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## **ASPECTS OF INSURANCE MARKET AND ITS RISK IN ALBANIA**

### **Introduction**

The beginnings of insurance industry in Albania could be found before the Second World War. By that time some English, French and Italian insurance companies entered the market. Their activity was limited only in the main Albanian cities, Tirana, Durrës, Vlora, Shkodra and Korca. After the Second World War, a communist regime was established and among other newly created institutions, the Insurance State Institute was founded in 1948. Some years later, it merged with Savings Bank and in 1954, the Institute of Savings and Insurance came to function. Its activity lasted for 37 years until the end of the communist power in Albania. All this period has been characterized by constant stagnation and domination of an obligatory insurance model. Types and forms of insurance were very limited.

In 1991, the Albanian Parliament approved the law for setting up the Insurance Institute (INSIG), splitting it from Savings Bank, giving thus start to a newly structured company, according to market principles. During the period 1991 – 1993, INSIG developed its activity related to life, property, naval and motor insurance. Another important moment in this sector was the approval of the law on compulsory MTPL ( Motor Third Party Liability)<sup>1</sup>. In 1996, an important step<sup>2</sup> was undertaken toward liberalization of the insurance market, allowing new subjects to enter in it. Two years later, the Insurance Supervising Commission (now incorporated in Financial Supervisory Authority) was created (now incorporated in Financial Supervisory Authority), in order to assure a correct and better functioning of the market.

### **Recent developments in the Albanian insurance market**

During 2006, there were operating ten insurance companies in the Albanian market, from which seven in the non-life market, two in the life market and one in both. Only four companies, however, altogether actually own about 60 % of the market – Sigal 28 %, Insig 19 %, Sigma 18,5 % and Atlantik 11 %.

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<sup>1</sup> Law nr. 7461, 01.12.1992

<sup>2</sup> Law nr. 8081, 07.03.1996

Gross Written Premiums (GWP) amounted that year around 3,75 mln EUR - an increase by 12 % compared to 2005. The market is still oriented toward compulsory insurance, which comprises 66 % of income from GWP. Non-life insurance stands for 93 % of total volume of premiums. MTPL dominates the non-life insurance market with 77 % of GWP in 2006. The total income from insurance premiums amounted only 0,5 % of GDP, and assets value around 1,3 % of GDP, both indicating for an underdeveloped insurance market in the country.

Latest developments in the Albanian insurance market consist of increasing interest from foreign insurance companies. Vienna Insurance Group, Uniqa (both Austrian) and Aspis Group (Greece) became lately shareholders, respectively at Sigma, Sigal and InterAlbanian.

### Some indicators of non-life market

Total assets of insurance market, by the end of 2006, amounted around 93,5 mln EUR, an increase of 11,7 % compared to 2005. The main contribution to this increase comes from investments on state treasury bonds and real estate, respectively 31 % and 24 %. Bank deposits amount in total 27 mln EUR, accounting for the main component of assets, about 29 % of the total.

**Table 1: Balance sheet of Albanian insurance market (in thousand EUR)**

Balance date	31.12.2005	31.12.2006
Bank deposits	28,500	27,060
Land and buildings	6,950	8,620
Shares	7,000	7,780
Treasury bills	14,370	18,800
Debts	7,830	9,160
Other assets	19,080	22,080
<b>Total Assets</b>	<b>83,730</b>	<b>93,500</b>
Technical Gross Provisions	40,300	44,080
Other liabilities	5,000	2,460
Own funds	38,430	46,960
<b>Total Liabilities</b>	<b>83,730</b>	<b>93,500</b>

Source: Annual report of Albanian Financial Supervisory Authority (AFSA), 2006

Despite the fact that investments of insurance companies in 2006 comprise about 67 % of total assets, debts are still high and increased by 17 % compared to 2005. The main reason for this situation is strong competition, which resulted in lower insurance tariffs of compulsory types. This worsened, on the other hand the cash flow, limiting the investment capacity of the non-life insurance companies. In order to prevent a greater deformation of the insurance market, the Ministry of Finance in mid 2006 issued an

order, which imposed a minimum price for compulsory insurances (about double of the lowest existing value in the market).

