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INSURANCE IN TRANSITION ECONOMIES: POLAND, CZECH REPUBLIC, AND HUNGARY

Mark S. Dorfman
Holder of the Endowed Professorship in Insurance
The University of North Carolina at Charlotte
Charlotte, North Carolina / USA

and

Karl C. Ennsfellner
Assistant Professor
Institut für Versicherungswirtschaft
Wirtschaftsuniversität Wien
Wien, Austria

INTERNATIONAL INSURANCE FOUNDATION
1233 Twentieth Street, NW
Washington, DC 20036

About the Authors

Mark S. Dorfman is *Holder of the Endowed Professorship in Insurance* at The University of North Carolina at Charlotte. A native of Chicago, he attended Chicago public schools and Northwestern University. He received his masters and Ph.D. degrees from the University of Illinois. Dr. Dorfman has taught insurance for nearly thirty years at the University of Illinois, Miami University (Ohio), and the University of Arkansas at Little Rock. He has also served as a visiting professor at the Wirtschaftsuniversität Wien in Vienna, Austria. He is past President of the American Risk and Insurance Association and has served on the boards of directors and editorial boards of several organizations. His *Introduction to Risk and Insurance*, now in its 6th edition, is one of the mostly widely read insurance textbooks in the world.

Karl C. Ennsfellner is Assistant Professor at the Institut für Versicherungswirtschaft of the Wirtschaftsuniversität Wien in Vienna, where he earned his Ph.D. He has also been a visiting lecturer at the University of Arkansas at Little Rock. Working as a quality manager for an Austrian insurance company, Dr. Ennsfellner implemented the first quality management system according to ISO 9001 for an entire insurance company in Europe. In addition to quality management, his major interests are insurance management and European insurance markets. He has published this research in several journals, including the *Risk Management and Insurance Review* and the *Singapore International Insurance & Actuarial Journal*.

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Introduction

The transition from central planning to market economies has been occurring for over a decade in Central and Eastern Europe. Currently more than a dozen countries are in various stages of transforming state-owned insurance monopolies to private insurance markets comparable to those found in the U.S. and Western Europe. Several of these countries, including Poland, the Czech Republic, Hungary, and Slovenia are likely to join the European Union within the foreseeable future. Therefore, the authors focused their research on these countries, which by most measures have made significant progress in their transition. Because insurance is a critical part of the financial services market, it is important for observers to understand the development of the insurance market. To date, however, the transition of the insurance market is less frequently examined in the literature than the banking system, or the development of private capital markets in transition economies.[1]

Regarding the importance of the insurance market in Eastern Europe, one learned observer notes:

> Western European insurers have shown great interest in Eastern Europe, an area that requires a long-term commitment. Real premium volume declined broadly in Eastern Europe between 1989 and 1992 because of a risky environment and massive structural adjustment. Former state monopolies still have life market shares of over 90 percent in some countries. Yet, the area holds considerable promise if inflation subsides and if market reforms are fully implemented.[2]

This paper rests on three foundations. First, the authors analyzed published data primarily provided by the insurance supervisor's offices of the various Eastern European countries. In general these data, especially for the early years of the transformation, are not robust.

A second source of data and information was the Financial Sector Assessment Program, a joint International Monetary Fund (IMF) and World Bank effort introduced in May 1999 to increase the effectiveness of efforts to promote the soundness of financial systems. Assessments seek to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses. The Financial System Stability Assessment reports include Reports on Observance of Standards and Codes, which summarize the extent to which countries observe certain internationally recognized standards. These reports focus on the areas of direct operational concern to the IMF, primarily the banking system, but they also examine the non-bank financial sector, often including the insurance sector. Among the recent assessments were the February 2001 report on Poland, the July 2001 report on the Czech Republic, and the June 2002 report on Hungary. All three

[1] For a good summary of transition issues for other aspects of the financial sector, see *Designing Financial Systems in Transition Economies: Strategies for Reform in Central and Eastern Europe,* edited by Anna Meyendorff and Anjan V. Thakor (Cambridge, MA: The MIT Press, 2002). Also see *Financial Sector Reform and Privatization in Transition Economies*, edited by J. Doukas, V. Murinde, and C. Wihlborg (New York: Elsevier Science, 1998).

[2] Harold D. Skipper, Jr., *International Risk and Insurance* (Burr Ridge, IL: Irwin/McGraw-Hill, 1998), p. 520.

countries opted to make the reports public, thus sending a signal to global financial markets about their progress toward internationally recognized standards of financial sector supervision. Summary assessments from these reports, which support the authors' findings, appear later in this paper.

In addition to these written documents, the authors conducted over two dozen interviews with participants in the transformation process. Many of the key decision makers were interviewed, including each of the insurance supervisors of Poland, the Czech Republic, Hungary, and Slovenia. Other people interviewed included the managers of trade associations, the managers of the (former) state insurance monopolies, several new insurance entrepreneurs, and other people with valuable experience in the transformation process. The anecdotal evidence found throughout this report provides relevant insight to accompany the data that are presented.

The authors' interviews were conducted over several years using prepared standard scripts. Using the same script to focus the interviews facilitated a comparison of responses. Much of the authors' insight into the transformation process came from these interviews. Many of the ideas appearing in this report, even though direct quotations are used sparingly, arose from the authors' interviews. Upon reflection after all the interviews were completed, a pattern emerged. The authors believe the transformation process can be better understood by analyzing the tradeoffs faced by the participants and the decisions they made when trying to solve the dilemmas confronting them. The tradeoffs were sometimes of a far-reaching nature, as when an insurance supervisor had to choose either a faster or slower pace of privatizing the state insurance monopoly. Generally, the tradeoffs facing new insurance entrepreneurs were narrower than those facing insurance supervisors, but were equally interesting and challenging, as when a new insurance entrepreneur had to consider the unknown opportunity costs to determine which classes of insurance to offer. Analyzing this problem solving process will be useful to other countries facing the task of establishing or growing private insurance markets. By describing the problems facing people in these particular economies, this paper should help principals in other countries evaluate their alternative courses of action, making the value of this work greater than it would be if its sole purpose were historical documentation.

The Cultural Legacy of Central Planning

To understand the problems faced in establishing private insurance markets in the former centrally planned economies, one must understand the starting point from which they moved. The authors have already described the economic legacy of central planning as it affected the insurance market.[3] This paper describes a second critically important part of the central planning legacy, culture, because culture plays a very important role in the process of privatizing the insurance marketplace.

It is difficult to understand the role insurance plays in society without an appreciation of the cultural factors that surround this relatively complex transaction. While the authors' background and expertise do not allow them to provide the weighty coverage this topic deserves, they do not want their inadequacies to cause this most important issue to be omitted from this report. The following material is meant to provide a starting point for the further examination.

Trust

Insurance is a transaction based on trust.[4] As Fukuyama explains it, trust has definite cultural roots.[5] Some societies, including the British and the American, have a long history of making, enforcing, and relying on contracts when transacting business. Other societies tend to rely on family relationships, or time-honored relationships, when transacting business. Western insurance transactions have a contract at their core, and thus societies without a history of relying on contracts are less likely to adopt an "insurance-oriented culture" than are cultures relying on different approaches to completing transactions. The central planning system was not based on contracts or contract law, thus the concept of the insurance contract was yet another innovation associated with the transition to private markets. Initially, automobile and some other types of insurance were provided without written contracts being distributed to insureds, and this system worked because people all assumed the provisions of the "contract" were generally known and accepted. However, a system for insurance contract conflict resolution, a prominent feature of the Western insurance market, was not available during the initial transformation process, and the authors believe this was a serious impediment to societal acceptance of the insurance transaction. Establishing a commercial legal system based on acceptable precedents takes years. An effective legal system is needed in many venues of

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[3]See Mark S. Dorfman and Karl C. Ennsfellner, "The Transition from Central Planning to Market-based Insurance Transactions: A Case Study of Poland, the Czech Republic and Hungary," *Journal of Insurance Regulation* (Winter 2001). Mark S. Dorfman and Karl C. Ennsfellner, *The Coming of Private Insurance to A Former Planned Economy: The Case of Slovenia* (Washington, DC, International Insurance Foundation, 1998).

