SOLVENCY II OVERALL INFLUENCE ON THE LATVIAN INSURANCE MARKET CHANGES

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Abstract

The purpose of the article is to analyze last 6 years overall Baltic insurance market positive and negative performance (changes of premium amount, losses amount, Loss ratios and etc) as well as insurance companies operation as such (companies amount increasing/shrinking, or consolidation/merger, and bankruptcy) from the perspective of the Solvency II preparation and implementation process.

Article task is to identify in what sense Solvency II implementation process has influenced Baltic insurance market overall changes, what took place during last 6 years. Taking into account that insurance industry has an effect on the overall country economy; the study gives the possibility to evaluate if SII implementation had a significant impact, or it was only one part of the economy factors of influence.

In the paper the quantitative research method is used, the available Baltic insurance market statistics as well as Insurance companies' balance sheets are analyzed.

During the research process will be analyzed the positive and negative Baltic insurance market changes as well as the Solvency II implementation process level of impact on these changes.

Key words: Solvency II directive, insurance, Non-life insurance, Baltic insurance market changes.

JEL Code: D04, L01, L11

Introduction

The insurance industry has an important impact on the overall country economy situation. Starting from the 1st January 2016 on EU insurance market will have changes in the solvency legislation. So called Solvency II (SII) is an EU legislative program expected to be implemented in all 28 Member States, including the UK, by 1 January 2016. It introduces a new, harmonized EU-wide insurance regulatory regime. The legislation replaces 14 EU insurance directives.

The Solvency I Directive 73/239/EEC was introduced in 1973. Already after introducing this directive, EU Solvency regime understood that changes in risk management are needed, and started to prepare the Solvency II Directive. During the last 5 years insurance industry started to fill the SII influence on the overall companies operation.

The Solvency II Directive is a world-leading standard that requires insurers to focus on managing all of the risks facing their organization. It offers European insurers a real opportunity to improve their risk adjusted performance and operational efficiency, which is likely to be good news for policyholders, for the insurance industry, and the European Union (EU) economy as a whole.[1]

The aim of the paper is to analyze Baltic insurance market performance during last six years and to see if there were any significant changes, which could be the consequence of the Solvency II preparation process.

1. Research results and discussion

1.1. Insurance Market Analysis

Talking about insurance companies operation in Baltic countries, should be pointed out that in Lithuania and Estonia there were no changes during last six years, but in Latvia there were some changes and even a bankruptcy case.

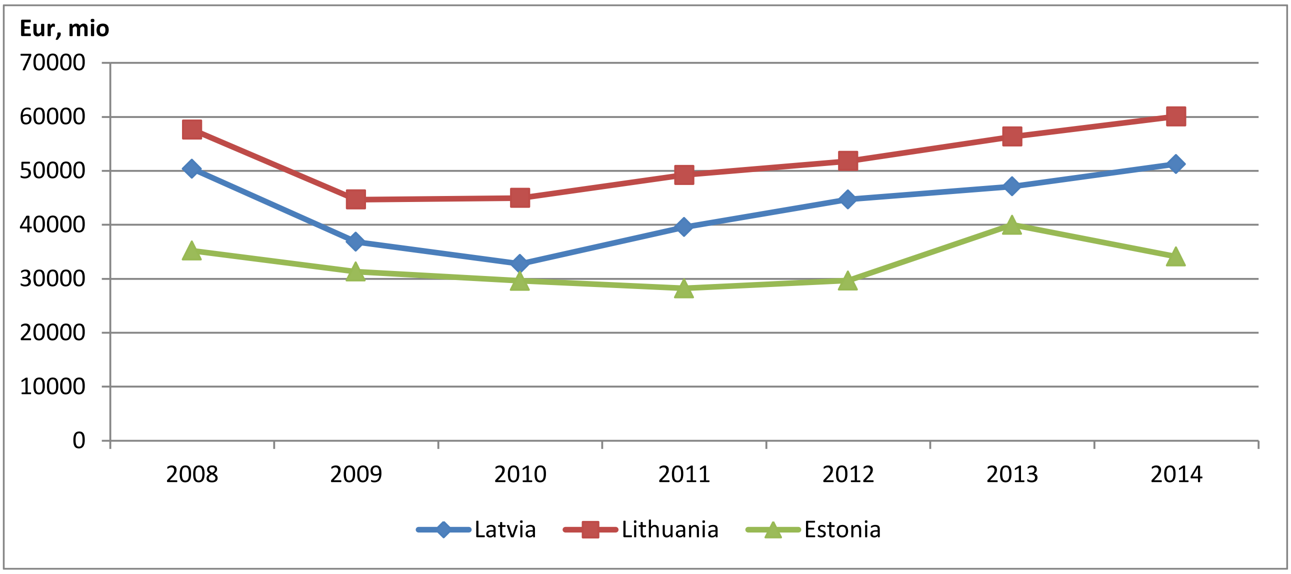
During last six years (looking into period 2010-2015) the amount of the originally Latvian companies decreased. For Non-life insurance the amount of the originally Latvian companies decreased from six (6) companies in 2010 to two (2) companies in 2015. For Life insurance – from tree (3) companies in 2010 to one (1) company in 2015. That does not mean that companies left the Latvian market. Some companies went bankrupt, such as Balva in 2014[2]. Some of the companies were bought by big Insurance groups, like Balta were bought by PZU Group[3], and Baltikums with BTA where bought by the VIG (Vienna Insurance Group)[4].