This compulsory measure has positively impacted the financial situation of the insurance companies, by increasing their incomes, improving cash flow and finally increasing the investing potential. In fact, fixing the minimum price, would not help effectively, because again companies competing between them would intend to return to previous price levels. Thus, the maintenance of minimum fixed prices was implemented by concentrating sales at only one agent – the Agency of Automotive Insurance. This solution significantly consolidated the insurance companies, but did not really impact the policy-holder situation. The claims ratio still remains in very low levels, about 35 %, in a market dominated by MTPL, far from normal levels: between 70 – 80 % (existing in other consolidated markets). There is however another important positive outcome from above mentioned developments, setting up for the first time an on-line system of sales infrastructure in Albania.

**Table 2.**  
**Diapason of Ratio Values (Financial Indicators IRIS)**

<u>Raporti</u>	<u>Maksimum</u>	<u>Minimum</u>
Premium Growth Rate	+ 40	- 40
Net Retention Rate	80	40
Expences Ratio	50	25
Claims Ratio	80	50
Combined Ratio	105	85
Investment Income Ratio	8	4
Other Income Ratio	1	N/A
Operating Ratio	101	80
Profit Ratio	20	- 1
Capital Ratio	50	20
Technical Provisions Ratio	30	10
Activity Monitoring Ratio	300	150

Source: World Bank Office Albania and AFSA joint project, 2006

Analyses of some financial indicators give a clearer view of specifics of Albanian insurance market. Table 2 contains a series of indicators (ratios) with their recommended value diapason for developing countries. These reports serve as an early warning system for insurance companies, the Supervising Authority may intervene when diapason values of those indicators are overcome.

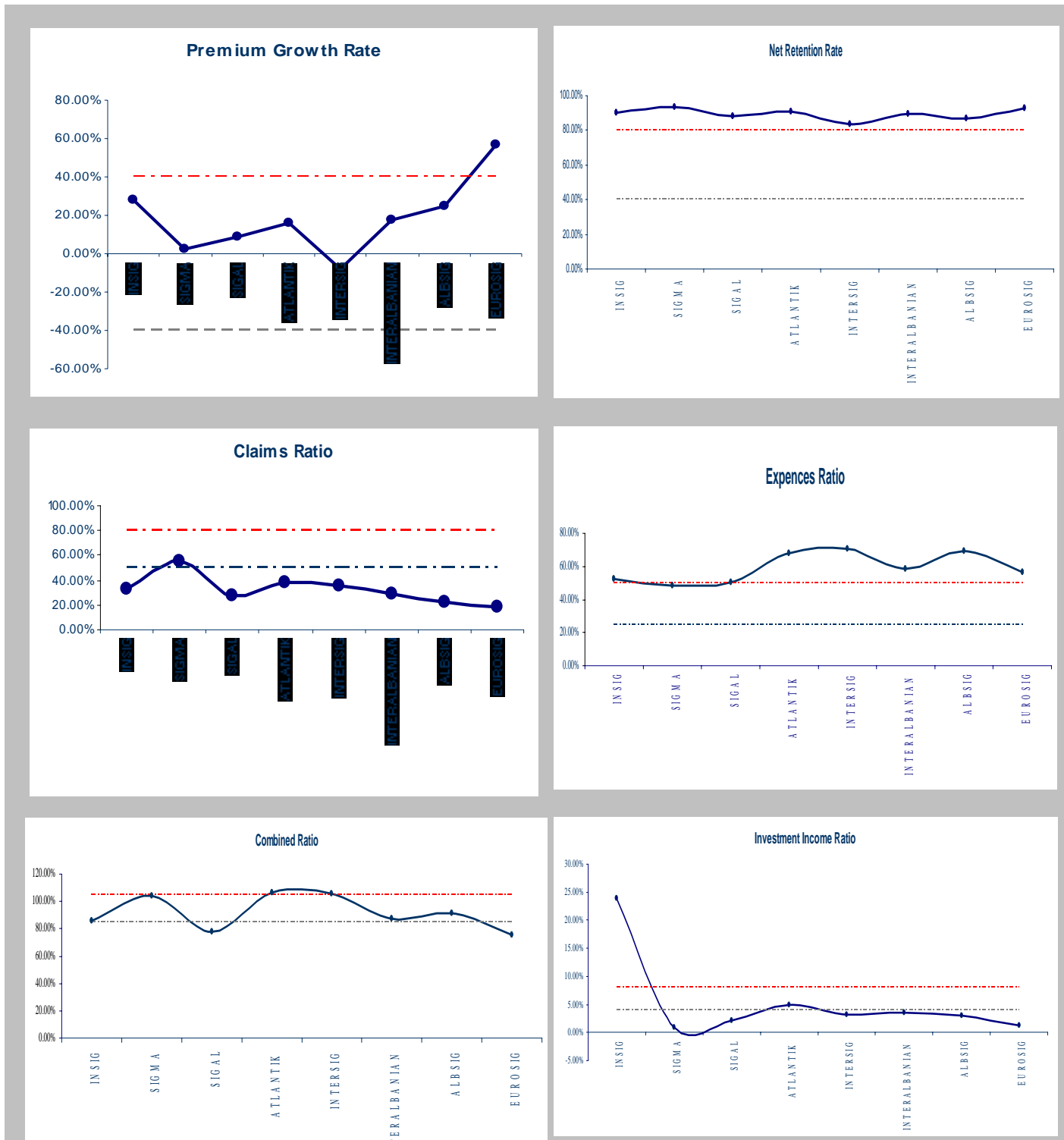
Table 3 gives an graphic illustration of these financial indicators for non-life insurance companies in 2006. Despite some general positive tendencies, the claim ratio values still remains far from normal target, but reaching a minimum of 50 % would be considered an important move toward consolidation of insurance market. The

