IIF Occasional Paper
Number 2

THE COMING OF PRIVATE INSURANCE TO A FORMER PLANNED ECONOMY: THE CASE OF SLOVENIA

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Introduction

This paper analyzes one aspect of perhaps the most interesting economic phenomena of recent years, the transformation of the former planned economies of Central and Eastern Europe to market-based economies.[1] Private insurance companies have appeared in most of these countries, but this transition brings new problems for which they are not necessarily prepared. This paper describes the initial development of the insurance market in one transforming economy, that of Slovenia.[2]

Slovenia, which shares a border with Austria and Italy, was the most developed region of the former Yugoslavia. Its independence was recognized in 1991, and negotiations are currently underway for its accession into the European Union (EU). Along with Poland, Hungary, the Czech Republic, and Estonia, Slovenia was identified among the Central and Eastern European countries most ready to join the EU. Thus in a relatively brief span of time, Slovenia is transforming its economic system from one resembling its eastern neighbors to one resembling its western neighbors.

Judged on its political importance, or on a geographic or economic scale, Slovenia is not a large country. Its population of about two million is smaller than that of many cities. However, the issues arising during Slovenia's economic transformation confront many other countries as well. Some of the important questions include the following:

- How does an insurance market transform from a state-operated monopoly to a competitive market?
- What is a normal, or desirable, industrial structure for the insurance industry in a specific country's economy?
- How does a former planned economy prepare for membership in the EU?

This paper then is a Genesis story. It describes the birth of a private insurance market. As such it can provide insight into the beginning of other insurance markets. It also provides a historical record, or case

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[1]This entire paper has benefitted from the comments and criticism of several reviewers, especially Claude Lilly, Harold Skipper, Howard Kunreuther, Michael Murray, and Robert Gibbons. The authors are very grateful for all suggestions for improvement but retain responsibility for any remaining deficiencies. The authors are pleased to give special recognition to the following leaders of the Slovenian insurance industry, without whose cooperation completion of this paper would not have been possible: J. Gorisek, J. Kaluza, and F. Skufca. The authors also would like to recognize Heinrich Stremitzer for his support of this project.

[2]While the focus of the paper is non-life insurance, some information and data on the development of life insurance in Slovenia also is presented. Analyzing life insurance markets is made more complex in both Western and transitional economies because differing tax laws and social insurance systems makes many comparisons misleading.

study, of a small event that may help explain a much larger phenomenon.

Despite the common former emphasis on central planning, each country of Central and Eastern Europe is unique. Extrapolations and generalizations from one country's experience should be done only with caution. The former Yugoslavia, for example, was a non-aligned country, not part of the Soviet bloc.[3] However, a case study such as presented here can provide insight into the problems and opportunities faced by insurance entrepreneurs in all the economies making the transition from central planning. Likewise, each historical period presents different problems and opportunities to insurance entrepreneurs. The English and American domestic insurance markets did not begin with the over-riding purpose of harmonizing the outcome with that of other countries or a multinational structure like the EU. Potential international competition presented much less of a threat to domestic providers, while foreign capital was less readily available to assist the development of the domestic market. Nevertheless, the sequence of events surrounding the birth of the private insurance market in Slovenia provides clues about the necessary and sufficient conditions required in all such births.

The paper integrates economic and insurance theory with the actual experience of a country undergoing the transition from a planned to a market economy. It adds relevant analytical insights from the burgeoning economic literature on this economic transition in Eastern Europe. Economic theory provides micro-economic and industrial organization explanations of firm behavior. Insurance theory applies the laws of probability to risk sharing, examines the problem of moral hazard, and suggests which types of insurance are most likely to appear first in the market. The Slovenian experience described will be analyzed in light of both economic and insurance theory. The paper concludes with an evaluation of Slovenia's progress and an identification of the remaining impediments to the efficiency of the Slovenian insurance market.

[3] The Slovenians interviewed by the authors were quick to emphasize this distinction. The Yugoslav economy, however, generally followed the central planning pattern, and the focus of this paper is economics, not politics.

The Transition from a Socialist Economy

The Soviet Union ceased to exist in 1991. Since that time the countries that previously followed the Soviet model have embarked on an independent path. With varying degrees of progress, many of them have pursued the goal of implementing market-based economies.

This transition from plan to market has been much studied in the economic literature.[4] In addition to general economic studies, there also have been industry specific studies, but securities markets and banking appear to dominate the studies of the financial sector, while to date private insurance has been substantially neglected.[5] A review of the literature reveals no academic study of the role of private insurance in the transition economies of Central and Eastern Europe. Some trade and news media stories mention the genesis of risk management and insurance transactions, but these narratives are merely descriptive.

The concept of insurance in a Soviet-style centrally planned economy was almost the exact opposite of insurance in a competitive market. The Soviet-style insurance model required insurance companies to be organized as departments of the Ministry of Finance. For example, in the German Democratic Republic, the chief executive of the state-operated insurer was an employee of the Ministry of Finance. Insurers were state-operated monopolies, but it was typical for one monopoly to operate in the domestic market and another to provide coverage for exports and imports. In general, compared to its role in Western economies, the insurance industry played only a minor role and was underdeveloped in Soviet-style economies. This result can be explained in part by examining the role of money and prices in Soviet-style economies, and also because the insurance industry could not develop its investment function in a fashion similar to Western insurers.

Rogers' 1988 study, *Insurance in Socialist Eastern Europe*, provides a comprehensive look at the Soviet-style model insurance system in several countries including Poland, Czechoslovakia, Yugoslavia, and the German Democratic Republic. Rogers's main conclusions are as follows:

- Socialist insurance operations were never actuarially sound in the sense that cash flow plus reserves were adequate to pay for

[4] A. Aslund, *How Russia Became a Market Economy* (Washington, DC: The Brookings Institution, 1995); R. Faini and R. Portes, *European Union Trade with Eastern Europe: Adjustment and Opportunities* (London: Centre for Economic Policy Research, 1995); M. Lavigne, *The Economics of Transition: From Socialist Economy to Market Economy* (New York: St. Martin's Press, 1995).

[5] J. Rostowski, *Banking Reform in Central Europe and the Former Soviet Union* (Oxford: Oxford University Press, 1995).

estimated losses and expenses.[6]

- When insurance transactions were made, because the state "owned" both the insurer and the insured, no underwriting criteria were used to accomplish the typical purposes of segregating loss exposures by the estimated risk transferred to the insurance pool. Insurance was granted automatically by state insurers, without issuance of policies.[7]

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[6]P. Rogers, *Insurance in Socialist East Europe* (New York: Praeger, 1988), p. 7.

[7]Pp. 26-27.

- For various reasons, Soviet bloc countries did not market business interruption, credit, or legal liability insurance. Export insurance was common in Soviet bloc countries, as was multi-peril property loss coverage. Loss and expense ratios were not published.[8]
- There was no Western-style risk management practiced by business firms because there were no experience-rated premiums or other practices associated with insurance-induced loss prevention activities.[9]
- (East) Germany, Poland, and Slovenia had a history of free market private insurance from the pre-World War II period before the Communist governments mandated coverage from a state-operated insurer. Yugoslavia, especially Slovenia, subsequently developed the most sophisticated insurance system among the centrally planned economies.[10]

Thus the Soviet-style model for insurance had little in common with the Western model of actuarially sound, privately owned, competitively sold commercial and personal insurance. As Rogers and others note, however, Western insurance systems often deviate from the competitive model. Common deviations include government-subsidized flood and earthquake insurance, government-provided social insurance and workers' compensation coverage, and government mandated coverage such as compulsory automobile liability.

Transition Economies

A burgeoning library of literature exists describing many aspects of the transition from planned to market-based economies. This section only highlights some of this literature, especially as it relates to private insurance.

Several common and undesirable conditions prevailed when the former planned economies abruptly abandoned their course. Among the problems found in these chaotic times were rapid inflation, absolute and relative economic decline as measured by gross domestic production and consumption, and unstable currencies. In such conditions, borrowing and lending are difficult or impossible, private saving becomes a high-risk decision, and uncertainty abounds. During the initial phase of transition, all financial transactions are difficult, with insurance especially so.

Stabilization Needed to Control Inflation. Because of severe "monetary overhang" (too much paper money in circulation relative to goods available or desired to be purchased), all the economies in transition experienced high inflation rates during the initial stages of transformation. The most immediate economic priority facing

[8]Pp. 26-27.

[9]Pp. 46-47.

[10]Pp. 23, 95, 131.

governments was stabilizing their currencies and controlling inflation. Inflation makes economic transactions more complicated and

In the transitional economies, accounting and economic data, to the extent they were even available, were not meaningful, because double (and even triple digit) inflation made comparisons and calculations extremely difficult to interpret. Moreover, the accounting purposes and requirements in a planned economy were not the same as those found in Western economies; therefore, it is not surprising that the planned economies had to re-develop their accounting systems to meet Western standards.