[4]Taylor-Gooby, Peter, ed., *Risk, Trust and Welfare*, (New York: Palgrave, 2000).

[5]Francis Fukuyama, *Trust* (New York: The Free Press, 1995).

commercial activity, but it is especially needed for a private insurance market, because, in some sense insurance is just one branch of contract law. Absent cultural acceptance of contracts, an insurance market is not likely to develop. And the authors believe the speed of the development of a private insurance market is directly related to the speed of development of societal trust in the commercial legal system.

The Impact of Psychological and Sociological Patterns Remaining From "Former Times"

The authors, as a matter of interest and curiosity, spoke to many people about their experiences in "former times."[6] It is beyond the scope of this report to include these impressions except to the extent that they affect the insurance transaction, and clearly many aspects of the thought patterns acquired during the communist period do affect the insurance transaction. For example, if citizens viewed their government as part of a framework responsible to an occupying authority, then distrust of the government was to be expected. Moreover, the habit of distrust of the government, which is not unknown in countries with a democratic tradition, appears persistent in former communist countries. Consequently, today if the (former) state insurance monopoly (or remnants thereof) remains associated with the government, then it is unlikely that consumers will expect "fairness" from this institution. Therefore, the authors believe that distrust of the government was part of the communist legacy that dampened the prospects for a quick start of a private insurance market when the market remained dominated by the former state insurance monopoly. In fact, this conclusion was repeated to the authors during many of their interviews. Because these interviews were with only a couple of dozen people involved in the insurance market they cannot be the basis of a generalization about the population, but they are suggestive of a general problem.

Another remainder of the communist period that had a negative impact on the development of private insurance markets was that many people apparently were still relying on the extensive communist social insurance system to provide for them even after it was no longer operating as it had during the communist period.[7] Continuing reliance on the state for economic security inhibits the purchase of life or health insurance or investing in retirement (non-mandatory) pension plans. Beginning insurance transactions in a population unfamiliar with such transactions, or unaware of the need for the transactions, was a serious handicap that persisted during the early years of the transition, and remained a significant problem a decade after the transition began.

The authors were also interested in the legacy of "former times" as it affected attitudes toward work and promoting one's self-interest. Many people found private markets to be a mixed blessing at best. The authors heard several people express appreciation for the improved quality and quantity of consumer goods, while simultaneously expressing

[6]There is a large body of literature providing a rich legacy of discussion of the effect of the communism on human relations. Even a listing of the authors of this literature is beyond the scope of this paper. Because the authors found many people more comfortable with the term "former times" than, for example, "the Communist Period," they will use the more comfortable descriptor in this paper.

[7]Field, Mark G. and Judyth L. Twigg, *Russia's Torn Safety Nets* (New York: Palgrave, 2000).

displeasure at the hard efforts and working long hours now required to obtain the money needed to purchase these goods. The authors were told of the breaking up of marriages and long-standing friendships, which people attributed to the long hours of hard work associated with the new economic system. Again, it is beyond the scope of this report, or the authors' expertise, to offer an assessment of the sociological phenomena unfolding in the transition economies, but it appears to these commentators that a successful private insurance market requires some level of social stability in families and some level of optimism about the future. Unfortunately, many people the authors spoke to expressed serious concerns about their lives, and their futures.

Did the Central Planning Legacy Provide an Advantage to Foreign Insurers?

An aspect of the transformation that is open to speculation and future research is assessing the impact of the central planning years on the ability of foreign insurers to begin operations in the transition economies. The argument that foreign insurers from developed economies had significant advantages runs along these lines. Foreign insurers, some with long histories, with extensive financial resources, subject to EU insurance supervision, and very importantly, not associated with the government, would be very appealing to many people.

Two bits of anecdotal provide evidence relating to this question. Trust in foreign insurers led to an unexpectedly high demand for pensions provided by foreign insurers operating in Poland in the spring of 1999, the first time that workers under age 30 could opt out of the state run pension system and purchase coverage from foreign insurers. At this time one co-author was in the main Warsaw office of a British insurer and was told the company had exhausted its supply of insurance (pension plan) applications as the demand was much greater than what had been expected. Part of the attraction of the product being offered was the ability to place money in Western equity markets, but this possibility was in addition to all the other advantages cited earlier.

A less desirable result of trust in foreign insurers arose in Slovenia, where the insurance supervisor told the authors that his office suspected a foreign insurer of large-scale fraud involving life insurance policies. Both of these anecdotal instances suggest that a study of people's attitudes towards insurance in general and foreign-provided insurance in particular might provide useful insight into the development of private insurance markets. This question is part of the much broader analysis of the issue of cross-border insurance purchases. A comparison between cross border insurance purchases in the transition economies and such purchases in the European Union, where to date, cross-border insurance transactions have not been very great, would prove interesting.

Insurance is a complex transaction. Proto-insurance has a long history, because risk transfer is perhaps an instinctive human tendency. However, this assertion lies in the domain of psychology. Actuarially sound insurance transactions have a much shorter history because these transactions require significant mathematical, legal, and commercial development before they can appear. This section of the paper provides some heuristic evidence to argue that culture plays a leading role in the speed of development of actuarially sound insurance markets.

Some Tradeoffs Faced By The Insurance Supervisor

The authors believe that the privatization process can be understood by reviewing the decisions and tradeoffs made by the participants. This section of the report presents some of these core issues.

Developing the Supervisory Function

Each of the insurance supervisors interviewed by the authors agreed on several points: their assignment was quite difficult, they did not received adequate funding commensurate with the responsibility they were given, and privatizing the former state monopoly was a difficult and often contentious assignment.

Organizing, Educating, and Training Staff

One of the most immediate tasks facing an insurance supervisor is to organize the office. The pool from which staff could be drawn would include bureaucrats from former times, emigrants who were willing to return home as advisors or employees, and people without previous experience in a government supervisory position. The pool did not include many people with experience in actuarially based, competitively marketed insurance. Politics, supervisory status in the central planning bureaucracy, and relationships from former times appeared to play a considerable role in the selection of the supervisory staff. Again, the authors intuited this conclusion based on their interpretation to responses to questions posed to various insurance supervisors.

As is often the case in the U.S., the role of state insurance regulator—whether elected or appointed—is often closely connected to the political process. Therefore, the tradeoffs presented the supervisors in staffing their offices are not unlike those prevailing elsewhere. While individual merit is not necessarily absent from political appointees, sometimes it is, and when choices must be made between individuals with different abilities and different political “contacts,” given limited budgets, political skill and wisdom greatly benefit the supervisor.

Because the countries studied were working towards accession to the EU, the goal in staffing their office was dictated in large part by this consideration. The need to administer laws consistent with EU membership, for consistent reporting and accounting practices, for consistent reserving practices and other actuarial standards, created job descriptions for many employees of the supervisory office. A significant number of supervisory employees had to be trained abroad. Upon their return home, these employees found their newly acquired skills were in considerable demand in the emerging private insurance sector. Unfortunately, the supervisor’s office often could not match the pay and other inducements offered in the private market, so under-staffing continued to be a problem even at the end of the first decade of the transition. The revolving door problem is not new to the insurance industry, but the dilemma presented a new supervisor is especially difficult. On the one hand, a supervisory office that trains its staff must be able to retain them after they acquire very marketable skills. Given budget limitations, attracting and retaining supervisory personnel was a challenge. On the other hand, an office that does not train an adequate number of people will not be able to perform the supervisory function at the required level. The

problem remained to be resolved during the first decade of transition, and all the insurance supervisors admitted that under-budgeting and under-staffing were persistent problems.