indicator of Net Retention Rate (NRR) is relatively high, in total market level - about 88%. Although apparently this could be explained with low level of outwards reinsurance premiums, in fact big amounts of liquidity (in absolute value) are being transfered out of the country. Virtually, there are several reasons for this situation:

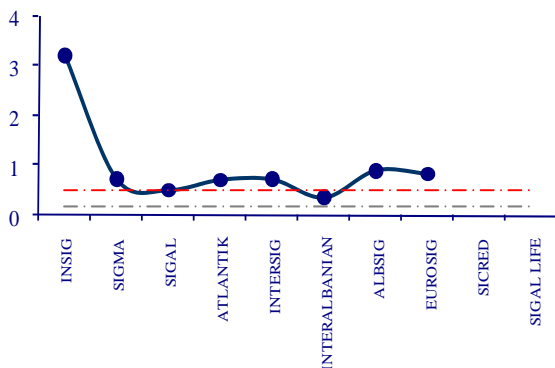
- the market is dominated by domestic MTPL, which impacts the NRR;
- Albanian market is still limited and characterised by relatively high risk for qualitative reinsurers, which often are out of access for domestic companies or often offer high mbajtjeje compared to companies capital;
- other insurance classes, except compulsory insurance, have small percentages in the market, so they do not impact the NRR;

On the other hand, since penetration in most of the classes (except domestic MTPL and Green Card) is relatively low, the accumulation risk (related to pending claims) is not really an primary issue in other insurance classes. The main concern in these classes consists on the level of risk retence ratio, which should not exceed 10 % of own funds of an insurance company, according to the regulations in force. Risks, which exceed retence capacities, according to the regulations, should be subject of optional reinsurance. A positive fact should be noted however, the increase of own funds of insurance companies, resulting among others in reaching of new levels of guarantee fund,