The tendency of mediums size companies sell their portfolios to a big players with much greater capital could be explained with the new Solvency II requirements. According to the new Solvency II regime companies should calculate Solvency level for every line of businesses separately in order to cover all risks, what they hold. Therefore small and middle size companies with quite big portfolios (mentioned companies are market leaders in Non-life insurance in different line of businesses) were forced to look into risk relocation. Some of the companies bought reinsurance programs, in such way relocating their signed risks to the reinsurance company, but for some companies the reinsurance would not save the company from the bankruptcy, therefore the management decision were to sell the company.

[1] https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/solvency-II.pdf
[2] http://www.balva.lv/lv/news/2013/aprilis2013/17062013-lv/
[3] https://www.balta.lv/lv/pzu
[4] http://www.vig.com/en/investor-relations/ir-newsad-hoc-news/detail/vienna-insurance-group-continues-expansion-in-the-baltics-1.html?tx_ttnews%5Byear%5D=2015

Talking about the overall Baltic insurance market performance, should be mentioned that market are showing the Gross Written Premium (hereinafter GWP) increase during last six years

Fig. 1. Insurance Gross Written Premium 2008-2014 (EUR mio)

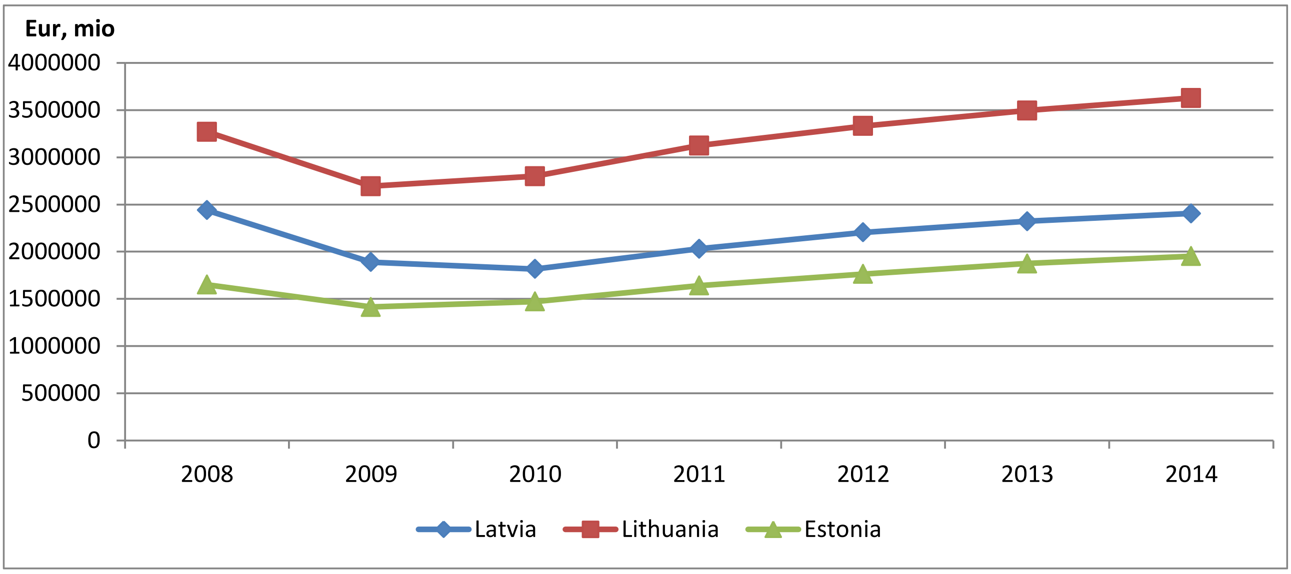


Source: author's construction based on – XPRIMM Market Insurance Report 2014 - http://www.xprimm.com/

The Figure 1 is showing the overall Baltic countries tendency of GWP increase starting from year 2009, when all countries when through the Economic crisis in all three courtiers. Should be pointed out that GWP in Estonian market is the lowest one, but in Lithuanian Market it is the biggest one. The Latvian market is in the middle, but nevertheless is showing the stable growth of GWP from year to year.