Insurance operations require accounting data for measuring loss exposures such as property values and income streams and for evaluating investment alternatives. In stable economies, insurance policies are denominated in fixed values, or using formulas based on fixed values, such as are found in "inventory reporting forms." Likewise, insurance premiums, including the many variations of experience-rated premiums, generally are fixed in some way when policies are begun. Inflation makes an already complex transaction even more susceptible to misunderstanding and distrust. Therefore, until a country's currency is stabilized, insurance transactions are not as likely to occur with the same regularity as in a stable economy.

Market Structure Left By Central Planning. To understand the

difficult than they would be in a stable economic environment. Insurance is no exception to this rule.

problems faced by the insurance industries of the former planned economies, one must understand the starting point from which they moved. Again, the following generalizations do not apply exactly in any given country, but they do provide the correct common impression.

OWNERSHIP BY STATE. The general rule in planned economies was that the state owned and controlled the means of production, agricultural property, and all providers of financial services. The state owned the factories, farms, and apartment buildings, and the state provided employment and social insurance. Money prices did not reflect the value of assets, goods, or services in terms of the Western economies. Profits were not the goals motivating managers, rather planners set the goal of meeting production targets, for example, tons of grain or a number of railway cars.

PRODUCTION BIASED TOWARDS HEAVY INDUSTRY AND AGRICULTURE. Unlike Western economies where prices provide the clues needed to invest resources efficiently, planned economies were able to minimize by decree output in the consumer sector and to maximize output in heavy industry and agriculture. Moreover, the size and location of industrial plants might have more to do with political than economic considerations. In Stalin's time especially, establishing efficiently-sized and conveniently located industrial plants was not as important as creating inherent dependencies all across the trading bloc. The result of such policies was that the economies of the socialist countries often were unbalanced in favor of heavy industry, often were inefficient by Western standards, and had underdeveloped financial sectors.

CONSUMERS UNFAMILIAR WITH MARKET ECONOMIES. Another fact facing economies in transition was the relative unfamiliarity of the civilian population with the role of consumers in a market economy. Unemployment, bankruptcy, civil litigation, and advertising, among other benefits of market economies, were unusual. Purchasing financial services, including having the choice to redistribute income over a lifetime through investments or insurance products, was generally not possible. At least during the initial transition, this inexperience in the financial market left a high potential for unfavorable consequences. Additionally, the providers had little incentive to improve their products as relatively uninformed consumers could not easily distinguish between a genuinely superior and an inferior offering. Some commentators even suggest that an established industry serving relatively uninformed consumers has a collective interest in maintaining the status quo, which obviates the need for informative advertising or price competition.

Requirements of a Private Insurance System

Certain conditions must exist in a country before a private insurance system will develop. Some of these conditions are the essential components of any market-based economy:

- Currency accepted as a medium of exchange and a banking system to make payments
- Laws and a legal system to uphold property rights and enforce contracts
- Financial instruments and financial markets
- Cultural acceptance—including a general level of education that provides a sufficient number of capable workers, a work ethic that encourages productive workers, managerial talent to take risks and provide direction, and a minimum level of honesty and trust, so that large organizations can be formed, and contracts honored without undue agency costs.[11]

Insurance transactions depend not only on these essential characteristics of a market economy, but also on several additional factors. A minimum list of these essential conditions would include:

- Special legal provisions and precedent-honoring court decisions forming a comprehensive framework in which insurance transactions can

[11] An excellent discussion of this point is provided by Francis Fukuyama in *Trust: The Social Virtues & The Creation of Prosperity* (New York: The Free Press, 1995).

be completed in confidence.

- Actuarial statistics and historical data allowing accurate loss estimates and reliable rate making.
- A regulatory authority with the power to enforce an insurance code protecting the rights of insurance buyers and sellers.
- Marketing channels capable of efficiently connecting buyers and sellers.
- Managerial expertise in insurance company operations.
- Investment outlets for the vast assets needed to operate private insurance companies.

Obstacles to Establishing Private Insurance Markets

Private insurance probably lags the appearance of other financial services during the transition period.[12] In general, there are significant obstacles to private insurance in most transition economies. To date, no substantial private insurance operations have arisen in these countries, although the seeds of such potential operations have sprouted, sometimes with the assistance of foreign investment, as is the case in Estonia and Hungary. Without further development of the commercial infrastructure, it is unlikely that large-scale private insurance operations comparable to those found in Western economies can prosper in Eastern Europe. Significant features of the economy taken for granted in the West do not yet exist in Eastern Europe.

[12] This discussion is adapted from a previous publication and reproduced by permission of the Publisher from *INTRODUCTION TO RISK MANAGEMENT AND INSURANCE*, 6/E by Mark Dorfman, pp. 116-122.

No Recent History of Private Insurance. In Russia, the Baltic countries, and East Germany (but not in all Eastern European countries), citizens did not own private property, including the houses or apartments in which they lived. Where they did not own property, the citizens had little need for property insurance. In countries, such as Bulgaria, where private ownership of homes was allowed, property insurance was mandatory. Moreover, the Eastern European countries, unlike many western economies, had a comprehensive social safety net, which generally provided universal access to health care, pensions, and survivor benefits. Consequently, private insurance was neither much needed nor purchased.

No Recent History of Risk Management. Government ownership of the means of production, such as factories and railroads, and centrally planned economies were the distinctive features of the Communist economic system. The system's shortcomings in producing consumer goods and fostering technological innovation are well known. In the Communist economic system, factory managers were given output quotas—for example, a specific number of automobiles, tons of steel, or pounds of sausage. The quotas did not specify that the output should minimize the number of worker injuries or the amount of environmental damage. Consequently, worker safety often was of less concern and environmental damage appears greater in Eastern Europe than in Western Europe. Moreover, if property were destroyed, it was the state's property that was lost, and the cost was not borne directly by the factory managers.

Factory managers with bad records for lost property or injured workers faced the risk of jail in some countries. This potential punishment was meant to provide an inducement for safe operations. An expert in game theory or a psychologist might analyze the effects of this risk-punishment environment in light of the results of failing to meet output quotas. This risk management trade-off is likely to produce different results than the financial reward system under which Western risk managers operate.

As Eastern European economies develop private markets and private ownership, it will be interesting to observe whether Western risk management practices are introduced. Private ownership provides a much greater incentive for a higher level of stewardship, and for the purchase of private insurance, than state ownership. In any case, a private insurance system would surely need to implement or encourage loss prevention activities at a much higher level than previously was the case.

Little Respect (Trust) for the Insurance Institution. An insurance contract at its most essential level represents a conditional promise to pay a future benefit. The transaction rests on a foundation of trust. In an unstable society, predicting which institutions will be functioning (as promised) in the next decade is difficult. With no historical experience to provide guidance, it takes great faith for an individual or a factory owner to forgo current consumption to purchase a conditional promise.

Unstable Currencies and Inflation. Insurance can function in an inflationary environment, but not as efficiently as when money

Few Places to Invest Funds Safely in Private Enterprise. To operate safely and economically, insurance companies must invest substantial assets efficiently. Many Eastern European countries are still in the early stages of developing the variety of financial instruments, the financial markets where securities can be traded, and the ancillary services, such as audited financial statements or the evaluations of financial rating firms, needed to facilitate trading in private capital markets. Until efficient, large-scale private capital markets are actively functioning, it is difficult to believe large-scale private insurance operations could begin. The alternative of allowing insurers to invest outside their country may solve one of the insurance problems but deprives a developing economy of one of its most needed assets—capital.

Accounting Standards Are Undeveloped. The Communist economies did require considerable record keeping. Double-entry bookkeeping was used at some factories, but different names were used for profit and net worth.

provides a stable yardstick of value. If the value of property or the economic impact of a premature death cannot be measured easily, or if the measurement changes on a monthly basis, it is difficult to know how much insurance to purchase. Thus, the unstable currencies of many Eastern European countries represent a serious obstacle to a private insurance operation.

Nevertheless, the Communist accounting system did not provide adequate information for internal management or for the disclosure expected in competitive capital markets. Varying degrees of progress in standardized accounting and auditing practices are reported in Eastern Europe, but until generally accepted accounting principles and practices prevail, operating an insurance enterprise will be difficult.

"Foreign" Insurance Regulations, No Local Legal Precedents. Many Eastern European countries reviewed the insurance regulations of the Western European countries when writing their insurance laws. In some cases this practice may prove useful, but until local precedents are set in each country, insurance regulation remains an untested environment, making such issues as maintaining insurer solvency and policing market conduct unresolved questions.