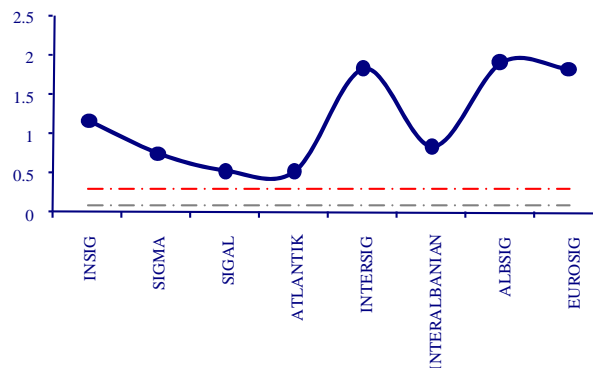
**Graphic 1. Values of financial indicators (IRIS) in several Albanian insurance companies**



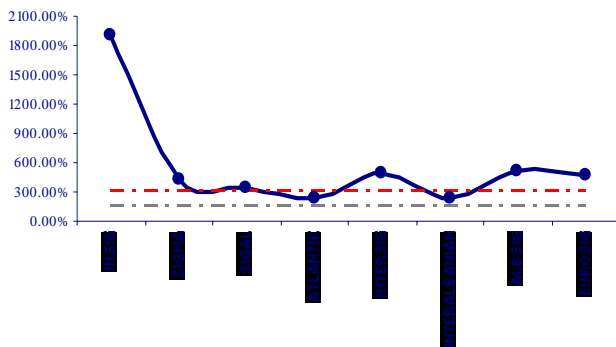
**Capital to gross written premiums**



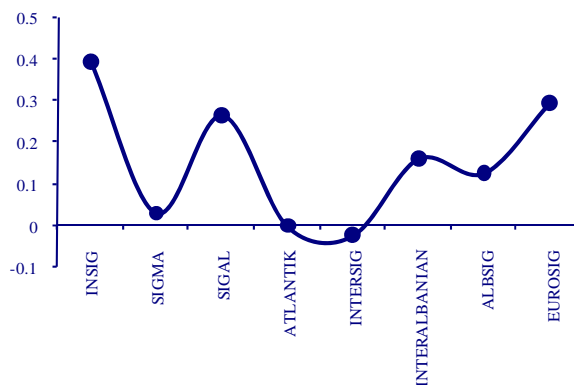
**Capital to net technical provisions**



**Activity monitoring ratio**



**Profit ratio**



Source: Authors' calculations based on AFSA data, 2006

which for non-life companies, is predicted to amount a minimum of 3 mln EUR by the end of 2008. Such achievement would increase the insurance retentant capacities of companies, enabling negotiation of more qualitative insurance agreements, and higher retention for domestic MTPL, eliminating at some extent the outflow from Albania of a considerable amount of funds, from a portfolio characterised by a very low claims ratio and as a consequence, reinsurance agreements might not be effective for the time being.

**Main risks in Albanian insurance market**

The profile of the business they conduct exposes the insurance companies toward risks, which can seriously threaten their existence. If we had to group the main risks that non life insurers face, we would have four main risk categories: Asset Risk, Liability Risk, Asset / Liability Matching Risk and Operational Risks. Under Asset risk one can list credit risk, market risk, valuation risk and concentration risk. Liability Risk comprises underwriting valuation risk, concentration risk and reinsurance assessment risk. Under the Asset / Liability matching risk we can mention the liquidity risk and market risk (mainly related to the interest rate risk). And lastly, operational risks comprise management risk, IT risk, business risk and concentration risk (related party transactions).

It is understandable that the majority part of these risks can have different impact on an insurance company, depending on its profile (life or non life insurer). As the Albanian market develops, some of these risks will have a greater impact on solvency, while others will diminish. The main risks facing Albanian non-life insurers are described below:

*Asset risks* – A high proportion of assets in Albania are held in bank deposits, treasury bills and real estate. The lack of an appropriate investment environment limits the earnings of insurance companies. Because of the cash-flow demands of the claims portfolio, in most markets, fixed income securities are the main investment category for non-life insurers. Subject to the level of capital surplus and the nature of the insurance portfolio, investment in stock securities can be both more profitable in the long term perspective than bonds and a natural hedge against falling bond prices. The lack of a stock market theoretically constrains investments in stocks. Recently the Albanian Government has issued 5 and 7 year bonds, which still haven't been found attractive to be part of the Albanian non-life insurers' investment portfolio. Municipal and corporate bonds still are not available in Albania, although these instruments do carry some credit risk on interest payments and potentially on the principal sum invested, which on the other hand is compensated by a higher profit margin than government securities.