Comparing the insurance industry GWP with the main countries Macroeconomic indicator – Gross Domestic Product (hereinafter GDP) current prices the same tendency could be seen (Fig. 2.)

Fig .2. GDP, current prices (EUR million) 2008-2014



Source: author's construction based on – XPRIMM Market Insurance Report 2014 - http://www.xprimm.com/

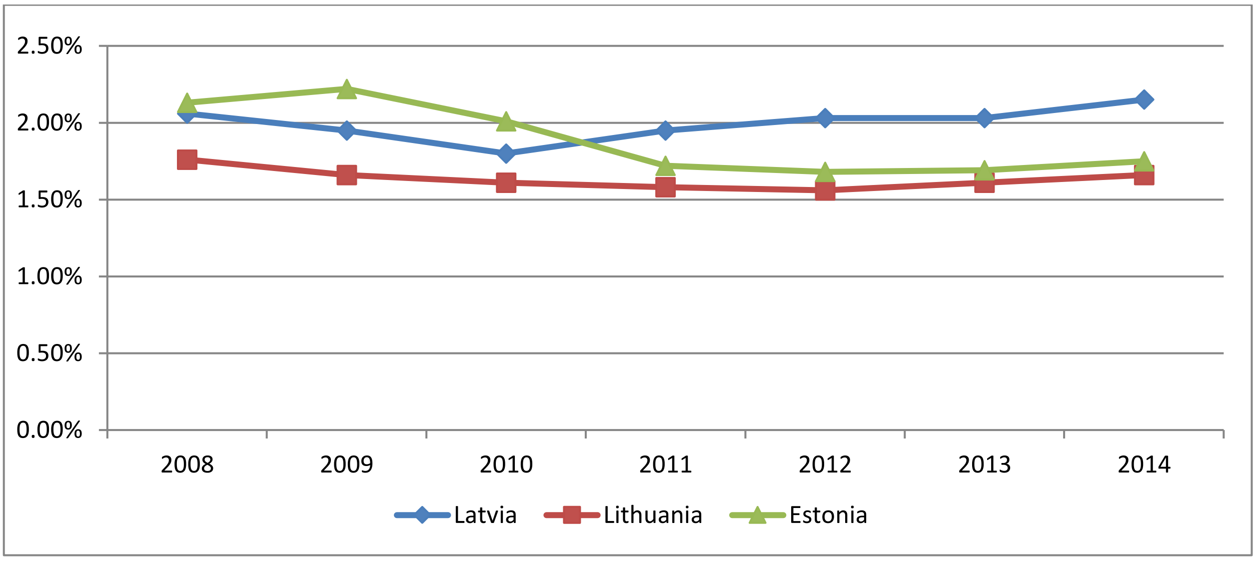
In all three countries starting from the year 2009 the GDP is showing a stable growth. The growing links between GDP and insurance sector emphasize the possible role of insurance companies in countries economic growth (Rule, 2001).

The availability of insurance services is essential for the country economy stability. By accepting claims, insurance companies are accumulating premium and make reserve funds. Therefore insurance companies are playing an important role by creating large amount of assets placed on the capital market and it may contribute to economic growth (P.Haiss 2006).

However Wachtel (2001) and Favara (2003) pointed out that the insurance sector's impact on the overall country economy has hardly been investigated. Only a few researchers mention the insurance-growth nexus, on the same time emphasizing the important of the topic, making the concentration on concrete countries (e.g. Catalan et.al, 2000; Ward and Zurbruegg, 2000), mentioning the negative effect what insurance industry can transmit onto the economy (e.g. Das et al, 2003) or treats the insurance growing link rather as a side issue (e.g. Holsbroe, 1999).

The major function of the insurance is risk transfer. Usually the insured pays a premium and is secured from different uncertainties. Measured in term of insurance premium paid relative to GDP, could be seen that the importance of insurance-based risk transfer grew for about 4% in Latvia during last six years. In Lithuania and Estonia remain on the same level, but is showing the growth tendency starting from year 2012.