Little Managerial Expertise, Especially in Insurance. Western insurers rely on risk-taking entrepreneurs, on advertising and marketing skills sharpened in a competitive market, and on being able to attract, retain, and motivate employees. There has been little chance for these essential characteristics of Western management to develop in the formerly centrally planned economies. Until they do, insurance companies generally will lack strong managements.

Little Actuarial Data. Western insurers use databases representing life, marine, and fire insurance experience dating back more than 100 years. Data on life expectancy in countries ravaged by the worst war in history, where national boundaries changed frequently, where millions of people "disappeared" for political reasons, or where health problems often went uncategorized, and where other data were kept secret or simply not recorded, would, at the least, provide an insufficient basis for calculating insurance premiums accurately. Thus, premium calculations will require substantial margins for error until sound loss estimates can be made.

Valuations for Former State Enterprises Difficult to Establish. The problems faced when privatizing financial institutions are especially troublesome. Both banks and insurance companies in socialist economies held inadequate reserves. Both had made long-term commitments at inadequate prices: interest rates and premiums, respectively. Both had to continue to function without interruption during the transition period, including the turbulent initial phases. Finally, both banks and insurance companies hold special places in the "financial psychology" of a country, which contributes to popular sentiments to maintain domestic control of both of these financial institutions.

While banks were privatized in the former planned economies, albeit with great difficulty in many cases, privatizing insurance companies was even more difficult. The typical approach used to create private property in previously planned economies, privatizing former state property, would not create a viable insurer, since any predecessor state-operated insurance company would have operated under entirely different objectives and constraints. Moreover, the valuation of the enterprise presents an even more complex problem because of the actuarially complex nature of the insurance transaction. Whereas the amount of a bank's loans and assets can be calculated, the amount of an insurer's liabilities must be estimated, and accurate estimates in the initial transition period would have been very difficult.[13]

Absence of Regulatory Experience. Few, if any, adequately trained regulators will be available to police the developing insurance market. When such individuals are available, they are likely to be tempted by salaries in the private

[13]In practice, both bank loans and insurance company investments (loans) were hard to value except in the frequent case when they were worthless.

sector substantially greater than those offered by the regulatory authority. Thus, insurance regulation, which, in theory at least, makes the market efficient and fair, is likely to trail behind the market's development, regardless of how slow the pace.

Prospects for Insurance in Eastern Europe

Transforming a planned economy into a market-based economy inherently impels and facilitates the development of a private insurance market. On the one hand, creating private property, both personal and commercial, creates a need for insurance. On the other hand, a "realistic" monetary economy creates the ability to pay appropriate premiums and to invest insurers' reserves.

Insurance is an integral part of any market-based economy because the societal benefits far outweigh the costs of the transaction.[14] Fortunately the economies in transition do not need to invent insurance; the model is known. Insurance, or insurance-like, transactions have appeared "spontaneously" since at least the time of the Phoenicians. Thus, it is reasonable to expect that private insurance companies will develop and assume their essential function in the market-based economies that Central and Eastern European countries are striving to build. An additional incentive is their desire to harmonize their economies with the EU.

Accession to the European Union. Absent a cataclysm in Russia, the Central and Eastern European economies will develop a private insurance market because they share the goal of harmonizing their economies with the countries of the EU. Developing their economies so that they can be integrated into the EU implies harmonizing private insurance transactions and regulations with those of the EU.[15] Moreover, the Eastern European countries have available both European and U.S. insurance experience and expertise, and foreign capital to help overcome the daunting obstacles to establishing a functioning private insurance market.

Given sufficient time to develop the essential components of a market-based economy, and for the "invisible hand" of self-interest to work its wonders, the Eastern European countries should develop successful economies including a growing amount of economic assets that will require private insurance transactions.

[14] See Dorfman, pp. 13 - 14.

[15] See K.C. Ennsfellner and M.S. Dorfman, "The Transition to a Single Insurance Market in the European Union," *Risk Management and Insurance Review*, Volume 1, Number 2 (Winter 1998), pp. 35 – 53.

Industry Structure. Industrial organization theory provides insight into the expected path of development of private insurance markets. The usual starting point of an industrial organization study is with an analysis of the industry's structure. Simply put, an industry's *structure* is described by such factors as the number of competitors, their market share, and the ease of entry into the market. Structure, in turn, leads to an industry's *conduct*. Conduct is measured by such things as price and non-price competition and money spent on research and development. Some economists believe that it is conduct that determines market structure, and not the reverse. *Performance*, the third analytical category, refers to efficiency in producing a good or service. A market that is performing efficiently produces goods and services that consumers want more quickly and efficiently than do poorly performing markets. It is not unusual that experts disagree on the sequence of causality in the structure-conduct-performance continuum or on exactly how to measure the conduct or performance segments. Since a complete industrial organization study is beyond the scope of this study, the focus is strictly a description and analysis of market structure. Even with this limited scope, the authors recognize a generalized case is presented, with exceptions to be expected in particular markets or in individual lines of coverage.

Many factors might explain the structure of a given industry at a point in time. Economies of scale, regulatory barriers to entry, predatory behavior by a dominant firm, or historical accident may result in monopoly. An absence of these factors would be consistent with a large number of competitors.

When analyzing the market structure of the insurance industry, perhaps no factor is more important than considering the question of whether or not insurance is a declining cost industry with significant economies of scale.[16] One positive argument for economies of scale is straightforward: insurance premiums (prices) are based on the statistical law of large numbers. In essence this law states that more accurate predictability results from a larger number of observations. Reduced to practical terms, the implication is that a large insurer can predict losses more accurately than a small one. The statement applies to probability and not to severity of loss exposures in the case where exposures are not homogeneous.

Assuming nearly homogeneous exposures, the larger insurer requires a smaller loading for uncertainty than a small insurer, which in turn sets off a dynamic process of lower premiums leading to more insureds, leading to lower premiums. The opposite effect arises with the smaller insurer which, once the dynamic process begins, loses insureds and subsequently must raise the loading for uncertainty,

[16]The entire paper, but especially this portion of the paper, has benefitted from the comments and criticism of Claude Lilly.

causing a further loss of insureds, and a further rise in price. Monopoly or oligopoly can be the end result of such a dynamic process, absent outside interference. The size of the market, as the range between

In practice, outside interference in competitive insurance markets takes many forms, with two “moderating” influences deserving special attention: rating bureaus and reinsurance arrangements. Rating, or data-collection, bureaus allow competitors access to loss data. Such data enables smaller competitors to assess underlying loss potential and developing trends on a basis more equal with larger competitors.[17] Reinsurance arrangements also allow smaller insurers to compete more equally with larger insurers. For example, reinsurance enables smaller primary insurers to accept larger loss exposures than their size otherwise would prudently allow. Also, reinsurers often provide administrative services that smaller insurers otherwise could not practically afford.

Another area where an insurer may enjoy economies of scale is the investment function. But again the moderating influence of financial intermediaries tends to counter the advantage that large insurers have over their smaller competitors.

[17]Some commentators believe the ability of smaller insurers to approximate underlying loss probability and subsequently to develop realistic premiums using computer-modeling techniques mitigates the reliance formerly placed on rating agencies.

Slovenia and the United States suggests, is a crucial factor in determining the number of competitors that actually survive such a dynamic process.

Other, more practical arguments to be presented shortly also favor the conclusion that the insurance industry left to itself would tend toward concentration, especially in small-sized markets. If the market began as a monopoly—as was the case in the planned economies—the arguments might appear superfluous. However, during the initial transition, the state insurance monopoly was often fragmented into smaller competitors, with the former state monopoly given a dominant market share. Thus, the following arguments can be used to support the contention that the former state monopolies will hold the dominant position, or re-acquire monopoly status, until and unless outside forces appear in the market. The arguments to follow assume the domestic insurance markets can be kept closed if the political powers desire. Joining the EU will reduce a national government’s ability to block foreign insurers from the domestic market.

Factors leading to the conclusion that insurance markets will be dominated by a few, or a single, firm include the following:

- The economies of scale inherent in exploiting information and communications technology favor large companies. Large scale operations can spread the costs of hardware, software, maintenance, communications, and personnel over a larger volume of transactions. This fact, in large part, has been used to explain much of the merger and acquisition activity involving financial services firms in the U.S. and Europe.

Some commentators reach an opposite conclusion, believing that insurers may be able to operate efficiently in the United States with one powerful personal-sized computer, almost all administrative functions "outsourced" and perhaps an internet web site as a main marketing channel. The applicability of such a model for Central or Eastern Europe at this point appears doubtful.