As for investments in real estate, mainly this portfolio comprises owner occupied property, a very small portion is held as investment. In general, current values are higher than book levels, which are entered at cost. The current risk related to investments in real estate in Albania are clear title to assets due to ownership conflicts going on throughout the country and changes in legal environment. Recently a law which applies a 10% transaction tax for property sales is believed to seriously constraint the liquidity of this market.

The valuation risk is minimal at present, due to limited investment opportunities in Albania. However this situation implies a limited capital growth through investments, which on the other hand leaves the insurance trading activity as the primary source of profit and capital growth.

Although claims ratio appears relatively low in Albania, administrative expenses are quite high, to the point where net insurance revenue is low. An increasingly competitive market and informed consumers will be in favor of the growth of efficient insurers, particularly as economic penetration of insurance products will increase as income level rise. At present the low investment income ratio of Albanian insurers is the main factor of the modest operational capital growth of the market.

Another present asset risk for Albanian insurers is the credit risk arising from operations with reinsurers as well as concentration risk, which may be caused by the domination of one reinsurer in the reinsurance program. The current regulations in Albania imply that at least 80 % of the reinsurance program should comprise reinsurers above BBB, according to Standards & Poor credit risk rating. For intermediaries the credit risk is not material, as for the moment there are no brokers in Albania. Distribution channels are rather direct.

*Liability Risks* – In Albania this risks addresses mainly to MTPL portfolio, which are characterized from accumulation of outstanding claims. Despite that Domestic MTPL has a very low claims ratio (less than 35 %), which cannot be said for the Green Card portfolio. Valuation risk is not limited to claims reserving, there is also significant pricing risk due to severe competition in the market, mainly in voluntary insurance.

*Asset/Liability Matching Risk* – This risk is not material for the moment for the Albanian non-life insurers due to short - term nature of their liabilities. As the liability business grows, the need for insurers of such classes to properly match their liquid assets to the pattern of claims settlements will therefore become more important. In particular, it is also noted that the asset portfolios of non-life insurers are liquid at present due to currently limited investment opportunities, which on the other hand further reduces claims settlement risk from the matching perspective.

Operational Risk is increasing, given the non-life industry's relative youth and rapid growth, particularly in systems and management, adapting to change in the market and its regulatory environment.

The current legislation applies the standard capital theory, where the solvency margin is related to premiums. Considering the high expense ratio in Albanian market (above 60 %), we can conclude that premiums are mainly used for expenses and not claims, which considerably reduces the relevance of this theory. On the other hand the solvency margin, even though it fulfills its warning role, it cannot replace the effective analysis of a company as well as guaranteeing full coverage of technical provisions.

### **Conclusions**

The need for a more sophisticated solvency regime for Albanian non-life insurers is mainly based on the fact that the current regime doesn't estimate the majority of risks mentioned in this article and its relevance is considerably limited referring to the actual risk situation in the Albanian market. On the other hand a strict regime where all known risks would have been measured and as a result companies would face strong capital requirements from the supervisory body, would be non efficient for the market. Such a situation would be favorable only from a pure supervisory prospective, but it would constrain investment initiatives, risking to cause even capital withdrawal from the market. An efficient and sound insurance market is for the benefit of all. But considering the fact that bankruptcy risk is always present, even in an efficient market, it is the supervisor's job to establish a reasonable solvency requirement, which would enable early intervention in case of problems, to the minimal cost for the policyholders. The challenge is to achieve a balance between safety and economic efficiency.

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