development took place at different speeds in the individual countries. It was not only Austrian insurers that entered the promising market but also most of the big European insurance groups, e.g. Aegon, Allianz, Aviva, AXA, Ergo, Generali or ING. The market share of foreign-controlled businesses is remarkably high in some CESEE countries, especially in the Czech Republic, Hungary and Slovakia, where foreign-owned insurance undertakings hold market shares of more than 90%.[3] A similarly high level of foreign ownership can be observed in the CESEE banking sector, except for Hungary. The significantly higher premium and credit growth rates in CESEE compared with those in international financial institutions' rather saturated home markets have been an incentive to invest in the region. However, the negative impact of the financial crisis on premium and credit growth in CESEE and the resulting economic downturn was more pronounced in CESEE than in Western Europe, including Austria.

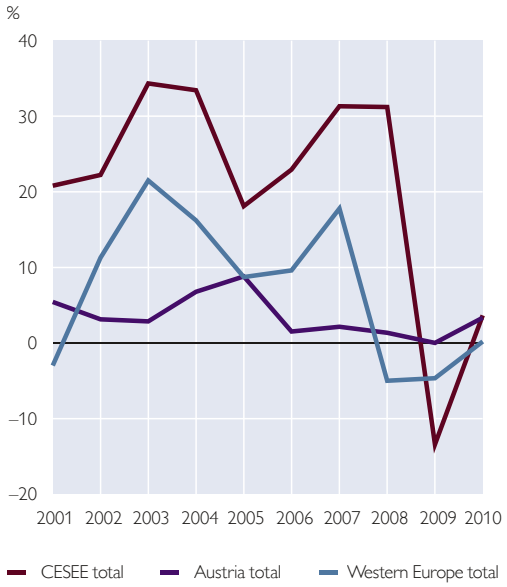
In 2010 the insurance market in CESEE[4] generated about USD 88.2 billion in premiums, which is 6% of the premiums generated by the Western European insurance market. The big-

Chart 1

Share of Foreign Ownership in Insurance Companies and Banks in CESEE



Premium Growth in CESEE and Austria from 2001 to 2010



Source: Swiss Re sigma, FMA, OECD.

[3] *Source: OECD Insurance Data 2009.*

[4] *As a proxy for CESEE we use the Swiss Re sigma definition of Eastern Europe, which represents Central and Eastern Europe and does not include Turkey.*

gest markets of the region are Russia with a share of 40%, Poland (20%) and the Czech Republic (9%). The insurance penetration level (premiums to GDP) in CESEE was still notably lower compared with the one in more developed regions (8.4% in Western Europe, 2.6% in Eastern Europe[5]). As a result of the financial crisis that broke out in 2008, the steady and high premium growth seen since 1989 came to a sudden and temporary end in 2009. However, economic recovery started to take hold in some countries already in 2010, while others still posted negative premium growth in 2010.

The non-life insurance sector grew by 2.7% (in nominal terms) in 2010, after contracting by 7.5% in 2009, still suffering from the impact of the crisis. A strong recovery could only be observed in Poland and Ukraine. Insurance penetration in the non-life sector in CESEE is closer to Western European levels (2% in Eastern Europe, 3.1% in Western Europe) than in the life insurance sector. As the non-life insurance market is more saturated than the life insurance sector, the growth potential of the former over the longer run is expected to be lower than that of the latter.

The life insurance sector recovered and grew by 9% in 2010 (after shrinking by a hefty 30% in 2009), mainly driven by the rise in premiums in Russia, the Baltics and in the Czech Republic. However, in the Czech Republic and in Hungary, life insurance premium growth was driven mainly by single premium products, which tend to be more volatile. In the life insurance sector, the catching-up process is just starting in some countries; in others, such as Hungary, Poland, Slovakia and the Czech Republic, the share of the life insurance business in the entire insurance business is already at the same level as in Austria.[6]

Life insurance penetration in most of the CESEE countries is between 0.1% and 2% of GDP, which is clearly lower than the Western European average (5.3%) and even the Austrian ratio of 2.7%. The demand for life insurance policies depends on the public pension system, the confidence in its sustainability and households' wealth and income. In some countries like Hungary and Slovakia, unit-linked life insurance products, where the investment risk is borne by the policyholder, account for a very high market share compared to the situation in Austria or Germany. Key indicators of the insurance industry in CESEE confirm once more the fact that the region is heterogeneous. The most developed markets according to the available indicators are Slovenia, the Czech Republic, Poland and Slovakia, whereas the catching-up potential is higher in Romania and the Baltic countries, for instance.

In the following, insurance premium growth will be estimated applying a panel regression (cross-section with fixed effects), where real premium growth was explained by GDP growth.[7] The growth potential of the insurance market in CESEE is closely connected with economic growth in the region. According to the GDP forecast in the IMF World Economic Outlook April 2011, GDP growth will gain hold in CESEE but will remain subdued until 2016 (end of projection period) com-

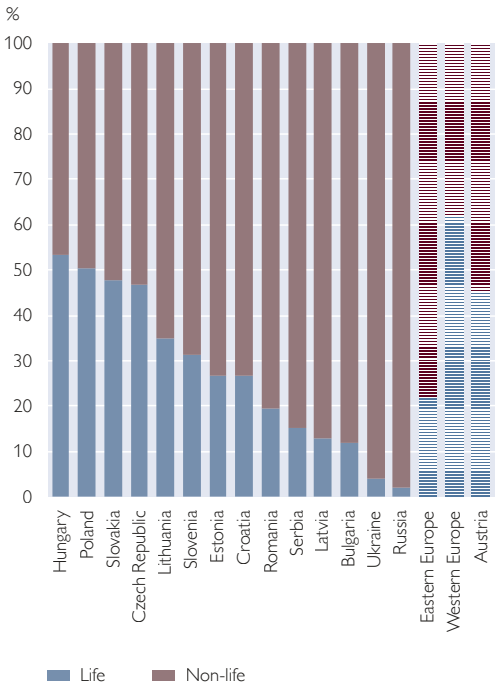
[5] *Source: Swiss Re sigma.*

[6] *In Austria, the share of life insurance policies has always been lower than in the rest of Western Europe due to the traditionally strong first pillar of the Austrian pension system.*