Fig.3. Premium in % of GDP 2008-2014



Source: author's construction based on – XPRIMM Market Insurance Report 2014 - http://www.xprimm.com/

By taking lot of risks insurance companies reduce impact of crisis situations on the micro and aggregate macro level. Insurance industry protects the country economy against losses of property caused by natural disaster, crime, violence, accidents, etc. Therefore the assured safety of the property or vehicles for example protects many companies from lot of risks, and lot of economy sectors rely on insurance services. These moments displays the insurance sector importance in respect of overall country economic situation.

1.2. Solvency II potential impact on the Baltic insurance sector

Under the Solvency II insurance companies will face overall external environmental changes. Already in 1999 Holsboer wrote about any changes which are planned to be made in the insurance sector. He argues that the change of importance of insurance services in the economy is dependent on the growing amount of assets and the increasing competition between the financial sectors, but the author emphasis the prominent role in the services industry and denotes insurance sector development as a determinant for economic growth.

The implementation of Solvency II might have potentially negative outcomes for financial markets. In the short run, the risk of market disruption will be closely connected to the magnitude of possible portfolio reallocations, while in the medium to long term, negative financial market feedback effect and herding behavior by financial institutions might worsen any financial turmoil amid a less diversified financial system.

The risk of European financial market disruption in the short term depends on the scale of the portfolio shifts that may be needed to meet any possible increase in regulatory capital requirements under the new solvency regime. Although Solvency II will lead to stricter capital requirements for most undertakings, the final impact on capital held in insurers' balance sheets remains highly uncertain. Many insurers hold more capital than is currently required by the EU Directive in order to obtain a certain credit rating, or because of stricter national regulations than EU ones. Furthermore, those companies that may be constrained by the new risk-based solvency regime may raise fresh capital or "save regulatory capital"[5] rather than reduce investment risk. As Solvency II will enlarge the list of eligible assets backing capital to subordinated debt, hybrid capital and securitization, it should be easier to raise capital than under the Solvency I regime. The need to shift investment risk downwards is likely to be dampened, which will contain the risk that large portfolio reallocations could disrupt the financial markets. Large insurers with sophisticated internal models, which would be able to demonstrate risk reduction through asset diversification, would thus be in a

[5] Strategies consisting in saving regulatory capital involve for example transferring risk from primary insurers' balance sheets to the reinsurance sector, to the capital markets through securitization or to households through the sale of unit-linked products, as well as the liquidation of some business lines transferred to specialized run-off providers.

position to increase their investment risk while keeping their regulatory capital requirements constant. While small players will be forced to look after addition capital either through reinsurance programs, allocating part of their risks, or through portfolio shrinking, what could cause of companies bankruptcy.

Conclusions, proposals, recommendations

The main role of this paper is to highlight the importance of insurance sector in the overall country economic and to point out that any changes can influence the economic situation in the country. The Solvency II implementation will bring a lot of changes into the insurance sector in Baltic countries. The Solvency II development process encouraged Insurance companies to make lot of calculation inside their companies with the purpose to see if there is enough capital according to the new Solvency requirements. This process stimulated companies' management to look deeper into existing portfolios in their companies and to see if there are any problems separately by line of businesses. Concluding should be sad, that Solvency II implementation process made a visible influence on the Latvian insurance market, but there is not so big influence on the Lithuanian and Estonian markets. The influence on Latvian market could be explained mentioning that the country is quite small and on the market is operating small and middle size companies. On the same time there are not presented local companies with local capital. Under Solvency II requirements middle and small size insurance business where forced either sell their business, or shrink the portfolio size. Biggest amount of the companies' management chosen the first option – sell their business, otherwise the shrinking option would bring company to the bankruptcy.

Talking about the influence to the Latvian economy, could be conclude that there are only a positive influence from big insurance groups coming to the market. It brings more protection to the policyholders.

Could be sad that during the process of the Solvency II implementation the Latvian insurance market became more stable and knowledgeable, started to develop and grow. Yes, there is some bankruptcy stories on the market, but there cannot be any changes without some losses.

On the same time Estonian and Lithuanian markets have not faces any big changes in the insurance sectors mainly because there are operated big insurance groups already and there is lack of small insurance companies. But for big players the coming Solvency II gives more advantages than disadvantages. It helps companies better evaluate their portfolios and to manage risks what they have by having a deeper understanding of the risks insured.

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