- The tendency of consumers to deal with better known (large) insurers who have an established history of paying for losses gives firms with larger advertising budgets or a longer history a significant advantage.
- The tendency of insureds not to switch insurers once a relationship has been established favors dominant firms.
- It is easier for the state to supervise a small number of highly solvent insurers than a larger number of competitors, some of whose solvency may be suspect. Thus, capital requirements favors large insurers. The theory of insurance regulation is another well-developed topic beyond the scope of this paper. However, the following question always is present when a state develops its regulatory scheme: is the consumer's interest best served when regulation encourages a large number of competitors and relies on open competition to produce fair prices? Alternatively, is the consumer's best interest served when regulation results in a small number of insurers with the state substituting its power to control prices for the effect of open competition?

All the assertions suggesting that the optimal structure of the insurance industry might be monopolistic or tightly oligopolistic can be met with counter-arguments. As the technology and cost structures of the industry evolve, the research on economies of scale in insurance is still inconclusive.[18]

Still the possibility that absent outside influences, the structure of the insurance industry tends to be highly concentrated has an intriguing implication for Central and Eastern Europe. A great irony may have occurred in the transition from planned to market economies with respect to industry structure. That is, to create the appearance of competition and a "normal Western-

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[18] J.D. Cummins and M. Weiss, "Measuring Cost Efficiencies in the Property-Liability Insurance Industry," *Journal of Banking and Finance, 17,* pp. 463-81; M.F. Grace and S. Timme, "An Examination of Cost Economies in the US Life Insurance Industry," *The Journal of Risk and Insurance, 59*, pp. 72-115; Economies of Scale in the Insurance Industry, *Sigma 1991*, Swiss Re: Zurich.

appearing" insurance market, the insurance industry may have been forced to change from what might have been an optimal or nearly optimal structure—the state-run monopoly—to a competitive-looking structure that is likely to produce relatively inefficient results. Inefficiency arises in this circumstance because the smaller insurers are more likely to have inadequate management and other resources, are not likely to challenge the dominant firm's pricing, and have less potential to produce any other benefit of open competition. Moreover, the newer and smaller insurers probably have a higher potential for insolvency than the former state monopoly left as a whole. Finally, the former state monopoly left intact, at least in the case of Slovenia, would make a much more substantial competitor after the inevitable entrance of foreign competition when Slovenia joins the EU.

Ideal Requisites for Insurance Transactions. Predicting which lines of insurance would be first to appear in the newly privatized insurance markets of Central and Eastern Europe is made somewhat easier by a review of historic results combined with the theoretical explanations used to describe the ideal insurance transaction.

Historically, transportation insurance has appeared first in what may loosely be described as market economies. The Chinese, Phoenicians, Northern Italians, Dutch, and English all employed insurance-like transactions to safeguard their water-based commerce. The perils of the sea were many, and the opportunity to share losses must have appeared logical, or even essential, to early entrepreneurs. The moving of commerce inland, the appearance of large factories, and the growth of cities all contributed to the appearance of fire—and related perils—insurance in Great Britain, elsewhere in Europe, and in the United States. By the 18th century the development of statistical techniques made it possible to calculate the frequency of losses and therefore to price fire, marine, and life insurance with greater precision.[19]

[19] R.J. Gibbons, *et al.*, *Insurance Perspectives* (Malvern, PA: American Institute for CPCU, 1992), pp. 3-11.

This historical record reveals some significant preconditions needed for insurance to function efficiently. Although in the modern world scientific methods and computer models in some cases might take the place of past loss data, insurers must somehow be able to quantify the risk and to analyze the potential for adverse selection, moral hazard, and correlated risks. Each of the aforementioned lines of insurance have characteristics in common that, reduced to a list, describe the essentials for an ideal insurance transaction:

- many loss exposure units
- accidental losses beyond the insured's control
- definite losses capable of causing economic hardship
- no catastrophic loss potential

Deviations from this list are possible, but the closer an exposure comes to this ideal, the sooner a viable market will evolve. Insurers need information to determine what premiums and type of coverage should be offered. Unless the anticipated demand is sufficiently high for some premium structure to cover the costs of developing and marketing the insurance, an insurance policy for a specific risk will not be offered.

Consequently, as the transforming economies develop their private insurance markets, it is most likely that the dominant lines written will be those presenting many similar exposure units. Typically these lines are motor, transportation, fire, and life insurance.

Life insurance, however, presents a special case in countries where social insurance covers adequately the major exposures of premature death and providing pensions. The more complete the social insurance program, the less opportunity for a private life insurance market to develop and grow. As the countries of Central and Eastern Europe transform their economies, they inevitably reexamine their social insurance systems. Thus the prospects for private insurance mechanisms addressing life, health, and retirement exposures range from nil to monumental, depending on the political decisions reached. In many cases reforms recently enacted or currently under discussion make life, health, and pensions promising growth areas for private insurance.

Insurance in Slovenia

The paper now turns from the theoretical to the actual case of Slovenia. Once part of the Austrian Empire, which collapsed at the end of World War I, Slovenia became a part of the Kingdom of Yugoslavia. After World War II, Slovenia belonged to the Communist Yugoslav Federation.

Slovenia's insurance tradition dates back to the beginning of private insurance companies in Austria in the late 19th century. What is now the largest insurance company in Slovenia, Triglav, was founded in Vienna, Austria, in 1900.

The post-World War II Yugoslav economic system was based on the concept of workers' self-management of the economy. Under this system, increasing workers' income gained priority over capital productivity. This political goal led to a serious economic crisis. Especially after the 1970s, the balance between government income and spending was maintained through heavy borrowing from abroad. "By the end of the 1980s the country's economy was afflicted by skyrocketing inflation, high unemployment, a huge foreign debt, and food shortages."[20] The ensuing economic crisis destabilized the Communist Yugoslav Federation and at the end of 1990 led to its collapse. In 1991 Slovenia left the Federation and became an independent nation.

Since independence, the currency of Slovenia has been the Slovene Tolar, which is commonly abbreviated as SIT.

Today, the Slovene economy is based on the following stated principles:[21]

- Politically, the country is a parliamentary democracy.
- Economically, the country aims to be a market-oriented economy.
- The country claims to be liberal with respect to foreign trade and foreign investment.
- With respect to convertibility of its currency, the country maintains a current account-oriented exchange rate policy.
- Slovenia's goal is incorporation into European and world markets in the near future.
- Privatization of the economy has been largely carried out, and continues to be a stated goal.

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[20] D. Turk, *Slovenia's Transition to a Free Market Economy* (Vienna, 1995), p. 9.

[21] Turk, p. 14.

	1990	1993	1994	1995	1996
Population (in 1000s)	1,998.1	1,990.6	1,988.9	1,987.5	1,991.2
GDP nominal (in SIT)	196.8	1,435.1	1,853.0	2,221.5	2,512.0
Real growth rate of GDP (in %)	-4.7	2.8	6.4	2.0	1.0
Consumer price increases (in %)	551.6	32.9	21.0	13.5	9.9
GDP per capita (US$ at exchange rate)	8,699	6,366	7,233	9,431	9,362
Exchange rate SIT / US$, average	11.32	113.24	128.81	118.52	135.37
Unemployment rate (in %)	5.8	15.4	14.2	14.5	14.4

After Slovenia's declaration of independence, Slovene companies lost most of their assets and free access to almost two thirds of their former Yugoslav markets. Prior to its independence, Slovenia conducted about 70 percent of its "foreign" trade within Yugoslavia. In addition to the trade loss with the other members of the Yugoslavian Federation, Slovenia's trade with other former socialist countries also declined sharply.[22] As a result, Slovenia's gross domestic product (GDP) declined immediately after independence. After 1993 the economy recovered and the GDP achieved positive growth rates. However, real growth has declined since 1994. Consequently, the unemployment rate, which rose significantly in the early 1990s, remains at the relatively high level of about 14 percent. The rate of inflation skyrocketed in 1990 to 551.6 percent but declined in the second half of the 1990s to 9.9 percent in 1996. The table above presents these and other relevant data.

[22] See Turk, p. 17. Also, J. Kaluza (Head of the Slovenian Insurance Association), Interview on May 27, 1998, Ljubljana.

Slovenian Insurance History

Each of the republics of the post-war Communist Yugoslav Federation operated one local insurance company. In Slovenia the company was the Triglav Insurance Company. Because the insurance companies of the other Yugoslav republics did little business in Slovenia, Triglav dominated the Slovene insurance market. All Yugoslav insurance companies were controlled by the state, but unlike other industries, no central plan was established. Therefore, insurance company management could set its own prices. "Most business was conducted in the field of property, fire, cargo and motor liability insurance. The volume of life insurance was relatively small because of the high rate of inflation and the high level of social security benefits provided by the State."[23]

[23]The State Office for Insurance Supervision, Poland (ed.), *Proceedings: The Conference of Insurance Supervisory Authorities from Central and Eastern European Countries* (Warsaw, 1998), p. 250.