Licensing Insurance Companies and Agents

It is easier for the state to supervise a small number of solvent insurers than a large number of competitors, some of whose solvency may be suspect. Thus, the following tradeoff always is present when a state develops its supervisory scheme: the state may authorize a relatively large number of competitors and rely on competition to control pricing. Or, the state may authorize a relatively small number of competitors, and use its regulatory authority to control pricing. The first alternative has the potential for reducing consumer welfare because of the potential for underpricing and insolvency. The second alternative, a small number of competitors, has the potential for reducing consumer welfare arising from collusive pricing. Determining market structure and hence market conduct and performance is a very delicate decision in the insurance marketplace, and one that will almost immediately face an insurance supervisor in a transition economy.

The same issue arises, to some extent, with respect to the number of agents and brokers' licenses granted, or stating this problem in different terms, the supervisor must determine what standards are enforced before a person becomes eligible for an agent's license. The supervisor must ask if the consumer is better served by a larger number of relatively loosely supervised agents, or by a smaller number of closely monitored and carefully examined agents. In the countries being studied, the supervisors began their program by allowing insurers to hire (and vet) their own agents without state licensing. The frequently expressed feeling was that this was not as crucial a step in developing the supervisory model as other steps, and that granting this power to insurers who presumably would act in their own best interest and not hire undesirable people as agents, would relieve the supervisors of this duty. All the supervisors planned to assume responsibility for agent licensing after more pressing regulatory needs had been met.

Reserves, Investments, and Guarantee Funds

The tradeoffs involved in requiring adequate reserves, in holding adequate safe investments, and in providing guarantee funds were complex and difficult to resolve. Without valid historical data, actuarial reserves cannot be calculated with any great degree of accuracy. The data from former times was either non-existent, not reliable, or inappropriate in the prevailing environment. For example, if the number of vehicles quadruples as it did in these countries, historical loss data cannot be the basis of sound forward-looking reserve calculations. Therefore, neither regulators nor the insurers —including the former state monopoly— could be sure the rates they were using were appropriate in the current environment. On the one hand, to enforce rules requiring strict actuarial calculations of reserves was not possible. As noted, among other problems, there were not a sufficient number of actuaries present to calculate reserve requirements for either the supervisor's office or the insurers even at the end of the period being analyzed.[8] On the other hand, to ignore reserve

[8]For example, in June 1999, the Polish Supervisor reported 99 people in the supervisor's office, but only 2 actuaries. Danuta Walcerz, interview, May 28, 1999.

requirements fosters unsound insurance operations and delays meeting the standards required for accession to the EU.

The Hungarian insurance supervisor in 1999, Dr. Laslo Asztalos, discussed his approach to the reserving issue frankly.[9] In his words, "The Supervisor knows how to negotiate the needed reserving." He then described a process of dealing with "weaker companies," wherein he, or staff members, pointed out to managers the inadequacies of the problem company's reserves. The supervisors then noted that upon their next examination they expected to see a particular level of (increased) reserves. This number represented compromise and "reality." This approach both earned respect for the supervisor's authority, and accustomed new entrepreneurs to the importance of meeting reserve requirements.

The tradeoffs involving investments were another area of complexity. Financially sound insurers need to hold a considerable amount of assets to offset their reserve requirements and liabilities. In the U.S., insurers, especially life insurers and pension funds, supply a very significant portion of the overall capital base of the economy. In the transition economies during the initial stages of the transition the capital market mechanisms are not developed in terms of both the quality and quantity of investments. Therefore, what assets are available for investments, in large part, must be placed in the state banking system. Unfortunately, this means that the link between state involvement in the "private" insurance market remains unclear and basically unbroken until the capital markets develop sufficiently to absorb the insurers' reserves. Put in different terms, the assets insurers maintained to support their reserves during the initial phase of the transition become a forced loan to the state bank. Providing capital to the state is precisely the role insurers played during the period of central planning, and a direct link exists between earnings on these "loans" and insurance pricing. Therefore, creating adequate investment opportunities was a critical step in the transformation process that still remained to be accomplished after ten years.

Guarantee funds, which provide payment to insureds of failed insurers, are mandatory in the U.S. In a sense these funds are conduits facilitating transfers of funds from insureds of stable insurers to insureds of failed insurers. That is, after an insurer fails to meet its obligation to its insureds, the supervisor can transfer its obligations to the state's guarantee fund. The guarantee fund, in turn, receives its finances by its ability to assess the solvent insurers a pro rata share, based on their share of the market, of the claims paid by the guarantee fund.

Upon simplification, one sees the outline of the assessment insurance system in the operation of guarantee funds. The centrally planned economies, to the extent they operated insurance systems, did so on the assessment basis. Thus, while no formal guarantee funds were in place during the first ten years of transition, the costs of what failures did occur, and there were some in both Poland and the Czech Republic, were met in part by foreign reinsurers, and in part by uncompensated insured victims.

Low Rates versus Adequate Rates

Setting rates for insurance coverage, or even establishing a system or approach to establishing rates, is not a settled issue in the U.S., and was not a matter of general agreement in Europe until the Third

[9] Laslo Asztalos, interview, June 3, 1999.

Insurance Directive for the Single European market was implemented in 1994. In general, two ratemaking approaches exist: open competition or prior approval of rates by the supervisor's office. Even where open competition is used for ratemaking, the supervisor usually has the explicit right to retroactively disapprove of rates, or has the implicit authority to do so by modifying reserve requirements.[10] The insurance supervisors in the transition economies faced the challenge of finding a solution to the rate making problem that resulted in adequate insurance rates from a solvency standpoint without being so high as to discourage people who were not used to making the insurance purchase. Ratemaking is a difficult problem even in the mandatory automobile liability insurance market in the U.S., where the driving population presumably is familiar with financial responsibility laws and the consequences of violating those laws. In the transition economies, where lack of familiarity with the law, or where a habit of evading legal requirements was fairly common, pricing automobile liability (casco) insurance, as well as other lines of coverage, remains a tricky challenge to both supervisors and entreprenuers.

Complicating the ratemaking issue was the supervisor's responsibility for privatizing the former state insurance monopoly, which was the main (only) provider of casco coverage. If rates were set too low, the insurer would be technically bankrupt. If rates were set at a level insureds perceived to be too high, evasion of the mandatory purchase requirement would be induced.

During interviews with chief operating officers of new private insurers it was suggested that competition for private automobile insurance was made difficult by many factors.[11] Near the top of the list was underpricing by the former state insurance monopoly that still held the dominant market position. This deliberate underpricing made this line of coverage unprofitable for all participants. According to this complaint, the underpricing was allowed to continue by the state insurance supervisor because the majority ownership of the dominant insurer was still in state hands. Several arguments suggest themselves for this supervisory decision, including the following:

- Declaring the market leading insurer "insolvent" is not a realistic or practical alternative because that would leave its insureds without coverage when there are no viable alternatives with sufficient capacity to provide the needed coverage.
- Allowing adequate rates to be charged would lead to (greater) evasion of the mandatory automobile insurance requirement.
- One purpose of the supervisor was to prepare for the privatization of the former state monopoly presumably at the best possible price. This purpose would not be served either by the liquidation process, or by a dramatic drop in market share.

The origins of the problem of inadequate rates, state ownership of the dominant insurer, and a strong need to promote the purchase of automobile liability insurance presumably will

[10]An interesting example of the use of the implicit technique arose in the U.S. when regulators applied "Regulation XXX" to long-term life insurance rates. This regulation came about because regulators believed that competition had produced inadequate rates for 30-year term life insurance policies.

[11]Because of the sensitive nature of the following paragraphs, the identity of the individuals interviewed cannot be revealed.

diminish as the transition proceeds. However, the problem of underpricing will likely persist as long as both conditions prevail. Because this underpricing affects both domestic and foreign entry it becomes a significant barrier to the achievement of a viable private market.