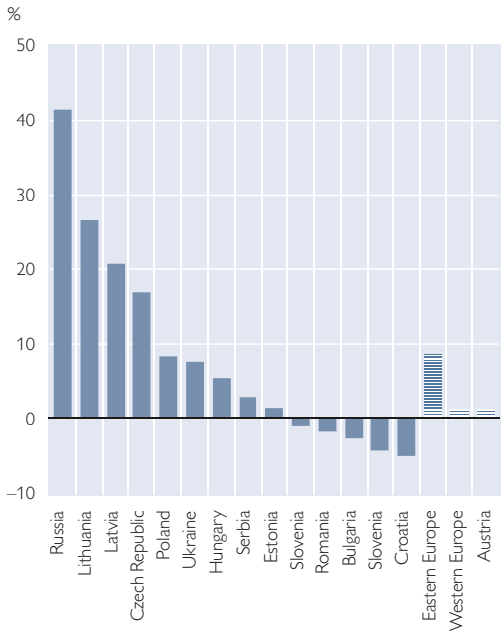
[7] *See table A1 in the annex for estimation results.*

Chart 2

Proportions of the Life and Non-Life Insurance Sectors in CESEE



Life Insurance Premium Growth Rates in 2010



Source: Swiss Re sigma 2010.

Table 1

Structure of the CESEE Insurance Market in 2010

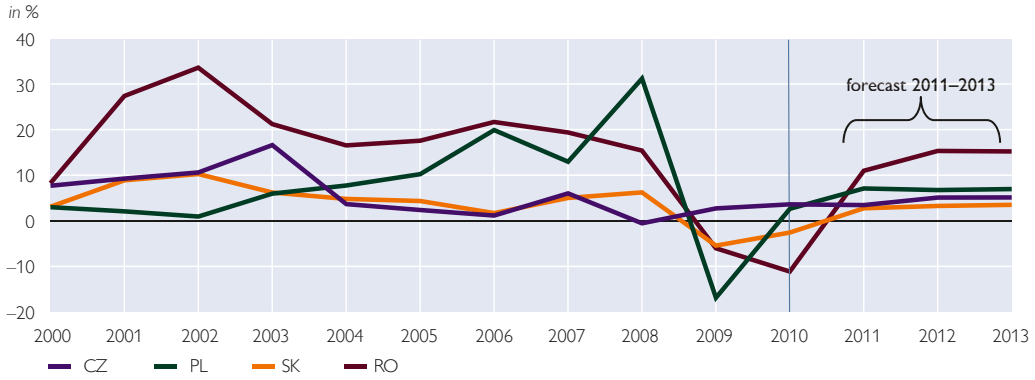
	Insurance penetration	Premium growth	Insurance penetration, non-life segment	Premium growth, non-life segment	Insurance penetration, life segment	Premium growth, life segment	Proportion of unit-linked insurance policies, life insurance segment
	%						
Slovenia	5.9	1.0	4.1	–0.4	1.8	–1.1	61.3
Czech Republic	*4.0*	*4.9*	*2.1*	*–3.9*	*1.9*	*16.9*	*40.1*
Poland	*3.7*	*5.4*	*1.8*	*6.2*	*1.9*	*8.3*	*21.6*
Hungary	3.0	3.0	1.4	–2.4	1.6	5.3	61.0
Slovakia	*3.0*	*–1.9*	*1.5*	*–4.0*	*1.5*	*–4.4*	*28.1*
Croatia	2.8	–1.8	2.0	–1.9	0.7	–5.1	n.a
Bulgaria	2.5	–2.7	2.2	–2.7	0.3	–2.7	n.a
Russia	2.3	6.5	2.3	5.9	0.0	41.7	n.a
Ukraine	2.2	12.9	2.1	13.1	0.1	7.6	n.a
Estonia	2.0	–5.5	1.5	–9.2	0.5	1.3	43.8
Serbia	1.8	5.6	1.5	3.6	0.3	2.8	n.a
Romania	*1.7*	*–5.7*	*1.4*	*–7.5*	*0.3*	*–1.7*	*n.a*
Lithuania	1.7	18.1	1.1	11.5	0.6	26.6	66.2
Latvia	1.5	–14.8	1.3	–18.7	0.2	20.7	12.5
Eastern Europe	2.6	4.0	2.0	2.7	0.6	8.6	n.a
Western Europe	8.4	0.2	3.2	–1.3	5.3	1.1	n.a
Austria	5.9	2.1	3.2	2.3	2.7	1.1	34.5

Source: Swiss Re sigma 2010, IMF World Economic Outlook April 2011, OECD Insurance Statistics.

Note: The four countries highlighted are those accounting for the highest exposures of Austrian insurance companies in CESEE.

Chart 3

Real Premium Growth in Selected CESEE Countries[1] from 2000 to 2010 and Forecast for 2011 to 2013



Source: Authors' calculations, Swiss Re sigma, IMF World Economic Outlook April 2011.

[1] These four countries account for the highest exposures of Austrian insurance companies in CESEE.

pared to pre-crisis levels. The estimate should serve as a rough indication of the development of the insurance sector in CESEE. The estimation results for real premium growth show that the outlook is positive but in general less dynamic than before 2007. Among the countries where the exposure of Austrian insurance companies is highest (the Czech Republic, Poland, Slovakia, Romania), Romania shows the highest growth potential. However, higher growth is often related with higher risk, which implies that in case of an economic downturn, premium growth rates might decrease equally strongly. Furthermore, heightened financial market tensions and weakening economic conditions in advanced economies could considerably slow down insurance growth.

A correlation analysis shows that in most CESEE countries premium growth is significantly positively correlated with credit growth, which is a result of the underlying dependency of both variables on GDP growth.[8] For instance, mortgage loans are often covered by life insurance policies and result in an increase in home insurance policies, while a rise in car loans or lease contracts might lead to an increase in motor insurance policies.

