LATVIAN INSURANCE COMPANIES – SUSTAINABLE DEVELOPMENT IN CHALLENGING ENVIRONMENT

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Abstract

Over the past years before the world financial and economic turbulences, the Baltic States – "the Baltic tigers" – have been the fastest developing economies in Europe. In 2002–2007, the local insurance market in three Baltic States doubled in volume. After the booming years insurance business (both life and non-life insurance) suffered from the economic downturn. The current paper is going to provide an overview about the situation on the European insurance market and in particular to analyze problems and challenges on the Latvian one in order to clarify the status que and identify the way for sustainable development in the challenging environment.

Key words: Latvian insurance industry, European insurance industry, Solvency II.

Introduction

Over the past years before the world financial and economic turbulences, the Baltic States – "the Baltic tigers" – have been the fastest developing economies in Europe. Growth in demand, both domestic and foreign, combined with a massive entry of foreign capital, including structural funding by European Union, kicked Gross Domestic Product growth rates up to double-digit figures. The Baltic insurance industry (and the Latvian one as well) was a direct beneficiary of this economic miracle. In 2002–2007, the local insurance market in three Baltic States doubled in volume. While the non-life sector kept pace with the overall economy, life insurance experienced an all out boom, with industry's products becoming one of the most popular savings strategies. After the booming years insurance business (both life and non-life insurance) suffered from the economic downturn as the income from main business operations did not show sustainable growth and companies should gain extra income from investing activities in order to stay on the market, but on the other hand due to the vulnerable financial markets the return on investment decreased. The current work is going to provide an overview about the situation on the European insurance market and in particular to analyze problems and challenges on the Latvian one.

1. European Insurance Industry Overview

1.1. General overview

Given the massive swings in economies and markets over the past couple of years – during the time period from 2008 to 2009, it is possible to state that by January 2010 the global economy remained in recovery mode, which, after such a severe recession, translated into above-trend growth. The expansion in Asia – where the recovery began – was downshifting to a more sustainable pace, but this was being offset by activity in the "laggard" such as the US. Nevertheless the challenges of financial and economic disasters of the previous two years 2009 was the first year after the crisis and featured a massive rebound in prices of several financial products and markets, as well as renaissance of some industries. According to the Standard & Poor's [1] the insurance sector has fared well relative to banks over the past two years. For example, no rated insurer based in Europe has failed, neither has any insurer been rescued by the state. However, while insurers were not the cause of financial turmoil, they still suffer some of its consequences. Over the period of 2008 and 2009, impairments on invested assets have substantially eroded insurers' capitalization and profitability; in some cases leading to downgrades in rating. This is compounded by weak economies. As for example, among 160 rated insurance groups in Europe, downgrades number 24 and upgrades total nine, while most of the downgrades relate to life insurers. Despite positive trends and forecasts in equity markets, lower credit spreads by the end of 2009, and signs of recovery in economies around the world, there is still a fear that economic and financial market conditions continues to put pressure on Europe's insurers. Although insurers fared better than the banks during the crisis and resulting recession, premiums for 2008 declined by 6% to just under € 1060 billion, with no improvement in 2009 [2]. Life insurance companies fared bet-

ter from the crisis than banks; however, they were shaken by investment losses. General insurance companies suffered from capital base erosion and by the continuation of soft rates, as impairments on certain classes of investments eat into insurers' earnings in 2009. Overall investment returns remain subdued over at least the next two years, reflecting a combination of lower investment yields and significantly lower realizations of capital gains from equity investments. As to investment politics in the European insurance universe it is worth to consider that as at 31 December 2009, the European insurance industry had more than € 6 800 billion invested in shares, bonds and other assets on behalf of millions of savers and non-life insurance customers [3]. Figure 1 shows that growth in 2009 in comparison to the previous periods is for the most part explained by the recovery in the capital markets that began in late March 2009. Developments in the total investment portfolio are mainly driven by life business, since the investment holdings of the life insurance industry account for more than 80% of the total.