Role of Foreign Capital

One choice faced by the insurance supervisor, or more likely by higher-level decision makers, including the legislative and executive powers, is the admission or restriction of foreign capital in insurance enterprises. The tradeoffs presented by this choice have been well documented by Skipper.[12] The following list summarizes some of the arguments, but many readers will benefit from reading the entire Skipper monograph.

Arguments favoring foreign participation in domestic markets of developing countries are:

- Including foreign insurance capital will lead to improvements in customer service and value.
- Foreign insurers will transfer technological and managerial expertise.
- Foreign insurers will provide more emphasis on loss prevention / reduction than local insurers.
- Foreign insurers should have a strong regulatory environment to protect consumers. Improved regulation benefits the market.

The common arguments opposing foreign participation are:

- Foreign insurers will dominate domestic market.
- Foreign insurers enjoy economies of scale (from multi-country operations).
- Foreign insurers won't have a long run commitment, and their coming and going could cause market instability.
- Foreign insurers won't transfer technology or managerial expertise but will use their own managers and not hire locals.
- Foreign insurers may promote long-run net capital (foreign exchange) outflow.

In the economies being described in this report two paths emerged. Hungary early on split the state insurance monopoly into two parts, and allowed two different foreign insurers to acquire significant interests in these entities. By 2001, neither Poland nor the Czech Republic had privatized the former state insurance monopoly. Both of these entities continued in state hands, and continued to dominate the markets in which they operated. The problem of the privatization of the former state insurance monopoly receives further analysis in the following section of this monograph.

Pace of Privatization of the State Insurance Monopoly

Among the most difficult challenges to be faced by an insurance supervisor in a transition economy is the problem of privatizing the former state insurance monopoly. Clearly, it is not a question of whether to accomplish this task; it must be done to have a *private* insurance market. The question involves the pace of the process. The pace of privatization presents this dilemma: if the supervisor moves quickly, the state may not realize the real value of the assets being privatized. If the supervisor moves slowly, the entire process of privatization may be impeded, as we have noted, because new entrepreneurs must try to begin and grow

[12]Harold D. Skipper, Jr., *Foreign Insurers in Emerging Markets: Issues and Concerns* (Washington, DC: International Insurance Foundation, 1997).

their operations in the shadow of a competitor with huge economic and political advantages. Other contrasting and conflicting outcomes also provide insight into this critically important decision. For example, a fast pace involving foreign capital may seriously impede the development of a domestic insurance industry: a slow pace may allow domestic forces to build political muscle that impedes the ability of foreign insurance capital to enter the market. The difficulty and delicacy of this problem was made clear to the authors in their meetings with each of the insurance supervisors they interviewed. Therefore, it is not surprising that each supervisor, and each country, has followed a unique path in resolving this problem.

Valuation Problems: Assets and Liabilities

The state insurance monopoly found at the beginning of the transition period was not a viable entity in a market economy. Its assets consisted of loans to the state or to business firms whose own assets may have had no "market" value. Its liabilities included commitments (not contracts) to provide coverage for losses, but at "rates" bearing little relationship to the underlying risk, accompanied by a non-enforceable ability to assess the entire pool of insureds to cover actual losses. That is, during former times the state insurance monopoly did have the ability to assess its insureds, because it was part of the state finance department which also included the state bank that held the assets of the (state) manufacturing sector. However, during the transition, the private enterprises did not have to pay assessments for "contracts" to which they were not a party, even if their predecessor organization might have been. An additional complication was found in the fact that the bureaucrats staffing the insurance organization were likely to be well entrenched in the previous system, and not necessarily going to be productive under a market system. Thus, perhaps the most valuable "asset" of this entity was its franchise to operate in the insurance market of the future.

Given this starting position, how does an insurance supervisor approach the privatization process? Any investor, foreign or domestic, adding new capital to such an enterprise will want a measure of control. Without setting a value for the enterprise, new capitalists putting in a set sum of money cannot know if they have a 10 percent interest in the ongoing firm, or a 90 percent interest. Thus, the supervisor's office, subject to domestic and foreign political considerations, and prevailing economic and market forces, must negotiate the value of the franchise to operate.

The Hungarian supervisor believed that allowing foreign insurers, with their considerable experience in mergers and acquisitions, to assume the lead in valuing the former state monopoly was the most desirable approach to the problem. It also provided the market with a deeper capital base, access to market-based business skills, and the ability to "free ride" on foreign supervisors to monitor the solvency of the largest segment of the insurance market. The other supervisors interviewed followed a slower pace in the process, believing the value of the state insurance franchise was not readily apparent in the early stages of the transition.

Some Tradeoffs Faced By New Insurance Entrepreneurs

New entrepreneurs in formerly centrally planned economies had an almost blank sheet of paper to design their plan to combine land, labor, and capital with their strategic plans for starting a new insurance enterprise. The greatest constraints on their behavior included accumulating capital and attempting to begin operations in the shadow of the (former) state insurance monopoly. Another significant obstacle was developing a marketing plan that would succeed in a population unaccustomed to purchasing insurance.

Sequence of Product Introductions

When one considers the typical classes of personal and commercial insurance found in the U.S., personal lines such as automobile and homeowners, commercial coverages including property damage and workers compensation, and various life and health coverages, arguments can be made to approach or avoid each class. (We have omitted liability coverages, except auto liability from this discussion, because these societies had not developed the litigious characteristic that makes this coverage so integral a part of a U.S. insurance program.)

The authors interviewed several entrepreneurs who had started their firms by offering automobile liability coverage. Initially they had to compete with "unfairly under priced" coverage offered by the (former) state monopoly and this competition had resulted in unprofitable loss ratios. These entrepreneurs believed, however, that the potential for niche marketing, offering consumers insurance with more sure loss adjustment, provided a wedge into this market, that would prove to be profitable. Niche marketing, offering coverage to that segment of society with both the private property and the premium paying ability, was a frequently considered strategy. The flaw in this approach was that during the first ten years of transition this segment of the market was relatively small, and would not allow the entrepreneur much room for growth.

One new manager in Poland discussed this tradeoff and indicated why he opted for a third approach.[13] He was approaching the automobile market, but charging "sound" prices, and was willing to postpone growth until the state monopoly was privatized. He believed the auto insurance market had the greatest potential for growth, but he was not willing to risk failure by charging inadequate prices. Instead, his strategy was to focus on providing improved service, making needed investment in agents and managers and patiently waiting for the point when the growing Polish market would make his strategy successful. It might be added, that this manager had extensive experience in Western insurance markets before returning to Poland.

The required "critical mass" for a viable private personal lines insurance market centers on the population having a minimum amount of valuable private property to protect, and a minimum amount of income to pay premiums. The essential ingredient for a viable private commercial insurance market is the adoption of a risk management paradigm by both profit and nonprofit organizations. Until these necessary conditions are met, new entrepreneurs must have sufficient financial strength to start and grow their insurance companies in the absence of profits.

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[13] D. Szymanek, interview, May 23, 1999.

Distribution Channels

Recruiting, training, and motivating agents are critical problems facing all insurance managers. Most western insurance agents are accustomed to being rewarded in whole, or in part, by commissions based on new sales. The commission compensation system was unknown in these centrally planned economies. Therefore, the move towards the market model involved providing a salary during the initial phase of employment, with a gradual move toward commission compensation. Many of the managers interviewed by the authors felt it would take an agent at least a year to accomplish the migration from salary to commission. The failure rate of newly recruited agents was likely to be about one-third of people offered this opportunity. Interestingly, one manager noted that his greatest success was in recruiting former (mostly female) teachers as new agents. The successful ones were able to make about three times their former earnings, and given this successful outcome, the retention rate was far better than average. Also, these successful agents helped recruit former colleagues.

The authors encountered one problem familiar to insurance historians, that is, competition for good agents driving up compensation costs. It was this problem that led to New York State's expense limitation law, because the unrestrained competition for agents produced an uneconomic premium. As we have noted, during the transition, all parties to the insurance transaction (the supervisor, the insurer and the insured), with the clear exception of the new agent, have an interest in keeping insurance rates and premiums "affordable."