Since 2010 the macrofinancial conditions in CESEE have reflected signs of an economic recovery, while at the same time the differences in the speed and the sustainability of the upswing confirm the heterogeneity of the region. It has benefited from the recovery of the world economy, develoments in the commodities markets and, in particular, from the relatively benign economic conditions in Germany, one of its main trading partners. Macroeconomic indicators for the region show that the economy grew in most of the countries in 2010. Given the sovereign debt crisis in some euro area countries as well as high levels of foreign currency loans and elevated unemployment rates in some CESEE countries,

[8] *Significant linear correlations between premium and GDP growth have been found in Bulgaria, Croatia, Hungary, Latvia, Poland, Romania and Russia. No correlations have been found in Slovakia, Slovenia, Ukraine and the Czech Republic (time series: 2000 to 2010).*

Table 2

Selected Macroeconomic Indicators for CESEE in 2010

	Credit growth	GDP growth	Total savings to GDP	Unemeployment rate	General government gross debt to GDP
	%				
Slovenia	1.9	1.2	22.2	7.2	37.2
Czech Republic	*3.2*	*2.3*	*19.9*	*7.3*	*39.6*
Poland	*8.5*	*3.8*	*17.3*	*9.0*	*55.7*
Hungary	3.3	1.2	19.4	11.2	80.4
Slovakia	*4.3*	*4.0*	*20.2*	*14.4*	*42.0*
Croatia	6.8	–1.4	21.7	12.3	40.0
Bulgaria	1.4	0.2	24.1	10.3	18.0
Russia	13.3	4.0	24.7	7.5	9.9
Ukraine	1.2	4.2	17.8	8.1	40.5
Estonia	n.a.	3.1	23.5	16.9	6.6
Serbia	26.6	1.8	14.8	19.4	44.0
Romania	*5.0*	*–1.3*	*22.2*	*7.6*	*35.2*
Lithuania	n.a.	1.3	18.7	17.8	38.7
Latvia	–7.6	–0.3	24.2	19.0	39.9
Eastern Europe	n.a.	4.2	16.7	n.a.	46.9
Western Europe	n.a.	n.a.	n.a.	10.0	85.0
Austria	0.8	2.0	25.1	4.4	69.9

Source: IMF World Economic Outlook April 2011.

Note: The four countries highlighted are those accounting for the highest exposures of Austrian insurance companies in CESEE.

the economic growth outlook for the region is rather uncertain and fragile. As public sector indebtedness is lower in CESEE than in advanced economies, public debt should have fewer direct negative effects on the economy. However, new public borrowing expanded more strongly in the course of the crisis and the necessary consolidation of public debt could have some decelerating effects on growth rates.

In view of the macroeconomic environment, the conditions for a deepening of the insurance market in CESEE and further growth are in place, and the outlook is generally positive. However, it is unlikely that growth rates will return to the unsustainably high levels observed before the crisis, as the external environment is more uncertain than in the past. As a result, the profitability outlook is positive, but tilted to the downside. Also, due to higher uncertainty and the challenge of maintaining a high risk-bearing capacity, CESEE subsidiaries' profit distribution to shareholders could be lower than in the past.

2.2 Austrian Insurance Companies in CESEE

Austrian insurance companies started their expansion nearly 20 years ago. Since 2000, expansion in foreign markets has been driven by entering various insurance markets through greenfield operations or mergers and acquisitions. Right from the beginning, CESEE has been the clear geographical focus of expansion. At end-2010, Austrian insurance companies operated 100 subsidiaries in more than 26 countries in the region. A total of five Austrian insurance groups (Vienna Insurance Group, Uniqa, Grazer Wechselseitige, Wüstenrot and Merkur) headquartered in Austria are currently active in CESEE.

Establishing branches or using the opportunity of the free provision of

Table 3

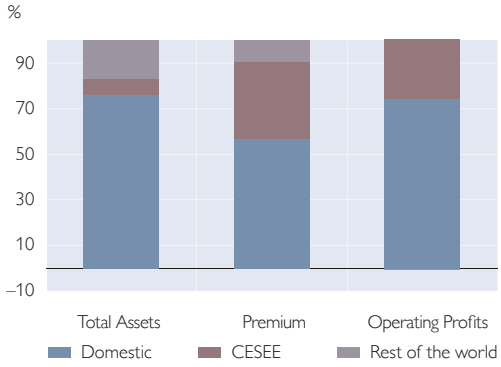
Change in the Number of Austrian Insurance Subsidiaries in CESEE from 2002 to 2010

	2002	2004	2006	2008	2010
Albania			1	2	4
Bosnia and Herzegovina	1	3	4	4	4
Bulgaria	3	3	7	9	9
Belarus	1	2	3	2	1
Czech Republic	6	6	7	7	8
Croatia	5	7	9	9	9
Hungary	9	8	8	6	6
Montenegro				4	5
Poland	10	7	9	9	9
Romania	4	5	8	8	8
Russia			3	4	2
Slovenia	3	3	4	3	3
Slovakia	7	8	8	6	6
Serbia	2	2	3	5	6
Ukraine	1	2	5	9	9
Other	2	3	4	8	11
Total	54	59	83	95	100

Source: FMA.

Chart 4

Austrian Insurance Groups' Business by Region 2010



Source: FMA.

services within the European Economic Area played only a minor role in Austrian insurers' CESEE business. The gross written premium volume generated by subsidiaries amounted to EUR 8.2 billion at end-2010, while branches and the free provision of services accounted for premiums of EUR 0.8 billion.

The EUR 8.2 billion in gross written premiums generated in 2010 corresponds to a share of 43% in these insurers' total business,[9] thereof 34% (i.e. EUR 6.4 billion) are generated in CESEE. These figures show that in terms of business volume, CESEE is much more important to Austrian insurers than their foreign business in Western Europe. The CESEE business' share in Austrian insurers' total profitability as measured by operating results amounted to 26%, while Western European activities posted a loss in 2010. This can mainly be attributed to reinsurance losses resulting from the covering of claims arising from natural disasters.

Total assets figures also illustrate the significance of the CESEE subsidiaries' business.[10] At the end of 2010, the total assets of Austrian insurance companies amounted to EUR 85.6 billion, with the share of the CESEE business coming to almost 17%. This relatively small share compared to that in premiums and operating results reflects the fact that the life insurance business in CESEE is still at an early stage and the high share of the non-life business in CESEE.

Taking a longer-term perspective, the share of premiums earned in CESEE increased steadily over the last three years, while the CESEE business' share in total operating results decreased, as Austrian insurers' results were particu-

[9] *In the following analysis, all licensed Austrian insurance companies have been included that have participations in one or more insurance subsidiaries outside Austria.*

[10] *However, it has to be borne in mind that the explanatory power of total assets may be different for life insurance companies and non-life insurance companies due to the differences in the composition and maturity of their portfolios.*

Table 4

Key Indicators of Austrian Insurance Groups' Business in CESEE from 2008 to 2010

	2008	2009	2010
	EUR million		
Gross written premiums, total	20,583	20,482	18,909
of which: gross written premiums, Austria	*13,283*	*13,106*	*10,714*
gross written premiums, CESEE	*5,690*	*5,855*	*6,402*
Share of CESEE business in %	27.6	28.6	33.9
Operating results, total	595	848	941
of which: operating result, Austria	*327*	*541*	*699*
operating result, CESEE	*249*	*258*	*247*
Share of CESEE business in %	41.9	30.5	26.3
Total assets, total	87,802	93,532	85,557
of which: total assets, Austria	*72,115*	*75,614*	*64,949*
total assets, CESEE	*11,004*	*12,662*	*14,389*
Share of CESEE business in %	12.5	13.5	16.8

Source: FMA.