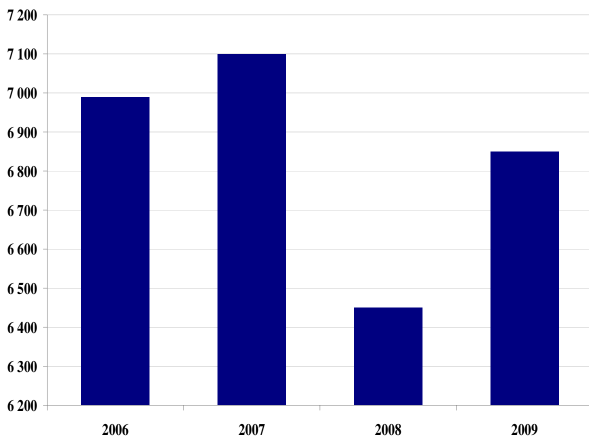

Fig. 1. European Insurers' Investment Portfolio, billion EUR

Based on the data provided by Figure 2 it is possible to conclude that the largest components of European insurers' investment portfolios were debt securities and other fixed income assets (~40%), followed by shares and other variable-yield securities (~26%) over the time period described.

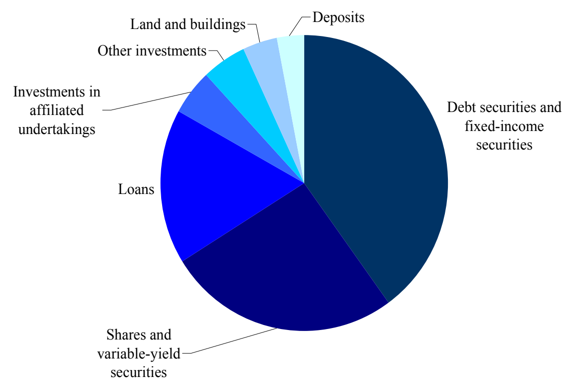

Fig. 2. Asset Allocations by European Insurance Companies

It is important to consider that low investment margins have a direct bearing on the returns that life insurers can offer their life insurance policyholders, which will adversely affect new business, while stagnant economies are hurting the insurer's earnings, as the risk of a double-dip recession remains, and the scale and likely pace of a potential global upswing is still unclear. This impacts insurers in a number of ways, but it hurts life insurers most. Life insurers' business is depressed in most European countries in 2009. This can be attributed to low investment yields, lower investor confidence, lower housing market activity, and lower disposable incomes. Furthermore, life insurance policy rates are elevated as policyholder's surrender their policies or terminate premium payments in order to realize cash. These issues have a direct bearing on insurers' profitability. On the non-life side, typical of recessionary conditions, the frequency of claims is on the increase. Europe's reinsures are better placed to the economic conditions than primary insurers. Premium pricing is sound for most lines of reinsurance business, which augers well for profitability in 2009. Reinsures have been posting impressive underwriting results so far. Their response to the impact of the financial turmoil on their marked-to-market balance sheets in the fourth quarter of 2008 was to quickly reverse the downward pricing trend. With their balance sheets looking much healthier today, upward pricing pressure has abated. Insurers do not respond in the same way to the new challenges, leaving a mixed picture around Europe in terms of the adequacy of rates. Rates in the U.K. and Italy are showing signs of significant progress in the key lines of business, whereas in Germany, downward pressure still prevails, as it does in much of continental Europe.