During the Communist period the most important underwriting purpose was to protect socially owned capital. Insurance premiums were not based on current or actuarially sound calculations and were believed to be inadequate. Also, many insureds were not able to pay their insurance premiums. In such cases, the insurance companies just wrote off the premiums. Insurers' investments generally were used to finance the debt of industrial companies. However, insurers had no guarantee of repayment when the loans matured. Consequently, Yugoslav insurance companies commonly suffered losses because of both unpaid or inadequate premiums as well as poor investment results.

Particular Problems Starting the Slovene Insurance Market

Immediately after independence, the Slovene insurance regulatory authority remained in Belgrade, the capital of the former Yugoslav Federation. During its first three years, the Slovene insurance market operated under Yugoslav insurance law. Only after three years of independence was Slovenia able to implement local insurance law and regulation. This Slovene legislation was patterned after German and Austrian regulatory law.[24]

After independence, the only Slovene insurance company, Triglav, was a monopoly. To foster competition between insurance companies, Triglav was split into four parts. Three of its regional branch offices became independent stock insurance companies: Adriatic, Tilia, and Maribor. The insurance monopolies of the other Yugoslav republics, which were also transformed into independent insurance companies, held relatively small shares of the Slovene market.

Dividing Triglav into four independent insurers caused immediate problems. First, dividing Triglav's already inadequate reserves between the four insurers weakened each new insurer. To help the industry survive, other industrial companies, mostly clients, invested in the insurance industry, bringing in fresh capital. Still unresolved in the on-going process of re-capitalizing the insurance industry is the exact share of Slovene state ownership in the new insurers. This problem is compounded by the inability to evaluate the reserves accurately. Second, Slovene insurance managers mostly lacked knowledge of how to manage an insurance company in a market driven economy. Spreading the limited management knowledge across four companies again weakened each company.

Law on Insurance Companies

On November 11, 1994, Slovenia adopted the *Law on Insurance Companies.* Like Western insurance codes, this law established rules governing the founding and supervision of insurance companies. For example, the law provides that

[24] *Law on Insurance Companies*, #460-01/93-4/3, Ljubljana, September 28, 1994.

insurers may be founded as a joint-stock or as a mutual company. The law also prescribes standards for technical provisions, solvency levels, and guarantee funds. Insurance accounting standards have also been adopted, based on the EU directive.

Slovenia imposed strict entrance barriers on foreign capital to protect its domestic insurance industry. In the primary insurance market, the law forbids joint-stock insurers exclusively financed with foreign capital. Furthermore, a foreign person or legal entity may become a shareholder in a domestic insurance company only with the consent of the supervisory authority. In the reinsurance market, a joint stock company in which foreign capital has a majority or controlling share, may not handle domestic reinsurance.[25]

[25] Article 22, *Law on Insurance Companies.*

Because Slovenia is among the next accession candidates to the European Union, its insurance law must be amended to conform to the provisions of the Third Generation of Insurance Directives of the EU. In general, the EU proposes that the Slovene government should promote a higher share of foreign investment, which will significantly affect the structure of the market.[26]

The Insurance Supervisory Authority of the Republic of Slovenia, an independent authority within the Ministry of Finance, was established in 1995. Its most serious difficulty is its shortage of administrators with actuarial and financial experience. According to its head, Juri Gorisek, the supervisory authority cannot compete with the pay scales private insurance companies are able to offer these experts.[27] In 1998, the supervisory authority of Slovenia had seven employees, and of these, four were still studying part-time. Gorisek stated in an interview, "there are big problems to be solved in the field of the restructuring of the market, recapitalization of the companies, completing the privatization process and other needed activities. The present number of the staff is not covering all these needs."[28]

Inadequate supervision is typical not only in the Slovene insurance market, but also in many other markets in former socialist economies. In a survey conducted by the OECD, about half of the participating supervisory authorities answered that they do not have adequate technical knowledge to monitor complex reinsurance transactions.[29] Clearly, this situation could lead to problems in the performance of the insurance companies and in their insureds' security.

The Prevailing Slovene Insurance Market

In 1998, 16 insurance companies operated in the Slovene market.[30] Two are reinsurers, and two are social insurance companies. One company, which is 90 percent owned by the state of Slovenia, provides export credit insurance coverage. The social insurance companies, which offer compulsory and voluntary pension and disability insurance and compulsory and voluntary health

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[26]See Ennsfellner and Dorfman, 1998. Also, http://europa.eu.int/comm/dg1a/enlarge/access_partnership/ slovenia_ap_annex.htm.

[27]J. Gorisek (Head of the Insurance Supervisory Authority of the Republic of Slovenia), Interview on May 27,1998, Ljubljana.

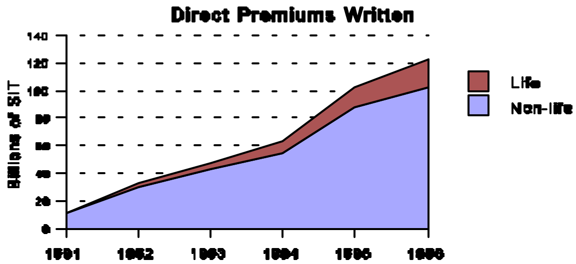
[28]Insurance Supervisory Authority of the Republic of Slovenia (ed), Questionnaire for the IAIS Meeting in Warsaw, Ljubljana, 1997, p. 14 (in following reference referred to as "Questionnaire").

[29]See OECD (ed.): *The Development of Reinsurance Markets in Economies in Transition* (Paris, 1997), p. 12.

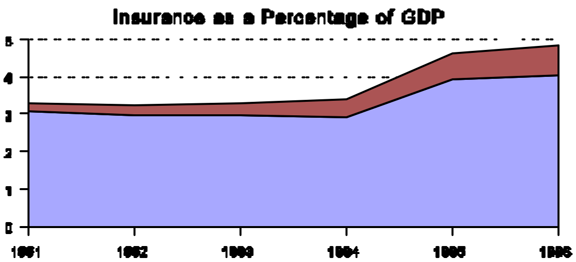
[30]See Slovenian Insurance Association (ed.), *Statistical Insurance Bulletin 1997* (Ljubljana, 1997), p. 13. (Note: If not cited otherwise, the figures describing the Slovene insurance market are taken from this source).

insurance contracts, are organized as public institutes. Therefore, they cannot be counted as part of the private insurance market.[31]

[31]Following the Slovenian Insurance Association statistics, the tables presented here count the social insurance fund as life insurance.



Unlike other industries in Slovenia, the privatization of insurance companies is incomplete. According to the head of the supervisory authority, 78 percent of

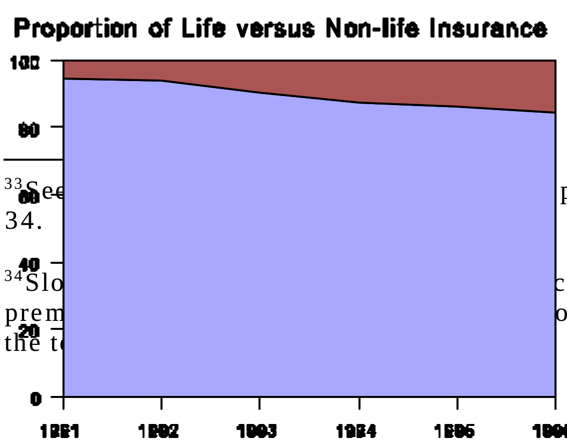


the Triglav insurance company, 56 percent of the Maribor insurance company, and 3 percent of Adriatic insurance company is public capital.[32] In addition, the largest reinsurance company, Sava, is largely publicly owned. Sava controls 94.3 percent of the reinsurance market.

The gross insurance premiums written in primary insurance in 1996 amounted to SIT 122 billion, about 4.8 percent of the GDP. Although impressive for an emerging market, the Slovene insurance industry's premium to GDP ratio is well below the EU average, which is 7.2 percent.[33] Slovene insurers wrote 102 billion SIT in non-life insurance premiums (about 4 percent of the GDP) and about 20 billion SIT in life insurance premiums (0.8 percent).[34] Gross written insurance premium in the reinsurance market was about 10 billion SIT. Annual per capita expenditure on insurance rose from SIT 5,754 in 1991 to 61,178 in 1996.

The historical data show the increasing importance of both the non-life and the life insurance market in Slovenia. The non-life insurance written premiums grew from about 10 billion SIT in 1991 to about 102 billion SIT in 1996. While some of the premium increase stemmed from inflation, much was real growth: non-life insurance expenditures increased from about 3 to about 4 percent of the GDP.