Note: The decline in Austrian premiums from 2009 to 2010 is due to the fact that Generali Group Austria has no longer been included in group statistics from 2010 onward as all significant cross-border subsidiaries of this group were sold,

larly low in 2008. All in all, aggregate premiums and operating results in CESEE proved to be remarkably stable during the crisis.

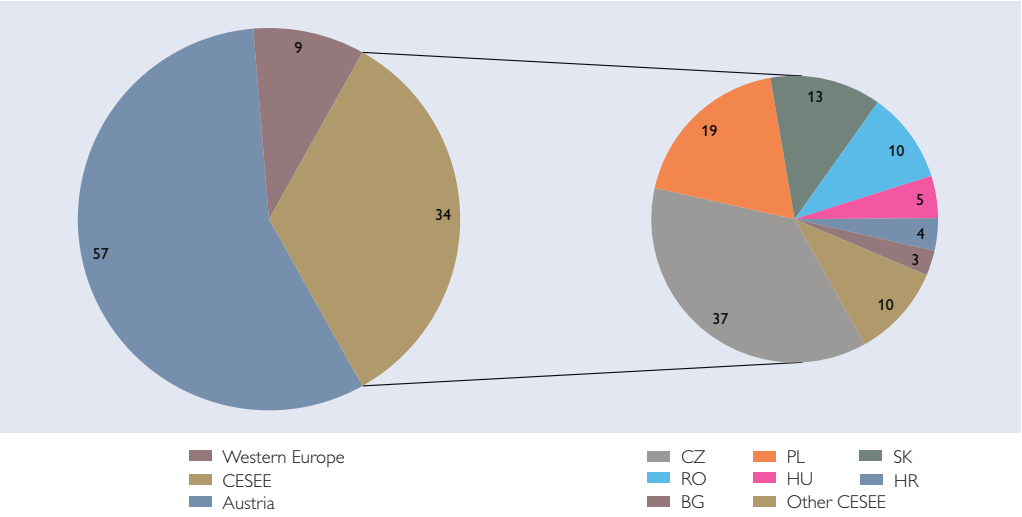
In CESEE, the following four countries play a key role for Austrian insurers: the Czech Republic, Poland, Slovakia and Romania. These countries account for more than 78% of Austrian insurers' CESEE premiums.

As the analysis of the CESEE insurance markets (see section 2.1) shows, CESEE markets differ significantly in terms of size and development of the

Chart 5

Distribution of Premiums by Region and Country

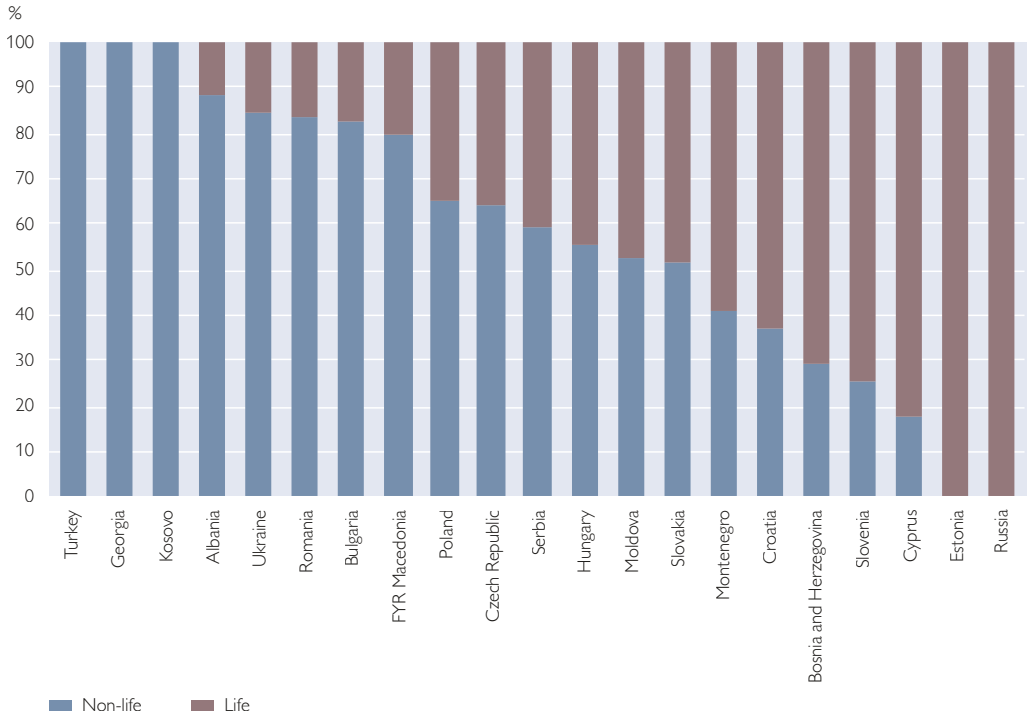
%



Source: FMA.

Chart 6

Distribution of Premiums in the Life and Non-Life Segments by Country in 2010



Source: FMA.

life and non-life insurance sectors. Austrian insurance companies provide life and non-life insurance products in most countries, but the contribution of non-life insurance premiums to the total premium volume is considerably higher than that of life insurance premiums.

2.3 Asset Allocation of CESEE Insurance Companies

Besides banks, mutual funds and pension funds, insurance groups are the major investors in financial securities. Premium growth provides insurers with higher investment capital; this causes positive second-round effects in the deepening of the local financial market, provided that at least part of the capital is invested in domestic securities. The stock and bond markets in CESEE are still underdeveloped compared to Western European standards. Table 5 compares the global bond market to the markets in Austria, the Czech Republic and Poland. It can be observed that the share of government bonds in the total volume of bonds outstanding in Poland (96%) and the Czech Republic (66%) is significantly higher than in Austria (38%) and higher than the share of government bonds in the total amount of bonds worldwide (58%). By contrast, bonds issued by financial institutions in Poland and the Czech Republic play only a very small role in the domestic debt securities markets.