1.2. Operating Environment for Life Insurance Companies

Customer demand for life insurance and savings products during 2008 and 2009 remained muted in the course of the recession, placing pressure on profitability. Life insurance gross written premiums in Europe declined 11% in 2008 to € 644 billion (+5% to € 647 billion in 2009 in comparison to previous year) according to European insurance and reinsurance federation. New business production remained subdued in 2009 and is expected to remain pressured in 2010. On the other hand capital markets conditions continue to affect the life insurance industry. Despite the recovery in equity markets in comparison to 2008 and early 2009, indices remain lower than several years earlier. STOXX 600 is up 61% from the low in March 2009, but remains 37% below its June 2007 high. This reduces fees on assets under management as well as realized gains from participating products. Further, low interest rates on the government bond market continue to pressure spreads versus guaranteed crediting rates. These factors create a challenging environment for life insurer's earnings profiles. Given the life insurance industry's inherent exposure to financial assets, there will be several areas of focus after 2009 [4]: State of the global economy, where solid economic growth in 2010 and 2011 is forecasted. This would bode well for life insurers, while potential ensuing pullback of government stimulus could create pockets of volatility in insurers' investment portfolios. While most European insurers have been reducing exposure to investment risks, the industry's savings and retirement products ensure the industry will continue to be affected by broader economic trends. Improved equity markets and tighter credit spreads were a boon to the insurance industry in 2009. They drove a decline in unrealized loss positions, which provided a substantial boost to shareholders equity, and solvency ratios, while in the coming period life insurance underlying earnings are expected to continue to stabilize as market conditions improve and the industry reprises risk. Finally, it is important to note that according to the Wall Street consensus operating EPS is showing some improvements from 2009, but to remain 27% below 2007 levels for European life insurers.

1.3. Operating Environment for Non-Life Insurance Companies

In the property sector, strong profitability from hard market conditions in the early to mid-2000s has led to competition-driven softer market conditions the past several years. Weaker pricing, along with higher recession claims and lower investment income is negatively affecting profitability. The ability for the industry to raise pricing is being forced by weaker conditions for the strong competition, particularly in France and Germany. The hurricane season in the Atlantic in 2009 has dampened momentum for improved catastrophe pricing. According to Munich Re, global insured losses from natural catastrophes were around $ 22 billion in 2009, down from $50 billion in 2008. Reinsurance broker Guy Carpenter [5] reported that global catastrophe reinsurance rates declined 6% during the 2009. Property catastrophe reinsurance rates were down 5-10% in the UK, flat to down 5% in Europe, and down 6% in the US. France and Austria, which were affected in 2009 by winter storm Klaus and hailstorms, experienced rate increases. In European casualty, motor liability reinsurance rates were flat to up 10% on working excess layers due to continued claims inflation. It is forecasted that most non-life insurance companies are able to generate adequate capital to support their businesses, and their achievements would result in average ROE of 12% for this group in the coming period, while in the long term, it will be important for the industry to maintain pricing discipline.

1.4. Other Concerns

Many insurers and their industry associations are voicing concerns about the future capital needs of the European insurance industry under the EU Solvency II Directive. Solvency II is intended to completely overhaul and harmonize the supervision of insurers across Europe and is scheduled to take effect from October 2012. The perceived view of insurers is that these requirements represent a knee-jerk response to the financial turmoil of the past two years, while the new capital requirements could lead to a strategic response from at least 25% of Europe's insurers according to analyst's evaluation. There is no doubt that Solvency II requirements are not the only concern to insurers` business, but the topic plays an important role for further considerations and should be discussed in details below. The results of the QIS4 study [6], combined with

weaker balance sheets both in 2008 and 2009 and the additional conservatism being recommended by CEIOPS for QIS5 [7], implies that Solvency II is likely to be more onerous from a capital perspective than originally expected. It is expected that this particular innovations to require further action from insurers to get regulators, rating agencies and also investors comfortable with the new assessment of solvency. While this does not mean direct capital actions in most cases, nevertheless the majority of companies in the sector are going to continue down the path of increasing capital efficiency. The ongoing pressures from lower investment returns, business volumes and earnings, compounded by competition and regulation, have focused managements' attentions on capital conservation and returns. Recent actions have included the following examples: Continued moves towards capital efficiency in product mix and capital allocation (AEGON, ING Group, Legal & General); Further actions on cost reductions (Swiss Life, Zurich); Reassessment of asset allocation and commitment to noncore subsidiaries (AEGON, ING Group, Old Mutual, Prudential, Aviva, Fortis); Increased use of reinsurance to offset risks (Aviva, Swiss Re); Greater moves towards consolidation at the smaller company end of the sector and for the larger companies that want to refocus on higher margin/lower capital lines of business. Interestingly, lower credit for diversification would likely add further momentum to insurers' willingness to divest out of ancillary businesses (Standard Life, ING Group).