The life insurance market started from 0.8 billion SIT (0.2 percent of the GDP) in 1991 and rose to 20 billion SIT (0.8 percent in 1996). During the same time, the share of life insurance rose from 5.6 percent to 15.3 percent of total written premiums. Within the life insurance industry, combined death and endowment insurance accounts for about 63 percent of the gross written



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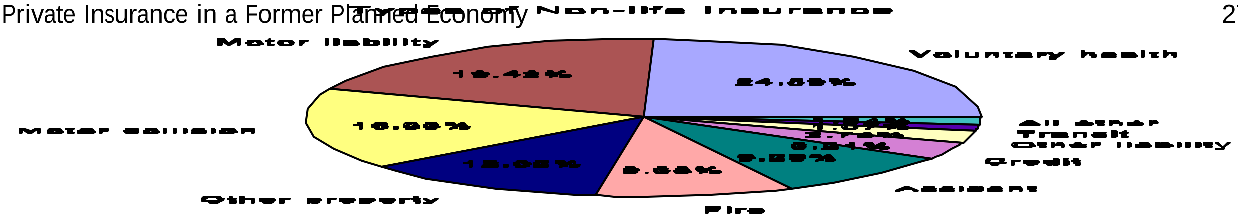
[32]The share of public capital in the insurance industry cannot be determined exactly. Therefore, it is referred to as "unknown capital." These figures, however, are taken from an internal paper of the Supervisory Authority of the Republic Slovenia.

[33]Se[illegible] p. 34.

[34]Slo[illegible] ce prem[illegible] of the t[illegible]



premium, followed by accident coverage (23 percent), and voluntary pension insurance (12 percent).

Compared to the EU ratio of life to non-life insurance, life insurance has a modest share in Slovenia. This relationship most likely can be explained by the relatively small GDP per capita in Slovenia compared to the EU countries. In the EU, non-life insurance accounts for 46.7 percent while life insurance amounts to 53.3 percent of premiums. The dominance of life insurance over non-life insurance in the EU rests on the considerable need for social protection and the gradual shift from state-provided to private insurance.

Importance of Private Health Insurance. Given that the social security system in Slovenia includes obligatory health insurance coverage, and given the relatively low GDP per capita of about $ 9,360, the dominance of the voluntary health insurance lines is surprising.[35] Voluntary health insurance accounts for about 0.85 percent of the GDP, while in other former planned economies the average is under 0.4 percent.[36]

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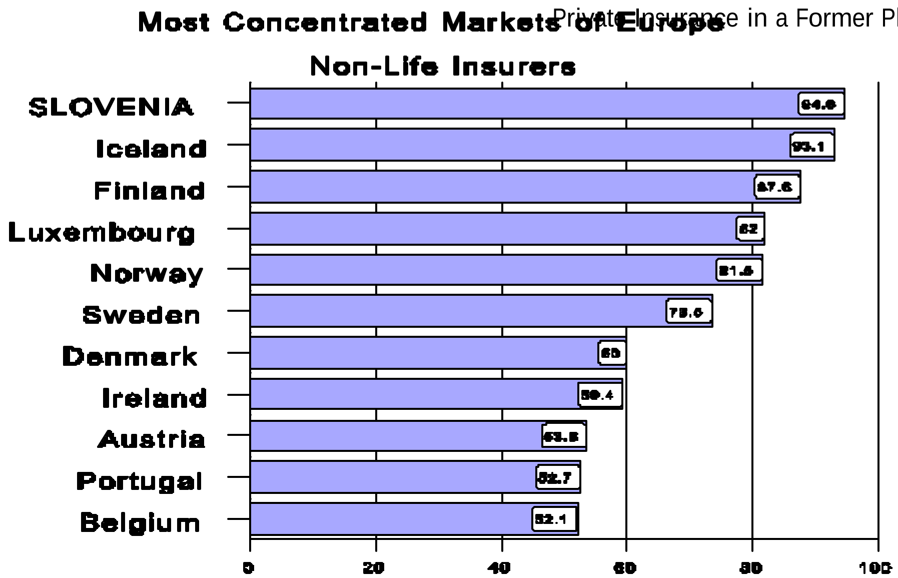
[35] See The Vienna Institute for Comparative Economic Studies (ed.), *Countries in Transition 1997* (Vienna, 1997), p. 92.

[36] See *Sigma 1/1998*, Swiss Re: Zurich, 1998, p. 7.



The unusually large amount of private health insurance sales appears to have two explanations.[37] First, the state-operated program has significant limitations, creating a need for private coverage. Second, private health insurance has been underpriced. Both the Health Insurance Institute of Slovenia, which has a 90 percent market share, and Adriatic Insurance Company, which writes the remaining ten percent of the coverage, have had consistent underwriting losses on this coverage. Before a scheduled change in the insurance code in 1999, the pricing of supplemental health insurance did not discriminate on the basis of age, so that a 50-year-old person paid the same premium as a younger person. Thus, the need for coverage combined with inadequate rates are the most likely explanations for the popularity of private health insurance.

Concentration In the Insurance Market. In 1990, Triglav, the former Slovenian-state insurance monopoly, controlled 95.5 percent of the non-life insurance market and 98 percent of the life insurance market. The market share of Triglav, after its split into four companies, declined significantly to 47.2 percent in the non-life insurance market and to 33.9 percent in the life insurance market. However, as in many other former socialist economies,[38] the successor companies of the former state insurance monopoly remain the dominant insurance companies in Slovenia. In 1998, Triglav, Maribor, Adriatic, and Tilia, the four new insurers arising from the original state monopoly, control 72.1 percent of the non-life insurance market and 75.2 percent of the life insurance business. The chart shown above allows comparison of this result with other European insurance markets.

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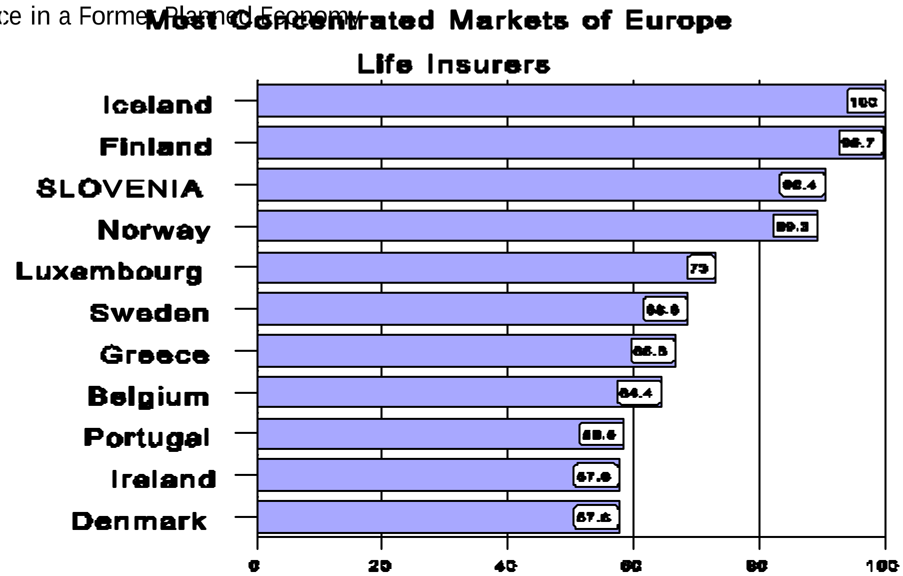
[37] Interview with F. Skufca, August 24, 1998.

[38] See K.C. Ennsfellner, "Process of Transformation in the European Insurance Industry – A Challenge for Multinational Insurance Companies," in L.C. Bock, ed., *Creating Success in a Global Marketplace*, Seminar Proceedings Volume 1 (New York, 1998), pp. 192 –214, here p. 205.

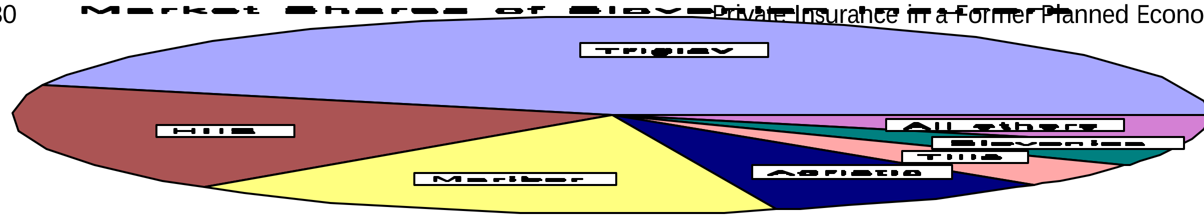


In life insurance, the concentration ratio of the largest three Slovenian life insurance companies is 79.5 percent, while the largest five life insurers cover 90.4 percent of the market. Compared to the other European countries, the concentration ratio of the Slovene life insurance market is relatively high. Presumably, this high concentration is a consequence of the early development stage of the Slovene life insurance market.