Local debt investment by insurance companies in CESEE is restricted by limited supply; therefore, insurers mainly invest in government bonds. By comparison, only 4.2% of Austrian insurance companies' security investments (at solo level) were Austrian government bonds, while securities issued by Austrian banks accounted for

Table 5

Amount of Outstanding Debt Securities as at December 2010

	All issuers	Government	Financial institutions	Corporates
	USD billion			
All Issuers	67,154	38,960	21,522	6,671.9
Austria	352	135	173	44
Poland	202	194	8	×
Czech Republic	74	49	16	9.2

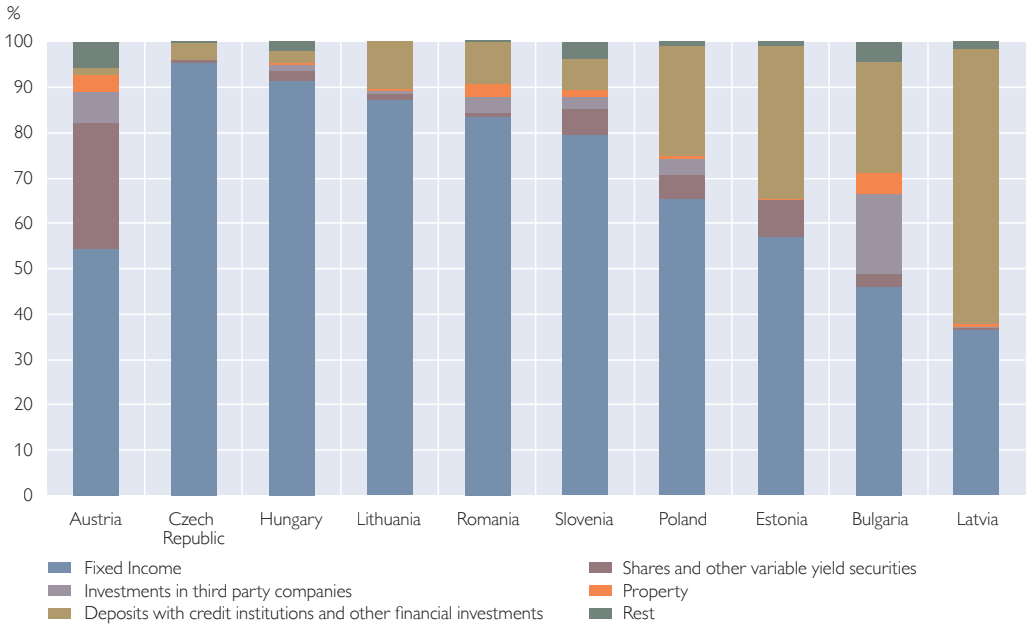
Source: BIS Quarterly Review June 2011, Statistical Annex p. A114, Table 16A, 16B.

19% at the end of 2010. Clearly, the supply of financial issuers is quite limited in CESEE countries. On a positive note, this reduces the risk of contagion from the domestic financial sector As government bonds with a maturity longer than ten years are hardly issued in CESEE, asset liability management at CESEE insurance companies in the domestic market is challenging.

It can be observed that the asset allocation of insurance companies is quite heterogeneous, but fixed income securities seem to play a slightly more important role in CESEE than for instance in Austria.[11] The high portion of fixed income securities causes a high exposure to interest rate and credit risk. Low interest rates make it more difficult to gain profits especially out of life insurance products with guaranteed interest. However, a rise in interest rates leads to lower market values of fixed income securities. A more conservative investment policy definitely makes investment profits more calculable and less volatile.

Chart 7

Asset Allocation of Insurance Companies in Austria and CESEE in 2009



Source: EIOPA.

Note: Percentage shares represent asset class to total investments excluding unit-linked insurance assets.

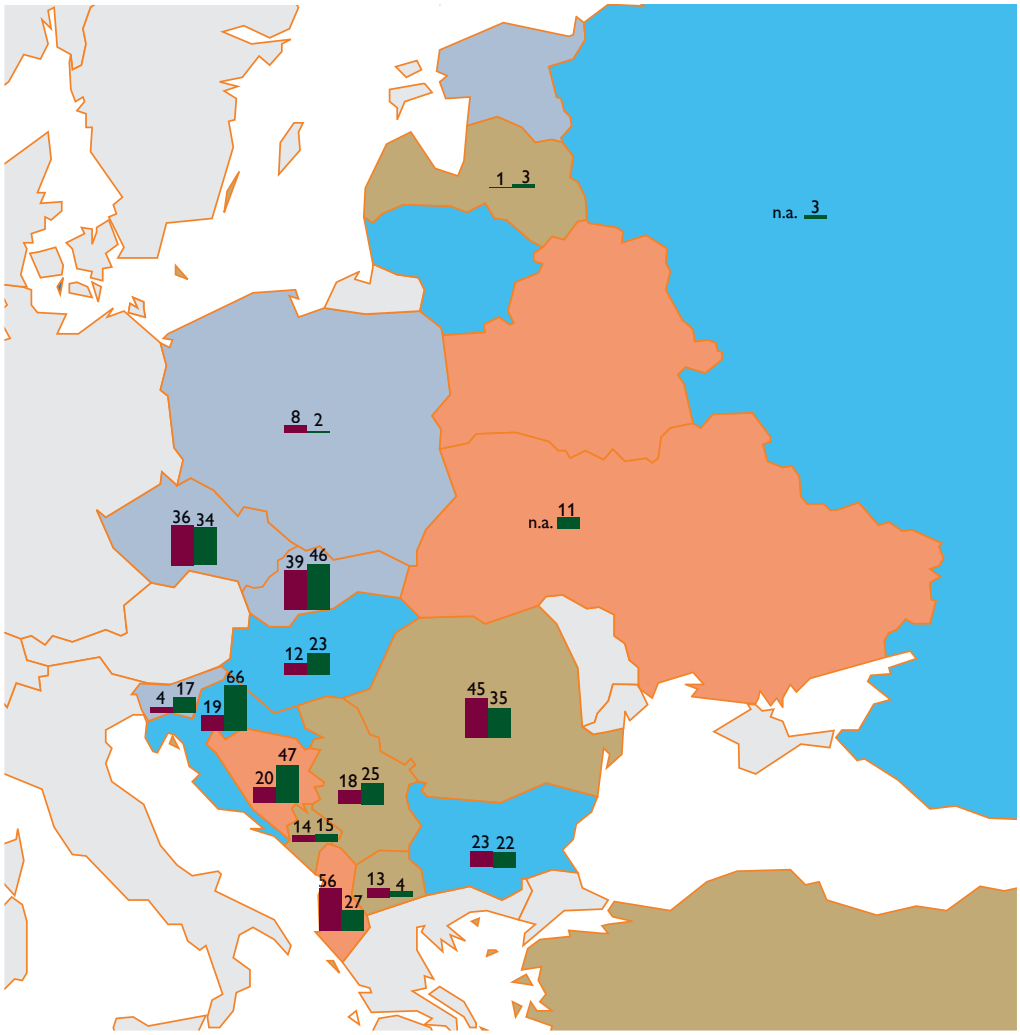
[11] *Source: Statisitical Annex 2009, CEIOPS Financial Stability Report 2010.*