2. Latvian insurance industry

By the end of 2009 according to the statistics published by Financial and Capital Market Commission there were 14 insurance companies operating in Latvia, whereof four companies were engaged in life insurance and 10 companies - in non-life insurance business, as well as 11 branches of foreign insurance companies. While comparing main business results in the insurance business for the time period from 2008 to 2009 it should be mentioned that all the sectors (both life and non-life insurance) are suffering from the economic downturn as the total amount of net premiums earned is decreasing, while the total amount of net claims incurred is increasing, and it is expected that such a trend is going to continue in the following periods further on. On the one hand the income from main business operations does not show sustainable growth and companies are forced to gain extra income from investing activities in order to stay on the market, but on the other hand due to the vulnerable financial markets the return on investment decreased in the previous periods. Due to the economic situation on the local market in the previous and in the current year insurance companies are forced to consider other possibilities of income generation and coverage of losses. In this concern the situation on the Latvian insurance market does not differ much from European one. Latvian Insurers' Association [8] data shows that during 2009 the non-life insurance market decreased by 35,6% in comparison to 2008 (-27,6% to 2007). Industry experts foresee that the non-life insurance market will continue to shrink by 10% to 15% during 2010, thus reaching its size of 2006. Total shrinkage of the non-life insurance market in 2009 and 2010 combined might reach 45% to 55%. At end of 2009 gross premiums written by non-life insurance companies accounted for 195,5 million lats or by 35,6% (-27,6% to 2007) down from the end of previous year, while the amount of gross claims paid contracted by 20,6% (+8,1% to 2007) as compared to previous and totaled 132 million lats. Even though the situation in particular sub sector is looking better than by life insurance, still there are no reasons for positive sector valuation and forecast, nevertheless in the reporting period, the non-life insurance companies operated with profit totaling 11,4 million lats (eight out of 10 non-life insurance companies reported profit in the reporting period). The solvency ratio, which characterizes the sufficiency of own funds at the disposal of an insurance company to ensure its minimum solvency was 151,7% in 2009, while the lowest permissible margin for this ratio is 100%. The life insurance market experienced a decrease of 24,1% during 2009 in comparison to 2008 (-17,4% to 2007). It is worth to mention other alarming tendency in the insurance industry: during the 12 months of 2009 the health insurance industry in Latvia suffered losses of approximately LVL 10 million mainly as a result of price increases for medical services and a decrease in State financing for the medical sector. Insurance indemnities paid out during this time increased by 52% in comparison to the same period last year. Statistics available allow concluding that there is no evidence that this particular sector and the industry as a whole are going to show any signs of improvement during the year 2010. It is expected that insurance