New insurance entrepreneurs in transition economies must overcome difficult obstacles before achieving success. They must acquire sufficient capital to withstand early losses, they must choose lines of coverage to offer having sufficient buyers with premium-paying ability, they must recruit and train a sales force, and all this must be done in the shadow of the (former) state insurance monopoly, and while new insurance regulations are being enacted and enforced.

Economic Indicators for Poland

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Population (in 000s)	38,183	38,309	38,418	38,504	38,580	38,609	38,639	38,660	38,667	38,653	38,650	38,653
GDP nominal (in billion PLZ)	56	81	115	156	224	308	388	472	554	615	685	729
Real growth rate of GDP	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.8	4.8	4.1	4.0	1.2
Consumer price increases (in %)	585.8	76.7	45.3	36.9	33.2	28.1	19.8	15.1	11.7	7.3	10.1	5.6
GDP per capita (1995 US$)	2,990	2,772	2,835	2,936	3,081	3,293	3,488	3,722	3,899	4,061	4,223	4,274
Exchange rate PLZ / US$, average	0.95	1.06	1.36	1.81	2.27	2.42	2.70	3.28	3.48	3.97	4.35	4.09
Unemployment rate (in %)	6.5	11.8	13.3	14.0	14.4	13.3	12.4	11.2	10.7	12.5	16.7	. . .
Passenger cars per 1,000	138	160	170	176	186	195	209	221	230	240	. . .	. . .

Sources: The Vienna Institute for International Economic Studies, *Countries in Transition 2000* (Vienna, 2000), pp. 32 ff.; The World Bank, *World Development Indicators*.

A Statistical Review of the First Ten Years of Transition

The following section of this paper puts the anecdotal evidence already presented in some context. The authors warn their readers that not all the data are reliable, and while some impressions may be gained, robust statistical conclusions are not possible. In contrast, the evolution of legal codes can be documented and this evolution allows the reader to see some concrete evidence of the progress of the transition to private insurance markets.

The Data Are Unreliable

No accurate or complete data are available to document the first ten years of the transition to private insurance markets. This section of the paper presents some of the official data prepared by the various insurance supervisory offices, and the authors have made tables and calculations based on this data.[14]

The final word on the robustness of the data after the first ten years of transition is found by careful interpretation of a statement from the Polish insurance supervisor's office presented in its 1999 annual report:

> Although these indicators and data are employed by the insurance supervisory services in Poland, they can only be used for elaborating the solvency criteria for insurance companies to a limited extent: during

[14]This point is given extensive discussion in, Mark S. Dorfman and Karl C. Ennsfellner, "Transition from Central Planning to Market-based Insurance Transactions: A Case Study of Poland, the Czech Republic and Hungary," *Journal of Insurance Regulation* (Winter, 2001).

the early stages of development of the insurance sector, little can be done except to observe the tendencies of the market, and draw conclusions and generalizations.[15]

Poland

The transition of the Polish economic system started in 1989 when the "Balcerowicz Plan" was implemented. This Plan was based on the following goals:[16]

- A "tight" monetary policy to control inflation.
- Privatization of the economy.
- Deregulation of prices.
- A freely exchangeable currency.

The table on the previous page shows the results of the Balcerowicz Plan. In 1990, at the beginning of the transition process, the rate of inflation was about 586 percent. Thereafter, while the rate of inflation steadily declined, it remained at a relatively high level until 1996. Since 1997 the rate of inflation has stabilized at about 10 percent.[17] These data support the conclusion that the Balcerowicz Plan set Poland in the direction of a stable, market-based economy, and that substantial results were achieved in a relatively short period.

Insurance Regulation since 1990

Poland implemented its *Act on Insurance Activity* in 1990. This Act was amended in 1995 and in 1999.[18] From its beginning the *Act on Insurance Activity* was designed to be in general accord with the requirements of the European single insurance market but without complying strictly with the technical requirements for solvency reserves and related issues.

Like the other Central or Eastern European insurance markets in transition, and in contravention of the EU Third Directive on Insurance, in 1999 the insurance regulatory code still required foreign companies to have a branch or a subsidiary when operating in Poland. The effect of these rules was to make cross border insurers subject to Polish rather than home country supervision. With that major exception, by 1999 the Polish insurance code largely complied with the insurance regulations of the European single insurance market. It is planned that at the latest by December 31, 2004, the regulatory code will be in compliance with the requirement for cross-border insurance activities.[19]

Insurance Data

The data on Poland's private insurance market can be interpreted when put in context with the general economic data and insurance code development. The table on the next page shows that the insurance market represents a

[15]State Office for Insurance Supervision (Warsaw, 1999), p. 2.

[16]P. Sliwicki, "Constructing a Market Economy in Poland and the Polish Insurance Market," Seminar Proceedings of the 35th Seminar of the International Insurance Society, 1999, p. 111.

[17]*Ibid.*

[18]The 1999 reform restructures the current laws relating to insurance activities into four laws, the law on insurance activities, the law on insurance supervision, the law on compulsory insurance and the law on insurance intermediaries.

[19]The State Office for Insurance Supervision, "Current Issues in Insurance Supervision," 1998, p. 94.

Annual Expenditure on Insurance in Poland

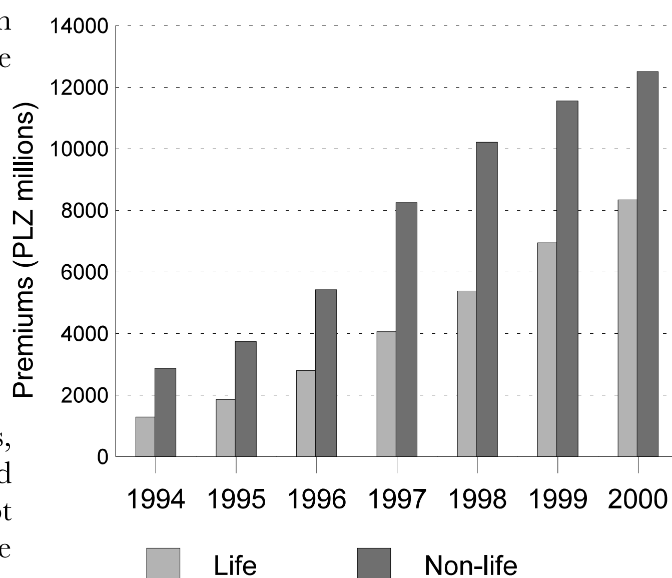
	Total premium written (million PLZ)	As % of GDP	Expenditure per capita (PLZ)			Annual growth rate
			Total	Life	Non-life	
1994	4,146.7	2.0	107.5	33.3	74.2	33.7
1995	5,583.3	1.9	144.7	48.0	96.7	34.5
1996	8,189.5	2.3	212.6	72.3	140.3	46.9
1997	12,309.8	2.6	318.4	105.0	213.4	49.8
1998	15,588.8	2.8	403.1	139.1	264.0	26.6
1999	18,487.6	3.0	479.6	179.9	299.7	19.0
2000	20,837.2	3.1	540.0	216.0	324.0	12.7

Source: *Authors' calculations based on data of the Polish State Office for Insurance Supervision, on data of the Polish Chamber of Insurance (2000, p 21) and on data of the Vienna Institute for Comparative Economic Studies (2000, p. 48). The table also incorporates data from Sliwicki.*

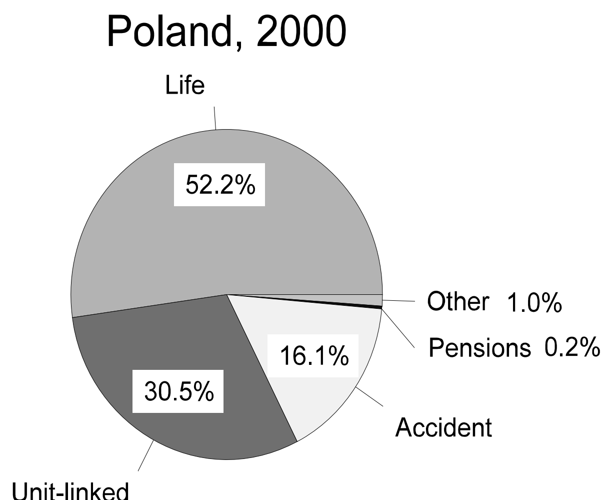
slowly increasing share of the Polish gross domestic product (GDP). The additional data that follows reveals that most of the coverage sold was for private passenger automobile insurance. Life insurance, commercial property insurance, and liability insurance did not show significant growth during the period under study. The growth in vehicles from about 3 million to about 13 million combined with a compulsory insurance law therefore accounts for much of the insurance sold in Poland during the initial transition to a private insurance market.