2.4 Comparison of Austrian Banks and Insurance Companies in CESEE

Both Austrian banks and insurance groups are important players in CESEE, which entered the market early. The aggregate exposure of Austrian banking groups (majority domestic owned) to CESEE amounted to around EUR 210 billion at the end of 2010, while the total assets of Austrian insurance companies in CESEE stood at EUR 14.3 billion. The much lower exposure of Austrian insurers reflects the traditionally different business models of banks and insurance companies and the stage of development of the insurance and banking markets. Nonetheless, Austrian in-

Chart 8

Market Shares of Austrian Banks (2010) and Insurance Companies (2009) in CESEE and Country Risk Assessments



Source: OeNB, FMA, S&P.

Note: Banks' market shares were calculated on the basis of total assets, insurance groups' market shares on basis of premium income.

Table 6

Shares of Austrian Banks' and Insurance Companies' Exposure in CESEE by Region

	Banking sector	Insurance sector
	%	
NMS 2004[1]	55.4	73.3
NMS 2007[2]	16.2	9.9
SEE	18.7	15.1
CIS	9.6	1.7

Source: FMA, OeNB.

[1] Member States that joined the EU in 2004: Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovakia, Slovenia.

[2] Member States that joined the EU in 2007: Bulgaria, Romania.

surance companies command a CESEE market share of around 9%,[12] which is at a similar level to Austrian banks' market share of 9.4%.[13]

To compare the significance of the CESEE business for Austrian banks and insurers we set the share of insurers' and banks' CESEE assets into relation to their total assets. We find that whereas Austrian banks' CESEE total assets amount to 37% of their total assets, the share is 17% for insurers (40% for insurers on the basis of premium income). Given the growth potential in CESEE, the shares will increase over time for both banks and insurers.

Austrian insurers' business activities are more widespread in the region: They are active in 26 CESEE markets, while Austrian banks own subsidiaries in 19 markets. However, Austrian insurers have a relatively higher exposure to CESEE EU countries, including the Czech Republic and Poland, where the macrofinancial conditions are more stable and economic fluctuations less volatile. By contrast, Austrian insurers' aggregate relative exposure to countries in Southeastern Europe (SEE) and the Commonwealth of Independent States (CIS), where political and economic vulnerabilities are more pronounced,[14] is lower than that of Austrian banks.

3 Risks and Opportunities in the Insurance Business in CESEE

This section will discuss the risks insurance companies are facing in CESEE other than the typical insurance-related risks such as weather-related large claims payments in the non-life sector or demographic change in the life sector. In other words, the focus will be on business risks specifically connected with CESEE.

As we have already pointed out, the developing CESEE insurance market still holds growth potential. All major European insurance companies are currently active in CESEE, which has tentatively increased competition. Although the margins are still relatively high, they have declined over the last years, for instance in the non-life segment, and here particularly in the car insurance business. Over the longer term a high level of competition could lead to accelerated consolidation in the CESEE insurance market, which might result in market exits of financially less sound players, or mergers and acquisitions and more risk-sensitive pricing, which would contribute to a more stable outcome in terms of financial stability.

So far the consolidation process has neither led to elevated uncertainty nor contributed to disruptions in some insurance services or higher volatility. To

[12] Calculations based on premium income (source: Swiss Re and FMA).

[13] Calculations are based on total assets, excluding UniCredit Bank Austria (the market share would be more than 13% if UniCredit Bank Austria were taken into account).

[14] SEE includes Albania, Bosnia and Herzegovina, Croatia, Montenegro, FYR Macedonia, Serbia, Turkey. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Kazakhstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

some extent this may be due to the fact that the CESEE region is perceived to be a growth market. According to CEIOPS (2010), market concentration tends to be higher in CESEE EU countries (with the share of the five biggest insurers in total gross written premiums in the domestic sector coming to between 50% and 80%) than in big EU Member States like Germany, France and Italy, or in Austria, where the market is more fragmented (with the five biggest insurers holding a market share of between 35% and 50%). The reason for market concentration in CESEE to be higher is that formerly publicly owned insurers still have a strong market position. Depending on the degree of market consolidation, concentration could even increase, as some insurance companies become even bigger and therefore potentially systemically more important in these countries.[15]

The high growth rates – albeit starting from low levels – in the run-up to the global financial and economic crisis are evidence of the growth potential of the insurance market in CESEE. Economic growth, households' increasing purchasing power and corporate investment led to brisk demand for insurance services. In other words, there has also been catching up in demand as compared to the more developed Western European insurance markets. Rapid premium growth, efforts to maintain and gain market share and expectations of high future growth rates have contributed to the formation of – potentially complex – group structures. Such groups and the risks they have assumed may be difficult to manage in particular in periods of high growth rates.

Market intelligence suggests that the acceleration of sales of insurance products, in particular of unit-linked life insurance policies, through independent brokers plays a prominent role in the distribution channel. It could, however, pose some medium-term risks to insurance companies, as the high commissions paid to independent brokers may be an incentive to aggressively sell insurance products which are not tailored to the needs of the policyholder. The sale of policies through independent brokers could thus contribute to misselling and therefore to reputational and, eventually, financial risks for the insurance company. Reputational and financial risk could also arise for companies that have sold unit-linked life insurance products, where policyholders bear market, credit and interest rate risks. These risks could be amplified by marketing products with overly optimistic return expectations, not very diversified and risky underlying stocks or other exposures and the distribution through independent brokers as described above. Market intelligence indicates that in some cases life insurance products served as repayment vehicles for foreign currency loans and were linked with high performance expectations. Although this has not been a widespread phenomenon in CESEE, it can nevertheless contribute to reputational risk for insurance companies.

Insurance companies use banks as distribution channels in particular for life insurance products. Banks and insurance companies benefit from each other by cooperating closely. Aside from the positive effects in terms of income generation and acquisition of new clients, this also reinforces the ties between them and makes both more vulnerable, for instance when the sentiment towards one of the other turns negative.