market is going to reach its "normal" growth by the end of 2011 or beginning of 2012. Performance indicators for life insurance companies allow the following picture: at end of 2009 the amount of gross premiums written by life insurance companies decreased by 17,4% in comparison to the previous year (-24,1% to 2007) and totaled 27,8 million lats. Whereas the volume of gross claims paid grew by 30,1% (+160% to 2007) and made up 21,8 million lats. As the result the cost-damage ratio increased rapidly and gave to understand the seriousness of the financial situation in the sector. In the reporting period, two life insurance companies operated with losses, however, overall life insurance companies made about 7 thousand lats profit. The leverage ratio for insurance companies that characterizes the sufficiency of own funds at the disposal to ensure its minimum solvency at end of 2009 was 159,5%, while the lowest permissible margin for this ratio is 100%. High solvency ratio shows that insurance companies are capable of operating more efficiently without jeopardizing their solvency. In 2009 total investments of non-life insurance companies accounted for 218,4 million lats. Investments in debt securities and other fixed-income securities constituted the greater part totaling 105,5 million lats or 48,3% of total investments of non-life insurance companies, and investments in time deposits with credit institutions were 60,8 million lats (27,8% of total investments). It is worth to mention that in 2009 the return on investments was 3,8%, while technical provisions of non-life insurance companies were 100% covered by investments. Total investments by life insurance companies in the same time period amounted to 70,5 million lats. For the greater part, investments were made in time deposits with credit institutions (49,7% of total investments), while the amount of investments made in debt securities and other fixed-income securities accounted for 30,0% of total investments made. Return on investments of the average value of the investments by life insurance companies was 7,4% (compared to 3,1% at end of 2008). Table 1 provides information about the market share of biggest insurance companies in total gross premiums written and their performance indicators, whereby it is clearly seen that companies should pay extra attention on financial portfolio management that allows generating extra income in order to cover losses from main business operations. In conclusion it is worth to mention that in the tough market environment the insurance companies are forced to look for other opportunities of profit generation than income from gross premiums written. According to the Latvian Law companies providing insurance services are allowed to invest up to 5% of their technical reserves in securities, excluding Latvian and OECD country's securities. In the previous periods insurance companies were building conservative portfolios while mainly investing in government bonds and keeping only small amount of shares due to the conservative investment politics, vulnerable financial market, etc.

Table 1. Company's Market Share and Main Performance Indicators as on 31 December 2009

	Market share, %	Technical provisions, LVL	Total balance, LVL	Loss ratio, %	Expenses ratio, %	Combined ratio, %	Investment return, %	Operation ratio, %
Insurance companies (Non-life Insurance Business):								
Balta	21,4	29 994 904	61 734 591	53,4	38,0	91,5	0,9	90,5
Baltikums	6,8	10 149 399	17 153 816	56,6	42,6	99,2	3,7	95,5
Baltijas Apdrošinãšanas Nams	4,1	3 150 036	8 812 258	45,9	53,4	99,4	6,6	92,8
Balva	4,5	4 502 613	9 522 337	71,1	55,9	127,0	2,7	124,3
BTA	24,8	38 466 238	66 170 508	63,8	31,2	95,1	3,6	91,5
Ergo Latvija	6,9	11 444 746	23 325 650	55,3	31,7	87,0	5,1	81,9
Lauto Klubs	0,1	325 216	3 116 074	48,8	211,3	260,1	4,9	255,2
Gjensidige	23,4	35 252 783	68 612 273	61,2	31,8	93,0	7,0	86,0
RSK Apdrošinãšana	3,3	3 705 539	7 020 879	111,3	40,7	152,1	-9,6	161,7
Seesam Latvia	4,7	7 862 347	15 525 763	60,8	33,0	93,8	6,6	87,2

(continued)

Insurance companies (Life Insurance Business):								
LKB LIFE	0,3	477 975	3 085 643	367,8	322,9	690,7	8,1	682,6
Ergo dzīvība	39,5	16 461 680	24 003 950	81,8	13,8	95,6	5,9	89,7
Parex dzīvība	1,5	286 321	3 824 078	3,9	41,0	44,9	7,0	37,9
SEB dzīvība	58,7	33 577 028	48 233 940	57,3	17,8	75,1	8,3	66,8

Conclusions

The paper provided brief analysis of European and Latvian insurance industry. Based on the considerations presented it is possible to conclude that insurance companies, who have been affected by a decrease in sales and challenging market conditions during the last world financial and economic crisis are de-risking portfolios and shedding questionable lines of business. The insurers seek to identify new sources of capital, as well as they need to allocate capital effectively among product lines and business units. Financial market crisis emphasized that insurance companies relied too heavily on quantitative models, external ratings and benchmarks. Moving forward, it will be important that new quantitative risk capital requirements under Solvency II be framed by an appropriate risk management infrastructure, with the proper internal processes and controls at all levels.

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