A number of insurance company bankruptcies at the beginning of the transition to a market economy provide one explanation for the slow start of private insurance in Poland. These bankruptcies were largely due to under-capitalization, lack of managerial knowledge, and fraudulent behavior. Westia, the largest insurer that went bankrupt in the beginning of the 1990s, failed because its premiums were too low and the return earned on investments could not offset its underwriting losses.[20] Insurance company bankruptcies clearly affect the average customer's trust of the Polish insurance industry and mistrust may be a contributing factor to the slow initial growth realized. Such distrust would have a profound negative impact on life insurance companies, which offer relatively long-term contracts.

Premiums Written in Poland



[20]B. Mrozowska, interview, October 11, 1998.



Source: State Office for Insurance Supervision Annual Report

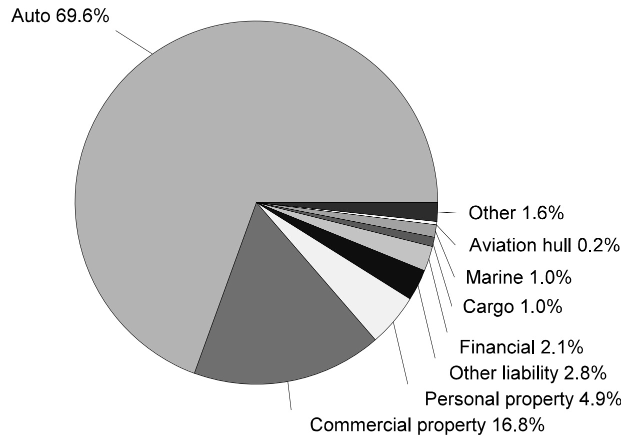
Macroeconomic factors also played a significant role in the development of the Polish insurance market. The Polish per capita GDP of about US$ 3,500 does not allow much spending for insurance contracts. Furthermore, the double-digit rate of inflation remains a significant impediment to the development of the real value of long-term life insurance policies. The above chart shows the composition of life insurance business.

Despite the problem with inflation and low per capita GDP, about 60 percent of the life insurance policies written in Poland in 1998 were endowment life insurance policies. The ability to save outside the state banking system, the ability to save with a British, American, or other non-Polish insurer, the liquidity of a policy offering payments before death, all may explain the popularity of endowment policies. The relatively high share of unit linked (equity-based) policies also is worthy of note. The intermediation of insurance companies provides a convenient way to participate in the growth of the Polish (or international) economy. The protection aspect of this policy, of course, simultaneously provides some protection against the financial problems caused by a premature death. If accident insurance were not classified as life insurance coverage, then endowment and unit-linked policies would be the only life insurance products on the Polish market that have been sold successfully during the early years of the transformation.

As was the case with life insurance, only two products account for the majority of sales in the non-life insurance market. Automobile insurance, which is compulsory in Poland, accounts for about 70 percent of the market. Commercial and personal property and third party liability coverage account for about 20 percent of the market.

Non-life Insurance Products

Poland, 1998



Sources: Wanat-Polec, Sliwicki

Evaluating Poland's Progress

In 2002 Poland was still struggling with the privatization of the former state insurance monopoly (PZU), which remained the dominant insurer in all markets in which it operated. PZU's market dominance kept the newly developing private insurers from mounting a challenge to PZU's prices, or from "aggressive" underwriting (loosening standards for competitive reasons) except in niche markets. The political difficulties encountered in the privatization process suggest that Poland remains in the early stage of its transition.

The IMF Financial System Stability Assessment in 2001 stressed the impact of the protracted privatization process on the insurance market overall:

- In the insurance sector, early reduction of the large role of the state should enhance the competitive structure.
- Low profitability is a concern, in particular for non-life insurance services; and PZU's early and transparent privatization will be important to the development of a competitive market.
- There is considerable concern that insurance premiums in property and casualty areas are not adequate.[21]

Poland was fortunate in its ability to attract some of its emigrants with solid insurance experience in Western markets to return to manage some of its newly organized insurance companies. Also, the size of the Polish economy and its solid progress attracted several large Western insurers to develop Polish branches. Thus, several Polish insurers employ a core group with Western managerial expertise, and regular growth in market-based management skills is likely to occur. Likewise, marketing and distribution

[21]IMF Country Report 01/67, Republic of Poland: Financial System Stability Assessment, (February 20, 2001), p. 38.

channels also show distinct signs of Western influence. By the beginning of 2001, agents and brokers as well as employees were distributing insurance.

The general consensus of the authors' many interviews in Poland was that the capital markets were not yet sufficiently mature to hold all the investments of the insurer's reserves.

Economic Indicators for the Czech Republic

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Population (in 1000s)	10,362	10,308	10,317	10,330	10,336	10,330	10,315	10,299	10,293	10,282	10,274	10,265
GDP nominal (in billion CZK)	579	750	847	1,004	1,149	1,381	1,572	1,680	1,821	1,836	1,959	2,146
Real growth rate of GDP	-1.2	-11.5	-3.3	0.6	3.2	6.4	3.8	0.3	-2.3	-0.2	3	4
Consumer price increases (in %)	9.7	56.6	11.1	20.8	10.0	9.1	8.8	8.4	10.7	2.1	4	5
GDP per capita (1995 US$)	5,270	4,682	4,654	4,651	4,752	5,037	5,261	5,226	5,168	5,157	5,311	5,502
Exchange rate CZK / US$, average	18.0	29.5	28.3	29.2	28.8	26.6	27.1	31.7	32.3	34.6	39	38
Unemployment rate (in %)	0.8	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4	9	. . .
Passenger cars per 1,000	228	236	244	261	287	301	325	344	358	335	. . .	. . .

Sources: The Vienna Institute for International Economic Studies, *Countries in Transition 2000* (Vienna, 2000), pp. 32 ff.; The World Bank, *World Development Indicators*.

The Czech Republic

In 1998 the private sector produced about 75 percent of Czech GDP. Nevertheless significant economic problems remained.[22] Among them:

- The process of industrial restructuring and increasing efficiency was slower than expected. The ownership structure of some of the newly privatized firms remained unclear eight years after privatization began.
- The privatization of Czech banks had not been completed.
- More financial reforms were needed to strengthen the confidence of both foreign and domestic investors.
- The aging population made pension reform a pressing need. The financial burden of the state pension system prevented much needed investments in infrastructure.

As the table above shows, the real growth rate of GDP was negative in the first years of privatization, but became positive from 1993 until 1996. In 1998 and 1999 growth was negative again. This general weakness of the economy was a clear impediment to the development of the insurance market.

Insurance Regulation since 1991

The first insurance regulatory law in the Czech Republic during the transition period, the Act on Insurance 185/1991, was implemented on April 26, 1991 and amended

[22] V. Uzel, "Transformation of the Czech Insurance Industry," Seminar Proceedings of the 35th Annual Meeting of the International Insurance Society, 1999, p. 120.