[15] *It has to be taken into account that premiums written by branches are not reflected in the data used and are therefore not considered in this analysis.*

Aside from the previously mentioned reputational and business risks, which are more related to emerging than saturated insurance markets, there are also the risks of insurance fraud and poor law enforcement, which could give rise to financial risk. These risks and their interplay are particularly relevant in third countries with a weaker institutional and legal framework. As confidence in the insurance sector is rather limited in some countries, the risk arises that insurance claims tend to be settled in a way that favors policyholders; in this way, insurers may "invest" in reputation.

The political risks in CESEE are elevated and have materialized in some countries in the recent past. For instance, although insurance companies have not contributed to the financial crisis, in Hungary they are now facing – at least temporarily – levies, which put pressure on their profitability. As a result, insurers will find it difficult to improve their risk-bearing capacity, which, however, would be conducive to attaining financial stability in the CESEE EU Member States, also in view of Solvency II.

The global financial crisis has not only revealed gaps in the macroprudential policy toolkit as regards systemic risk and cross-border businesses, it has also shown that the supervision of financial institutions can only be effective when the institutional framework is strong enough to ensure a policymaker's (supervisor's) ability and willingness to act (IMF, 2011). That is easier said than done, because there are some incentives which counteract this intuitive objective. The benefits of policy measures typically show rather gradually over the longer term, whereas costs or slower growth often show immediately. This can create a strong bias in favor of inaction, which can be exacerbated by industry lobbying or political pressure.

4 Participations und Risk Management

In view of the above-mentioned risks, it is essential to have appropriate strategies, processes and procedures in place to adequately manage these risks. Chart 9 shows the hierarchy of the relevant strategies.

On top of the hierarchy there is a company's business strategy, which defines the nature and scope of the business lines, the basic objectives (e.g. intended market share) and the expansion and integration strategy (e.g. buying existing insurance companies or build-

Chart 9

Hierarchy of Strategies

Source: FMA.

ing from scratch, accepting majority or only 100% holdings, pursuing a single or a multi-branding strategy). Normally, the supervisory board has to approve this strategy.

On the next level there is the risk strategy (sometimes part of the governance guidelines) defining how the business strategy should be implemented in terms of risk, including the setup of group-wide risk management, internal control and reporting systems and the corresponding steering committees.

The group strategy (a part of the overall investment strategy) represents the third level. It lays down the principles of investment as well as the processes for the identification and selection of potential holdings, due diligence and decision making. At the same level, we can find all the other group strategies, such as underwriting or reinsurance.

The internal audit function accompanies all strategies, verifying the proper implementation, application and functioning of procedures.

Each subsidiary will then, according to local corporate law and internal decision-making structures, implement a set of strategies and corresponding procedures as well as controlling, reporting and auditing processes to meet the group guidelines and to ensure a completely integrated risk management system in the group.

According to the Austrian Companies Act, purchasing, selling or closing down participations as well as starting or ending business lines are considered to be extremely important and therefore require the approval of the supervisory board.

To organize their CESEE participations, Austrian groups usually apply two different methods (the method of establishing branches is of minor practical relevance and will therefore not be discussed here): The first method is to concentrate all participations at the top parent company, the Austrian insurance company. This is practicable when the number of participations is small; it allows directly steering the subsidiaries without additional control mechanisms. However, this method fosters a very personal management style, which may lead to a lack of committee decisions or discussions where many different opinions are offered on the one hand and a reduced management capacity in case the (sole) decision-maker is unavailable on the other hand. The second method is the pooling of participations in a holding company, which typically is a subsidiary of the top parent company. This is practicable for larger groups, but leads to additional administration and control processes. The holding company as a separate legal entity has to make sure that all procedures are in place for proper decision making at all decision levels (e.g. investment committee, executive board, supervisory board). This may concern investment decisions, capital increases or other refinancing techniques and the strategies mentioned above. All decisions must be in line and in time with the corresponding decisions of the parent company.

Very large groups or groups with a very heterogeneous portfolio of participations may implement a third method, where different holding companies are responsible for different parts of the participations. This method requires – according to the principle of proportionality – a more complex risk management system.

All Austrian insurance companies have a group risk management that has the lead responsibility with regard to all risk management matters and the competence of methodology throughout the group. Each subsidiary has in place a risk management function or at

least a risk management coordinator, even if this is not a local legal requirement. The risk managers (and coordinators) are members of the group risk committee, which discusses (and in some cases decides) all risk relevant topics, e.g. risk analysis, regular review of the risk map, risk reports, risk-reducing measures, or the roll-out of new procedures.

Concerning the group asset management, a wide variety of methods and steering procedures is implemented because of the complexity and diversity of local legislation and the different development stages of the markets. Even the core business in the different countries influences asset allocation via the asset liability modelling and liquidity needs. Basically a group asset management and an asset management committee is set up with the central competence of methodology and an accumulating view on assets and their risks and an appropriate limit system.

Regarding the reporting needs, it is necessary to have a central data definition and an adequate reporting system to facilitate the consolidation of all relevant (risk-related) data across the group, the calculation of central risks (e.g. concentration risk) and modelling needs. It is also necessary to bear in mind that there are different systems of valuation in different countries (local GAAP vs. IFRS). The reporting system includes a data transfer and storing/saving mechanism of all relevant data, regardless of their source – general ledger, subsidiary ledgers, statistical and actuarial data and all metadata necessary for correct data accumulation. These reporting standards require an integrated IT system providing for secure data access and transmission. Legislation in some countries requires that IT hardware be physically installed in this country, which raises the costs and complexity of the system and the ensuing control procedures.

The most complex areas in terms of risk management and centralization are underwriting and reinsurance, which are the core business of insurance companies. Apart from different languages, economic development and local requirements concerning the minimum information to be provided to the customer before signing a contract, the chosen expansion strategy adds to the complexity of these areas. If the strategy is expansion by acquisition, it will be necessary to integrate actuarial tariffs and models and to consider existing contracts, business connections or distribution channels. On the other hand, companies pursuing a strategy of expansion by development cannot use existing structures but have to build them themselves. The same is true for, e.g., IT systems, all procedures concerning claims or anti-fraud-efforts.

Last but not least, in developing and implementing a CESEE strategy it is essential to bear in mind that CESEE is not a homogeneous area but consists of different countries with different geographical and economic conditions and, of course, customers and staff from different cultures and backgrounds, which could create a kind of diversification effect.

5 Impact of Solvency II on Business in CESEE

The new risk-based supervisory regime for the insurance sector, commonly known as Solvency II, is expected to have a direct and indirect impact on the CESEE business of insurance companies.