In 1998, Triglav still controls 45 percent of the entire Slovene insurance market. The concentration ratio of the largest three insurance companies is 79.7 percent, while the largest five insurance companies control 91.4 percent of the insurance industry. Four of the five largest companies are successors of the former state insurance monopoly. The second largest insurer is the Health Insurance Institute, which is responsible for social insurance related tasks.

The dominance of these five insurance companies can be explained in large part by their retaining previously existing customers. Insurance is built on trust in the security of the insurer. Thus, the success of an insurance company largely depends on how quickly it can build up a trustworthy and positive image. The market share of each of the Slovenian primary insurance companies is shown in the chart on the next page.

Because the Slovene economy is relatively small, the largest insurance companies are small compared to the largest insurance companies of the EU. If cost efficiency is a function of



size, even the largest insurance companies in Slovenia seem to be too small to be viable or efficient compared to insurers in the EU. For comparison, in terms of gross written premium Triglav in 1996 was only about 5 percent of the size of the largest non-life insurer in Europe, the German insurer Allianz. However, the largest insurance companies of Greece and Iceland are smaller than Triglav.

Market Entry. From January 1991 until June 1998 three new insurance companies were founded in Slovenia. Austrian insurers control two, and Slovene industrial companies control one.

An interesting case study is the Generali SKB Insurance Company, which was registered in 1997. This "new" insurer is the successor company of the Ljubljanska Insurance Company, the branch of the Serb Republic insurance monopoly that had operated in Slovenia. Ljubljanska conducted business until December 1995 when it transferred its entire portfolio to another insurance company. The Generali group required this turnover because it wanted to start its business in Slovenia without the historic portfolio during the Communist years. In addition to eliminating the historic bloc of insurance, all the employees of Ljubljanska were released, allowing Generali to start with market-trained employees.[39]

To date almost no evidence exists of increased competition in the non-life business arising from foreign insurers. Perhaps the first success will be Generali, which since March 1997 has been competing with Triglav for industrial clients.[40] In life insurance, on the other hand, two foreign controlled companies gained a market share of about 11 percent.

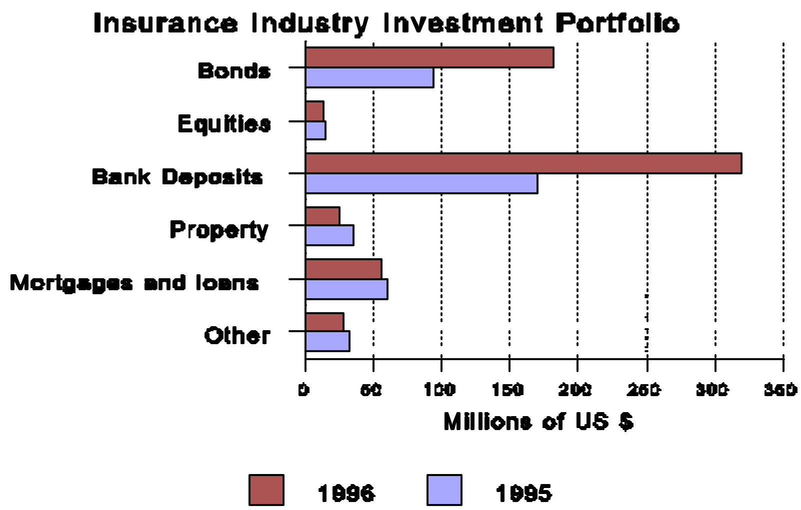
Marketing Channels. Primary insurance companies in Slovenia distribute their products through employees, exclusive agents and brokers, but information on the market shares of these distribution channels is not yet available.

[39]F. Lucchesi-Palli (General Secretary of the EA-Generali Insurance Group, Vienna), Interview on February 26, 1998, Vienna.

[40]G. Gruber (Board member of the EA-Generali Insurance Group, Vienna), Interview on May 28, 1998, Portoroz.

Investment. In the Communist Yugoslav Federation there were no insurance investment regulations because, as noted, insurance investments represented one branch of the state investing in another branch. No regulation of an insurance company's investments existed until 1994, even though investment success is critical to the financial soundness of insurance companies.[41] With respect to pre-independence investments, over 40 percent of the total (about SIT 17.5 billions) had to be written off, "leaving Slovenian insurance companies, especially middle-size companies, with inadequate capital."[42] Unfortunately, many insurance assets still are invested in industrial companies in the process of privatization. In many cases the insurers' investment has little market value. Thus, capital adequacy, from an actuarial standpoint, will continue to be a problem for the immediate future.

The Slovenian stock exchange is volatile, and the quality of listed securities is below those traded on EU stock exchanges. The highly speculative element in the Slovene stock exchange explains why bank deposits constitute about 51 percent of the total insurance industry investment. Government bonds account for another 29 percent of insurer's investments. The high share of bank deposits means a relatively low overall investment profitability for Slovene insurance companies.[43] However, because Slovene banks are secure and the bond issuers are believed capable of repayment, 80 percent of the investments of the insurance industry are evaluated as secure. The above chart shows the investments of the Slovenian insurance industry.



[41]In the more than 130 years of its insurance history, Slovenia—with the exception of a few years before World War II—did not have investment regulations.

[42]J. Gorisek, "Investment" (Internal paper of the Insurance Supervisory Authority of the Republic of Slovenia), Ljubljana, 1998, p. 2.

[43]According to F. Skufca (Board member of Triglav insurance company), there are no aggregate data available on the profitability of the investments of the insurance industry. Interview on May 27, 1998, Ljubljana.

New financial regulations or amendments to existing regulations for financial transactions (banking, securities, and foreign exchange laws) are expected to be implemented in 1998 and 1999. Liberalizing the strict investment regulations to permit insurance companies to invest in first class EU securities should allow Slovene insurers to increase the quality and return on their investment portfolios.

As in many other insurance industries in transition from a command to a market economy, the Slovene insurance industry suffers from under-capitalization. According to the supervisory authority, the Slovene insurance industry lacks about SIT 5.2 billion to comply with the insurance solvency margin directives of the EU.[44] Capital inadequacy has caused five insurance companies to be put under a recapitalization recovery program between 1994 and 1996. In addition to the unattractive investment environment, three other problems also contributed to the capital deficiencies of the companies placed under rehabilitation: excessive growth, lack of insurance management expertise, and not following the Slovenian insurance code.[45]

Trust. Trust in Triglav, the former monopoly insurer, was high when Slovenia became independent. After Triglav was split into four parts, trust in the new insurers rose while the image of Triglav declined. However, as the problems of the new insurance companies became apparent to their customers, trust in Triglav now is rising again. Overall, despite at least one instance of large-scale consumer deception by a foreign insurer, and the failure of about one-third of the new insurers, according to the head of the Slovenian regulatory authority, "the trust of customers in the Slovene insurance industry never has been as strong as now."[46]

Consumer trust in the insurance industry can be seen in the steady increase in premium per capita. Slovenia's rising standard of living is an important reason for the rising demand for insurance. Moreover, the implementation of modern risk management techniques and the imposition of insurance requirements by trade partners also are influential factors affecting the buying behavior of commercial lines clients.[47]

The Future Of The Slovene Insurance Market

Slovenia has applied for membership in the European Union. The EU in turn has recommended that Slovenia "insure the continuity

[44] *Law on Insurance Companies*, Articles 71 and 72.

[45] See Insurance Supervisory Authority of the Republic of Slovenia (ed.), (Questionnaire), p. 15.

[46] J. Gorisek, Interview.

[47] O. Ludozianovich (Manager of Jauch & Hübener Slovenia), Interview on May 30, 1998, Vienna.

and reinforcement of progress in liberalization, and privatization, in order to bring about long-term convergence with the EU."[48] With respect to insurance, the Slovene law regulating the insurance industry must be made consistent with the provisions of the Third Generation of Insurance Directives.[49] Given Slovenia's intention to join the EU and the need to modify its commercial and insurance codes to conform to EU requirements, the following developments in the Slovene insurance market can be expected:

THE COMPLETION OF THE PRIVATIZATION OF SLOVENIAN INSURANCE COMPANIES. In the near future, the state's share of Triglav will be divested to private entities.

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[48]http://europa.eu.int/comm/dg1a/enlarge/access_partnership/slovenia_ap_annex.htm.

[49]For the principles of the European single insurance market see Ennsfellner and Dorfman, pp. 36, 50.

LIBERALIZATION OF INVESTMENT REGULATION FOR INSURANCE COMPANIES. Specifically, Slovenian insurers must be allowed to invest in EU capital markets.