Annual Expenditure on Insurance in the Czech Republic

Year	Total premium written (CZK millions)	As % of GDP	Insurance expenditure per capita (CZK)			Annual growth rate
			Total	Life	Non-life	
1991	13,882.4	1.8	1,339.7	396.7	942.9	N/A
1992	16,121.3	1.9	1,562.5	438.4	1,124.1	16.0
1993	23,396.4	2.3	2,264.8	571.7	1,693.1	44.9
1994	29,679.4	2.6	2,871.4	721.9	2,149.5	26.8
1995	33,731.9	2.6	3,265.2	892.9	2,372.3	13.7
1996	40,248.8	2.7	3,901.8	1,051.1	2,850.7	19.5
1997	47,986.3	2.9	4,657.3	1,231.6	3,425.7	19.4
1998	55,166.9	3.1	5,358.7	1,468.0	3,890.7	15.0
1999	62,795.3	3.4	6,107.0	1,937.0	4,170.0	14.0

Source: Authors' calculations based on data of the Czech Insurance Association: Annual Reports for the years 1993, 1994, 1996, 1997, 1998, 1999, and on data of the Vienna Institute for Comparative Economic Studies (1997 and 2000).

under Acts No. 320/1993 and No. 60/1995.[23] Major new legislation, Act No. 363/1999, implemented with Decree No. 75/2000 in April 2000, brought further harmonization with the EU insurance directives. The new supervisory approach abandoned prior approval of products and premium rates in favor of stricter solvency monitoring. Under the new law, each company must appoint an actuary to furnish an annual report on the adequacy of technical provisions and other matters.

Insurance legislation during the transition created some market distortions. Protective measures for the former monopolist insurer, Ceská pojist'ovna (CP), remained in place to allow the company more time to adapt to market conditions. This company had not been privatized by 1999 and was owned by the Czech State.[24] Continuing state ownership provides a reasonable explanation for the prevailing market distortions favoring this organization. For example, CP has been allowed to maintain its monopoly in auto liability insurance, which is compulsory in the Czech Republic. This critically important monopoly provided the company with scale advantages over competitors in all lines despite the fact that the premiums for automobile insurance are fixed by the Ministry of Finance at a relatively low level.[25]

[23] The Act on Insurance 185/1991 abrogated the Act No. 82/1966 on Insurance as amended under Act No. 162/1968 that regulated the insurance activities under the Soviet style command industry in the Czech and the Slovak territories.

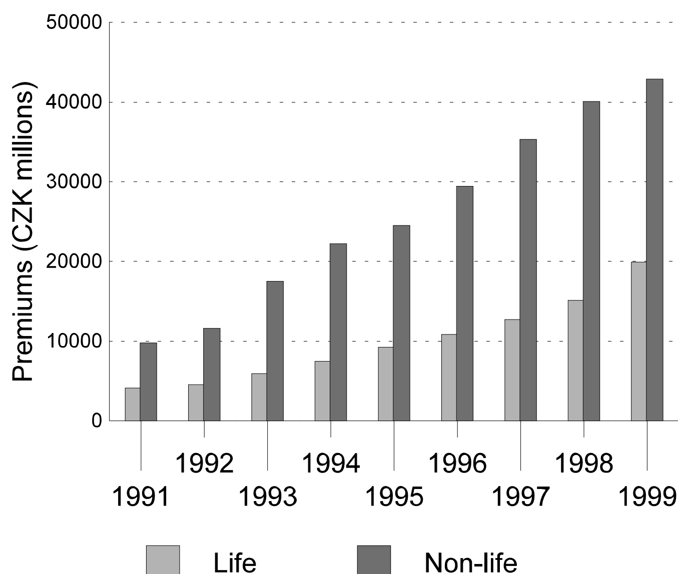
[24] The ownership of CP is a matter of some contention. The insurance ministry claims a joint ownership of CP exists but it cannot identify the capital of the non-state owned portion, which could be other entities under state control.

[25] M. Hofmann, *Versicherungsmärkte ausgewählter EU-Beitrittskandidaten—Eine Analyse* (Vienna thesis,1998), p. 68.

Insurance Data

Private pension insurance, which accounted for about CZK 2.4 billion in 1999, is included in the total life insurance premiums. This finding reveals that private saving for retirement is not widespread in the Czech Republic. Possible explanations for the slow growth of life insurance sales in the Czech Republic include the general economic problems and comparatively modest per capita income. In addition it is likely that many potential customers might not yet perceive the need for private life insurance contracts to provide protection against the financial problems caused by premature death or to accumulate retirement wealth.

Premiums Written in Czech Republic



Evaluating the Czech Republic

The Czech Republic has experienced a number of impediments in its efforts to privatize its insurance market. Its economy has not been very robust in recent years. It has not allowed much foreign participation in its insurance markets on a basis of equal competition. And it has been slow to privatize CP. As a consequence, the Czech Republic has not made as much progress as Poland or Hungary in the transition process.

The IMF Financial System Stability Assessment appears slightly more optimistic about the status of the insurance sector:

> 78. The insurance sector is growing and performing generally well, with adequate levels of capital and profitability.[26]

The new insurance law was cited as "a major step towards harmonization with the EU." Regarding prudential supervision, however, the IMF assessment reached conclusions similar to those of the authors:

> 80. Supervision of the insurance companies is conducted by the Office of Supervision inside the Ministry of Finance. Currently the Office is understaffed, supervisors are not adequately trained in modern techniques of supervision by risk, and have not conducted frequent on-site inspections.[27]

Both the authors' conclusions and the IMF's were reached before the devastating flood losses incurred during the summer of 2002. As this material is being prepared in the fall of 2002, insufficient time has elapsed to evaluate the impact of this catastrophe on the Czech insurance sector.

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[26]IMF Country Report No. 01/113. Czech Republic: Financial System Stability Assessment, (July, 2001), p. 30.

[27]*Ibid.*, pp. 30-31.

Economic Indicators for Hungary

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Population in (1000s)	10,364	10,337	10,310	10,277	10,261	10,212	10,174	10,135	10,092	10,044	10,209	10,187
GDP nominal (in billion HUF)	2,089	2,498	2,942	3,548	4,364	5,614	6,893	8,541	10,180	11,439	12,877	15,001
Real growth rate of GDP	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8
Consumer price increases (in %)	28.9	34.2	22.9	22.5	18.9	28.3	23.4	18.3	14.2	10.0	9.8	9.1
GDP per capita (1995 US$)	4,857	4,286	4,162	4,144	4,273	4,343	4,408	4,617	4,849	5,058	5,326	5,540
Exchange rate HUF / US$, average	63.2	74.7	79.0	91.9	105.1	125.7	152.6	186.8	214.4	237.1	282.2	286.5
Unemployment rate (in %)	1.7	8.5	9.8	11.9	10.7	10.2	9.9	8.7	7.8	7.0	6.5	. . .
Passenger cars per 1,000	186	195	199	203	211	222	237	224	231	234	. . .	. . .

Sources: The Vienna Institute for International Economic Studies, *Countries in Transition 2000* (Vienna, 2000), pp. 32 ff.; The World Bank, *World Development Indicators*.

Hungary

Of the three countries comprising this analysis, Hungary was the earliest to start liberalizing its economy, and remains the most liberal in terms of its openness to foreign capital, insurance regulation, and progress in the privatization process. The table above shows the general economic context for the period of transition.

Insurance Regulation Since 1990

Hungary was the first former centrally planned economy to enable competition between insurance companies. The insurance monopoly was abandoned in July 1986. At that time the Hungarian government implemented a directive establishing the framework for insurance regulation in a competitive market. Included at the core of this directive were the following provisions:

- Prior approval of policy terms and rates.
- Both stock and mutual companies were permitted.
- Foreign companies were not permitted to sell insurance products in Hungary directly from their home countries.

In 1989 the first rules concerning the solvency-regulation of insurance companies and rules for the investment of assets of insurance companies were introduced. In 1995 the Hungarian Insurance Act based on the first and second generation of the EU insurance Directives was implemented.[28] This code also incorporated features that liberalized the insurance regulation.

[28]Act XCVI of 1995 on Insurance Activity. This Act was amended in 1997, by Act CXLVII.