Direct effects will be observable in the calculation of the solvency capital requirement (SCR).

According to the Solvency II directive, the solvency capital requirement

shall reflect all material risks an insurance undertaking is facing in its business activity. As could be observed in various quantitative field studies carried out in preparation of the new regime, market risk is one of the key drivers of the solvency capital requirement from the Austrian perspective. Insurance undertakings in CESEE mainly follow a rather conservative asset management strategy, which is also due to the fact that the range of investment opportunities is rather limited in most markets (see also section 2.3 of this study). Therefore, a major part of assets is invested in government bonds or cash deposits at local credit institutions. Such an asset allocation may have an impact on the solvency capital requirement due to a higher concentration risk and a lower counterparty risk because of the positive treatment of European government bonds under the standard model of Solvency II.

In applying Solvency II rules, insurance companies may benefit from "old" structures. After entering the EU, European directives had to be transposed into national law that often included the obligation to separate business lines. This means that an insurance company may either provide life insurance or non-life insurance products but not all lines of business together. However, existing insurance companies were allowed to keep their license to provide all kinds of insurance as so called "composite insurers." Under the new solvency regime, composite insurers can now benefit from this structure as they can make use of diversification effects between the lines of business and therefore reduce the solvency capital requirement at solo level.

In general, the Solvency II rules may lead to a change in the structure and organization of insurance companies and groups; therefore they will have an indirect effect on the CESEE business as well.

The application of Solvency II rules requires well functioning structures and systems at every insurance company: On the one hand, complex calculations have to be carried out that require a sound and comprehensive data basis and special knowledge and skills. On the other hand, it is not only the quantitative but also the qualitative requirements related to the governance system and market transparency that require the well documented implementation of sound reporting, risk management and control systems (also see section 4 of this study).

Especially smaller companies within a group will find it difficult to meet all these requirements in a cost-efficient way. As a consequence, groups may decide to centralize and/or outsource functions, either within or outside the group. Moreover, a parent company may decide to restructure the group and convert subsidiaries into branches.

Solvency II might lead to a stronger centralization within insurance groups with respect to back office systems and governance functions. Even though every insurance company has to have its own governance system and every group has to ensure a group-wide governance system, the Solvency II directive allows an even more centralized approach. Title III subsection 6 of the Solvency II framework directive[16] deals with the possibility of installing centralized risk management within a group. Even though the detailed requirements

[16] *Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit oft he business of Insurance and Reinsurance (Solvency II).*

of this subsection have not been specified, this provision makes it possible for internationally active insurance groups to benefit from strongly centralized structures. The main advantage of centralized risk management for an insurance group is that it is incompatible with subgroup supervision. In other words, if an insurance group gets the approval from its supervisor to apply centralized risk management, there will be no (potential) subgroup supervision of subsidiaries in the jurisdictions concerned.

From the supervisory authorities' point of view, Solvency II will also bring a new focus to supervision with regard to group supervision. Due to the increasing importance of group supervision, the cross-border cooperation of supervisory authorities will be intensified, e.g. by strengthening the role of the group supervisor and the supervisory colleges. The group supervisor, who, in most cases, is the supervisory authority responsible for the supervision of the ultimate parent company of a group, is responsible for group supervision to be carried out for each group. In doing so, the group supervisor is supported by the supervisory college. A supervisory college is established for each cross-border active insurance group and consists of all the supervisory authorities that are responsible for the supervision of the parent undertaking or any subsidiary of an insurance group. A major aim of the supervisory college is to exchange information and cooperate in the supervision of a group on an ongoing basis in normal times as well as in case of crisis. In the latter case, a functioning supervisory college should also allow quicker and well-coordinated action to counter major events that might threaten the financial stability of a cross-border insurance group.

6 Conclusions

CESEE still holds substantial growth potential for the insurance market, even though in some countries of the region non-life insurance penetration is quite close to Western European levels. Competition is increasing and putting pressure in particular on non-life products and on the profitability (margins) of insurance companies as a whole. Recent developments show that premium growth has been influenced strongly by economic developments and the catching-up process. Therefore premium growth tended to be more volatile. The investments of CESEE insurance companies are focused on debt instruments. The domestic financial markets in CESEE are rather underdeveloped and may be the reason for some restrictions in investment strategies. Both the individual insurance markets and the economies of CESEE are at different stages of development, which confirms the heterogeneity of the region.

Austrian insurance groups have entered the market early and are important market players in many countries of the region. Their CESEE activities contribute significantly to their overall profitability. From a macroprudential perspective, the exposure of Austrian banks and insurance companies to CESEE warrants close monitoring, in particular as catching-up has not yet been completed. In the worst case, a crisis of confidence at one Austrian financial institution could spill over to other Austrian banks or insurance companies, even though ownership and financial linkages are generally limited. As the exposure of both, Austrian banks and insurers, to CESEE is sizeable even on a stand-alone basis, this risk is non-negligible. On the positive side, Austrian insurers' CESEE business activities are to a large extent focused

on countries with comparatively more stable macrofinancial conditions.

As regards risk management issues, a central data definition and an adequate reporting system are key to the sound management of risk and to modeling purposes. Challenges may arise from the low harmonization of accounting and valuation standards. The most complex areas in terms of risk management and centralization are underwriting and reinsurance.

In the context of Solvency II, smaller companies will find it most challenging to meet the requirements in an appropriate and cost-efficient way, which may result in centralization and/or the outsourcing of functions within or outside a group, and subsidiaries could be converted into branches. From the supervisory authorities' point of view, Solvency II will also bring a new focus to supervision with regard to group supervision and will increase harmonization.

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Annex

Table A1

Panel Regression for Insurance Premium Growth in CESEE

Dependent variable: premium growth

Variable	Coeffi-cient	Std. error	t-stat	Prob
C	0.03	0.01	3.75	0.0003
GDP	1.51	0.14	10.68	0.0000
Fixed effects				
Bulgaria	0.01		Poland	–0.02
Czech Rep.	–0.02		Romania	0.06
Estonia	–0.02		Russia	0.03
Croatia	–0.04		Slovenia	–0.02
Hungary	–0.02		Slovakia	–0.06
Lithuania	0.03		Ukraine	0.14
Latvia	–0.06			
r-squared				0.55
Adjusted r-squared				0.51
F-stat				12.15

Source: Authors' calculations.

Note: Panel regression: pooled EGLS (cross-section weights); cross section included 13; data: 2000–2010; total observations: 143.