LIBERALIZATION OF THE MOTOR LIABILITY INSURANCE MARKET. Current law requires prior approval of motor liability policies using rates set by the government. This arrangement is a clear infringement of the EU Insurance Directives.

INCREASE OF FOREIGN CAPITAL IN SLOVENIAN INSURERS. Currently, only three Slovene insurance companies are controlled by foreign capital. Accession to the EU might attract foreign capital to the Slovene insurance market; however, the relatively small size of the Slovene insurance market must be taken into account. With a population of about 2 million people, the Slovene insurance market has fewer potential customers than regional or even local offices of large European insurance companies. Therefore, the Slovene insurance market might be too small for EU insurers to start a subsidiary in this market. It is possible that EU insurers operating in the Slovene insurance market in the future will be providing services primarily to their international clients operating in Slovenia.[50]

INCREASE IN COMPETITION AND PRODUCT INNOVATION. The expected liberalization of Slovenian insurance regulation and the expected entrance of foreign insurance companies should lead to an increase in competition. Any increase in competition should not only put premium rates and profit margins under pressure, but should also lead to an increase in product innovations on the Slovene insurance market.

INCREASING IMPORTANCE OF COST-CUTTING PROGRAMS. Cost cutting programs are essential if domestic insurers are to be able to offer insurance at EU-competitive rates.

INCREASE IN MARKET VOLATILITY. The number of new market entrants and the number of insolvencies both can be expected to increase. This result also is expected for the EU.

Several factors argue for the merger or cooperation of Slovenian insurance companies. The increase in competition from EU insurers, the number of undercapitalized Slovenian insurance companies, and the relatively small size of the Slovene insurance companies all create pressure to form domestic insurance groups or otherwise intensify cooperation. Another possibility is for Slovenian insurance companies to affiliate with international insurance groups. An obstacle to this alternative is that some Slovenian insurance companies still have historic insurance pools suffering from bad risk selection, still

[50] The prerequisite is that the three generations of Insurance Directives of the European Union will be fully implemented on the Slovene insurance market. Despite the Slovene government's preparing to become a member of the European Union as early as 2002, it can be expected that there will be a limited transition period to protect the Slovene industries, including the insurance industry, to help them adjust to greater competition.

charge inadequate rates, still maintain inadequate reserves, and still have managers and employees unfamiliar with a competitive insurance environment. These undesirable characteristics could lower the price for such insurance companies, making them a takeover target for international insurers.

Marketing Intermediaries. It can be expected that the role of insurance intermediaries will increase in importance with increased competition. Because there are no standardized insurance policies in the EU insurance market, less market transparency exists for personal lines customers than in the United States, for example. Thus, intermediaries will be useful guides through the increasingly complex market. This role will be especially important because Slovenian consumers, both of commercial and personal lines, have had little experience shopping for the most efficient insurance arrangements in competitive markets.

Cost cutting programs allowing Slovene insurers to offer products at more competitive rates also could lead to a decrease in the importance of employee-agents. This trend already can be observed in some EU insurance markets. Some EU insurance managers believe agents operating their own agency but tied to one insurer are a more efficient distribution channel than employee-agents.

In 1998, there were just two international brokers in Slovenia, each of which was a subsidiary of an Austrian-based brokerage. As the commercial market continues to develop, it is likely that other international brokers will become active in Slovenia, and the range of services they offer to commercial clients will increase as they compete for business.

Insurance Supervision. The liberalization of the Slovene insurance market should bring about greater product variety as insurers engage in product development. As noted, an increase in product variety might cause problems for individual customers who generally are not experienced in dealing in a highly competitive insurance market. Protecting inexperienced consumers creates a need for increased regulatory vigilance.

The Slovenian insurance regulatory authority also will experience increased burdens when the current insurance code is made consistent with the EU mandates. The EU requires the Slovene supervisory authority to concentrate on insurer solvency, on licensing insurance companies, and on participation in the further development of EU insurance regulation. If Slovene insurance companies write business in other EU countries, the responsibility of the Slovene supervisory authority will become international. The principle of home country control must be enacted before Slovenia joins the EU. This rule requires the Slovene regulatory authority to supervise activities of Slovene insurers throughout the EU. Thus, joining the EU inevitably will lead to an intensification of international contact for the Slovene supervisory authority.

Conclusions

Compared to the reported problems of other former Soviet-style economies transforming themselves into market-based economies, the Slovenians have been successful in avoiding many pitfalls. In fact, the Slovenians are far advanced in the process. This conclusion certainly holds true with respect to the transformation of the Slovenian insurance market. However, despite significant initial progress, several steps remain before the process is complete.

The authors believe that the transition with respect to insurance will not be over until the following conditions are met:

- Property, including insurance companies, is in private hands. Evaluating and privatizing the remaining government stake in Triglav and its partitions is imperative.
- Insurance transactions are conducted at prices reflecting the fair market value of property and of human life contingencies.
- Insurance transactions are conducted on an actuarially sound basis, including sound premium calculations and adequate reserves and concomitant assets.
- Insurance regulation is adequate to the task. Developing a strong, adequately trained and compensated staff of insurance regulators, independent of both political and insurer pressures is an urgent priority.
- Slovenia's insurance code conforms to the EU Insurance Directives.

Slovenia has already come a long way towards meeting these exacting requirements. In fact, the authors were surprised and greatly impressed with the difficult work that has already been accomplished by Slovenia's insurance industry. In terms of the essential conditions for a private insurance market to function, the following comments seem fair.

By mid-1998 Slovenia had over six years of experience with a private insurance market. Personal lines consumers of health, life, and automobile insurance have already moved Slovenia ahead of some EU members in per capita insurance consumption. Commercial lines consumers are now seeing the first possibility of international insurance transactions as Generali has begun to provide an alternative to domestic insurers.

Slovenia now has a modern insurance code patterned after the Austria-German model.

Public trust in the insurance institution is at an all time high according to the head of the supervisory authority. The quantity of voluntary insurance purchased substantiates this belief.

The Slovene currency is stable, the economy is no longer in the post-Soviet decline, and inflation appears to be under control.

Some domestic outlets for quality investments are available, but the

Management expertise is increasingly available. Over 300 managers attended the 1998 congress of the Slovene insurance industry, which the authors observed in person. This Slovenian insurance managers projected an optimistic and positive view of the Slovenian insurance market.

The positive outlook of these market participants, as well as of the regulators, provides grounds for expecting much further growth of the Slovene insurance market. A considerable reason for optimism is the great progress that has already been made in such a short time.

great proportion of investments is still held as banking deposits or in government bonds.

Accounting standards are established, and accounting data appear increasingly reliable.

Actuarial data from Austria, Germany, and other EU countries are available and appear useful in the Slovenian market.

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Statistical Appendix

Direct Premiums Written in Slovenia (in 1000 SIT)

	Life insurance		*Non-life insurance*		*Total*
Year	*Premiums*	*Growth**	*Premiums*	*Growth**	*Premiums*
1991	779,644	---	10,739,155	---	11,518,799
1992	2,456,917	215	30,445,061	184	32,901,978
1993	5,014,678	104	42,400,200	39	47,414,878
1994	9,031,034	80	53,931,371	27	62,962,405
1995	15,151,319	68	87,222,388	62	102,373,707
1996	20,127,028	32	101,688,385	17	121,815,413

*Premium growth (in percent) unadjusted for the inflation rate

Source: Slovenian Insurance Association (ed.): *Statistical Insurance Bulletin 1997* (Ljubljana,1997), p. 35.

Annual Expenditure on Insurance per Capita

Year	*Total premiums (in 1000 SIT)*	*As % of GDP*	*Growth**	*Expenditure per capita (SIT)*
1991	11,518,799	3.30	---	5,754
1992	32,901,978	3.23	186	16,485
1993	47,414,878	3.30	44	23,819
1994	62,962,405	3.41	33	31,658
1995	102,373,707	4.65	63	51,509
1996	121,815,413	4.85	19	61,178

*Premium growth (in percent) unadjusted for the inflation rate

Source: Slovenian Insurance Association (ed.): *Statistical Insurance Bulletin 1997* (Ljubljana,1997), pp. 35 and 41.

1996 Gross Insurance Premiums Written by Line
(in 1000 SIT)

Life		20,127,028
Non-life:		
Voluntary health, sickness	25,005,103	
Motor vehicle liability	19,751,749	
Land motor vehicles collision	17,216,329	
Other damage to property	12,225,391	
Fire and natural forces	9,542,457	
Accident	9,446,847	
Credit	3,265,552	
Other liability	2,782,674	
Goods in transit	1,087,171	
All other	1,365,112	
Non-life total		101,688,385
Total		**121,815,413**

Source: Slovenian Insurance Association (ed.): *Statistical Insurance Bulletin 1997* (Ljubljana,1997), p. 39.