Annual Expenditure on Insurance in Hungary

Year	Total premium written (million HUF)	As % of GDP	Insurance expenditure per capita (HUF)			Annual growth rate
			Total	Life	Non-life	
1991	60,800	2.4	5,882	1,694	4,188	N/A
1992	58,435	2.0	5,667	1,132	4,535	-3.7
1993	73,396	2.1	7,130	1,644	5,486	25.8
1994	93,596	2.1	9,123	2,350	6,773	28.1
1995	119,014	2.1	11,635	3,466	8,169	27.5
1996	152,205	2.2	14,985	4,733	10,252	28.8
1997	194,654	2.3	19,218	6,278	12,940	28.2
1998	244,591	2.4	24,113	8,755	15,357	25.8
1999	297,756	2.6	29,519	11,898	17,621	22.4

Source: Authors' calculations based on data of the State Supervisory Authority of Insurance, Hungary, Annual Reports for the years 1993 through 1997; on data of MABISZ , *Hungarian Insurance Companies Yearbook 1995, 1998, 2000*, Budapest 1995, 1998, and 2000; and on data of the Vienna Institute for Comparative Economic Studies (1999), p. 48.

Insurance Data

Since the beginning of the 1980s almost all loss exposures that are insurable in a market economy have been insurable in Hungary. The insurance of the farming industry was highly developed and held about 25 % a share of the premium volume. About 90 % of the farms in Hungary are covered.

Auto insurance in Hungary under Communism was interesting. There was no policy limit for the auto liability insurance. Furthermore, the premium was paid as a surcharge on the gasoline price. Homeowners insurance also was widespread. It was a simple product designed without policy limits. The premium was dependent on the number of rooms and the coverage was written for an unlimited time with premiums paid annually.

Life insurance was dominated by group life insurance contracts. The premiums for these group life insurance contracts were based on the average age of the work force. The premium was deducted from the wages and salaries and was the same for all insureds. This group life insurance contract also included accident insurance and health insurance coverages. About 90 percent of the Hungarian work force was covered under this type of contract that was offered in addition to the broad basic coverage provided by the social insurance of Hungary.[29]

The above table shows the development of the insurance market in Hungary, which has outpaced the growth of the overall economy.

[29]Rogers, *Insurance in Socialist East Europe*, p. 305.

Evaluating Hungary

Because it had a "running start" and was liberal in its attitude towards foreign capital, Hungary is the clear leader in the transition process among the three countries analyzed in this paper. While its market for insurance remains concentrated, the dominant insurers are not state owned. Foreign insurers have been consistent in providing training at their home offices for Hungarian managers, and in sending managers to Budapest. The appearance in Budapest of international risk management and brokerage firms has quickened the move toward Western-style competitive underwriting. The cooperative relationship between insurers and the state supervisory office has facilitated the implementation of an insurance code that is almost in compliance with most EU standards.

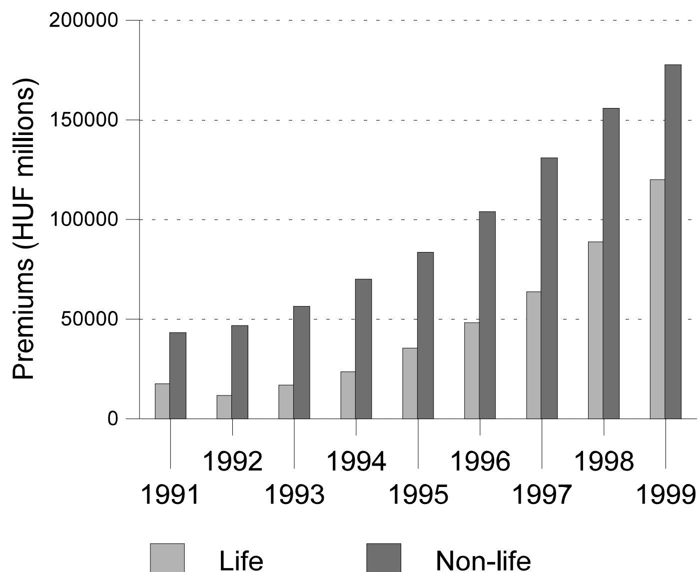
Not surprisingly, the IMF Financial System Stability Assessment took note of Hungary's progress:

> Hungary is in the final stages of transition to a market economy and has one of the most developed and diversified financial systems in Central and Eastern Europe.[30]

Although the initial IMF assessment did not examine the insurance sector specifically, the update in 2002 did. Its observations closely paralleled the other findings of this study:

> 38. Notwithstanding the above developments, prospects of the entire insurance sector remain good and no stability issues were raised. Profitability of the sector remained satisfactory. However, it is expected that the margins will come under pressure in the medium term as a result of competition created by EU accession.[31]

Premiums Written in Hungary



[30]IMF Country Report No. 02/112. Hungary: Financial System Stability Assessment Follow-up, June 2002, p. 1.

[31]*Ibid.*, p. 19.

Lessons Learned

In the ten years between 1991 and 2001 much has been learned about the problems of transforming a centrally planned insurance market to a private insurance market. When the authors began their research on the transformation to private insurance markets they believed that insurance would be the most difficult of the financial service markets to privatize, and their continuing observations support this belief. Insurance requires credible loss data, and that takes years to develop. Insurance requires skilled entrepreneurs and technically trained accountants and actuaries, and they take years to educate. Insurance requires a high level of social trust because the contingent promises made are intangible and long run; building such trust takes time. Insurance requires a high level of supervisory oversight, and developing a competent and effective supervisory service also requires years to develop. Therefore, while there has been remarkable progress made during the first ten years of transformation, the task remains incomplete.

The foregoing general conclusion can be followed with more narrowly focused observations.

- Privatizing the state insurance monopoly is a very difficult assignment requiring many compromises. There are no easy or costless solutions to the problem. However, the authors observed that Hungary, the one country that early in its transformation allowed foreign capital to acquire an interest in the former state monopoly, was also the country that was furthest along in privatizing their insurance market.
- The required level of insurance supervision is costly, and the need for adequately funding this function is not easily apparent to politicians facing a clamor for funding from many sources. Insurance in many respects is a less obvious financial service than either banking or the securities markets, and it would appear that this lack of visibility possibly has resulted in relative underfunding of the insurance supervisor's office in these countries. Insurance company insolvencies or a general reputation for unfair claims denials will cast a pall on the development of private insurance markets. Insurance fraud of any type will also be extremely detrimental to this market's development. For these reasons, the importance of adequate and efficient supervisory oversight is difficult to overstate.
- Entrepreneurship in insurance markets in the transition economies was very demanding and foreign experience or a foreign partner was extremely helpful in establishing new firms.

The Future

This report ends with some predictions about the next decade of the transformation to an actuarially sound private insurance market fully harmonized with the EU.

More investment income will be factored into premiums and this will lower insurance premiums. The continuing development of private capital markets combined with the shrinking importance of state operated financial institutions argues for this outcome.

Rationalization of market structure. At some point the number of entrances and exits from the insurance market will achieve equilibrium. Stable economies, stable currencies, and a stable amount of insurance purchases will contribute to this result. Mergers and acquisitions will be likely as insurance tends to be a relatively concentrated industry in the United States and the EU. That is, the largest companies tend to dominate their market and maintain their dominance over long time periods.

Foreign competitors are very likely to enter these markets. And, where permitted, have eagerly done so. These economies should grow and there will be concomitant growth in insurance sales. Therefore, it is to be expected that international insurers will want to participate in these markets.

Growth of all insurance markets. This prediction is based on the assumption that insurance penetration in the transition economies will approximate the average insurance penetration found in the EU, which is about 6 percent of GDP. If that target is reached insurance sales will more than double from current levels. One new insurance entrepreneur provided a fitting bottom line to this report when asked what motivated him to tackle the difficult project of establishing a new insurance company, he responded “we expect 300% growth in 5 years.”

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