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The economic importance of insurance in Central and Eastern Europe and the impact of globalisation and e-business

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1 This paper, prepared at the request of the secretarit, is based on various studies published in Swiss Re's *sigma* series: *sigma* No. 1/2001: Insurance industry in Central and Eastern Europe – current trends and progress of preparations for EU membership, *sigma* No. 5/2000: The impact of e-business on the insurance industry: Pressure to adapt – chance to reinvent, *sigma* No. 4/2000: Emerging Markets: the insurance industry in the face of globalisation.
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1. Introduction

1.1. Focus and structure of the study

Efficient insurance markets are an essential basis for the transition countries in Central and Eastern Europe to achieve integration into the global economy and sustainable strong economic growth. With their capacity, capital and know-how, global insurers play a major role in the establishment of an efficient insurance sector. In conjunction with the forces of global consolidation, current advances in information technology and the potential of e-business mark the beginning of a veritable efficiency revolution in the insurance industry.

The following study initially examines the role insurance plays in economic growth and the current developmental stage of the insurance industry in Central and Eastern Europe. It then provides an overview of the heated debate on the potential and challenges of market access liberalisation and examines the importance of foreign insurance companies in the various countries. The study also analyses the impact of e-business on the insurance industry.

1.2. Country groupings

The region has been divided into the following groups according to geographical and economic criteria:[2]

- Central Eastern Europe (CEE5): Poland, Slovakia, Slovenia, Czech Republic, Hungary
- Baltic States: Estonia, Latvia, Lithuania
- Southeastern Europe (SETE7): Albania, Bosnia and Herzegovina, Bulgaria, Yugoslavia, Croatia, Macedonia and Romania
- CIS: Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Georgia, Republic of Moldavia, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, Belarus

The 10 candidates up for EU membership include the CEE5, the Baltic States, Bulgaria and Romania.

1.3. Data

The insurance data on premium volumes for the individual countries come mainly from national supervisory authorities, and in some cases from insurance associations and the trade press. The subdivision into life and non-life has been carried out in line with OECD conventions. Health insurance thus always counts as non-life business whenever the data available make this possible.

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[2] This classification of Central and Eastern European countries is also used by the UNO and the Vienna Institute for International Economic Studies (WIIW).

Growth rates are based on premiums in local currencies and adjusted for inflation using the consumer price index for each country. Premiums were converted into US dollars to facilitate comparison between the different countries. The conversion was performed at the average exchange rate over the calendar year.

2. The economic importance of insurance

2.1. The role of insurance for economic development

2.1.1. Risk transfer

One of insurance's key roles is safeguarding the financial health of small and medium-sized enterprises. In addition to the protection provided by social security systems, private insurance cover is crucial for people to insure themselves against inability to work, set aside money for retirement or protect themselves against the loss of their assets. This is where insurance comes in as a key component in ensuring the healthy development of small and medium-sized enterprises - a fact which is of paramount importance to a country's political stability.

A sophisticated insurance sector is also important in encouraging domestic production, innovation and trade. Insurance reduces the investment risk faced by companies and the state. Many companies find it far more expensive, if not impossible, to take out a loan without purchasing the requisite insurance protection. Insured, thereby reduces the costs of raising the capital they need. This is especially important in emerging markets, as a shortage of capital is one of the major disincentives to investment. By reducing investment risk, insurance can also encourage companies to think more long term and increase their risk tolerance. A lot of investments in new production facilities and newly founded companies would never happen if every company was required to have the necessary financial means to make good every conceivable loss. While arguable, it is no exaggeration that the availability of insurance is sometimes being heralded as a factor of production in itself.

The same applies to infrastructure investments: if it weren't for insurance, a lot of infrastructure projects - such as power plants, railways or airports - would never be realised; because in the absence of sufficient financial funds to enable them to resume operations in the wake of a loss event, and without insurance, these projects would be reduced to nothing more than white elephants.

2.1.2. Information role

Insurance plays an additional role in the economy: that of providing information. The level of insurance premiums provides an indication of existing risks and of how probable it is that a loss will occur. This helps companies make a comparison of the risk/return profiles of projects, thereby ensuring that the available resources are put to the best possible use. Insurance companies also offer consultancy services, advising on how to improve safety standards and a product's quality.

2.1.3. Capital market role

As well as stabilising the financial circumstances of private individuals, companies and the state, in their role as institutional investors, insurance companies contribute to the development of a well-functioning capital market thanks to the huge amount of assets they have to invest. Insurance companies receive premiums and set them aside as provisions for the payment of future claims. They proceed to invest them in the capital market, which gives them the status of major investors. From a macro-economic point of view, the insurance market could help to mobilise national savings and narrow the investment gap of emerging economies. In emerging markets, domestic savings have not been fully mobilised despite huge funding needs arising from infrastructure projects, for example. Insurance companies as important long-term institutional investors, therefore functioning as financial intermediaries, contribute to bringing together savers and borrowers. Life insurance, in particular, can make savings available – although life insurers are themselves dependent on a functioning capital market if they are to measure up to their role in the area of risk transfer.

2.2. Insurance spending in Central and Eastern Europe

In 1999, the 27 Central and Eastern European transition countries, including the CIS generated a total premium volume of USD 15.2 billion.[3] The seven largest countries in terms of insurance premium volume (CEE5 countries plus Russia and Croatia) accounted for 89% of the region's total premium volume.

2.2.1. Low insurance penetration

In Central and Eastern Europe, the share of income spent on insurance (insurance penetration), is still considerably lower than in Western Europe. In non-life business, average premiums as percentage of GDP is 1.7%, equivalent to around 55% of the average level in Western Europe (3.0%), while in life business it is only 0.7%, or just 14% of Western Europe's level (5.0%). Penetration is higher among the 10 EU candidates, with average values of 2.0% for non-life and 1.0% for life business.

Despite a recent boom, life insurance is still under-developed in all Central and Eastern European countries. This is a reflected by the low proportion of income spent on life insurance. Only the CEE5 countries and Russia achieved penetration rates above 0.5% (exceeding 1% of GDP in Hungary, Czech Republic and Slovakia). In Croatia, spending on insurance was just under 0.5% of GDP, while the insurance sector is virtually in its infancy in the other Central and Eastern European countries.

The differences are not as marked in the non-life sector. Besides the CEE5 countries and Russia, a number of Southeastern European countries, as well as Estonia and Latvia, show penetration rates in excess of 1.0%. Some of the countries in Central and Eastern Europe already show a higher insurance penetration than some EU member states in Southern Europe (see Figure 1). Conversely, the countries of the former Soviet Union (with the exception of Russia) have a comparatively low insurance penetration of

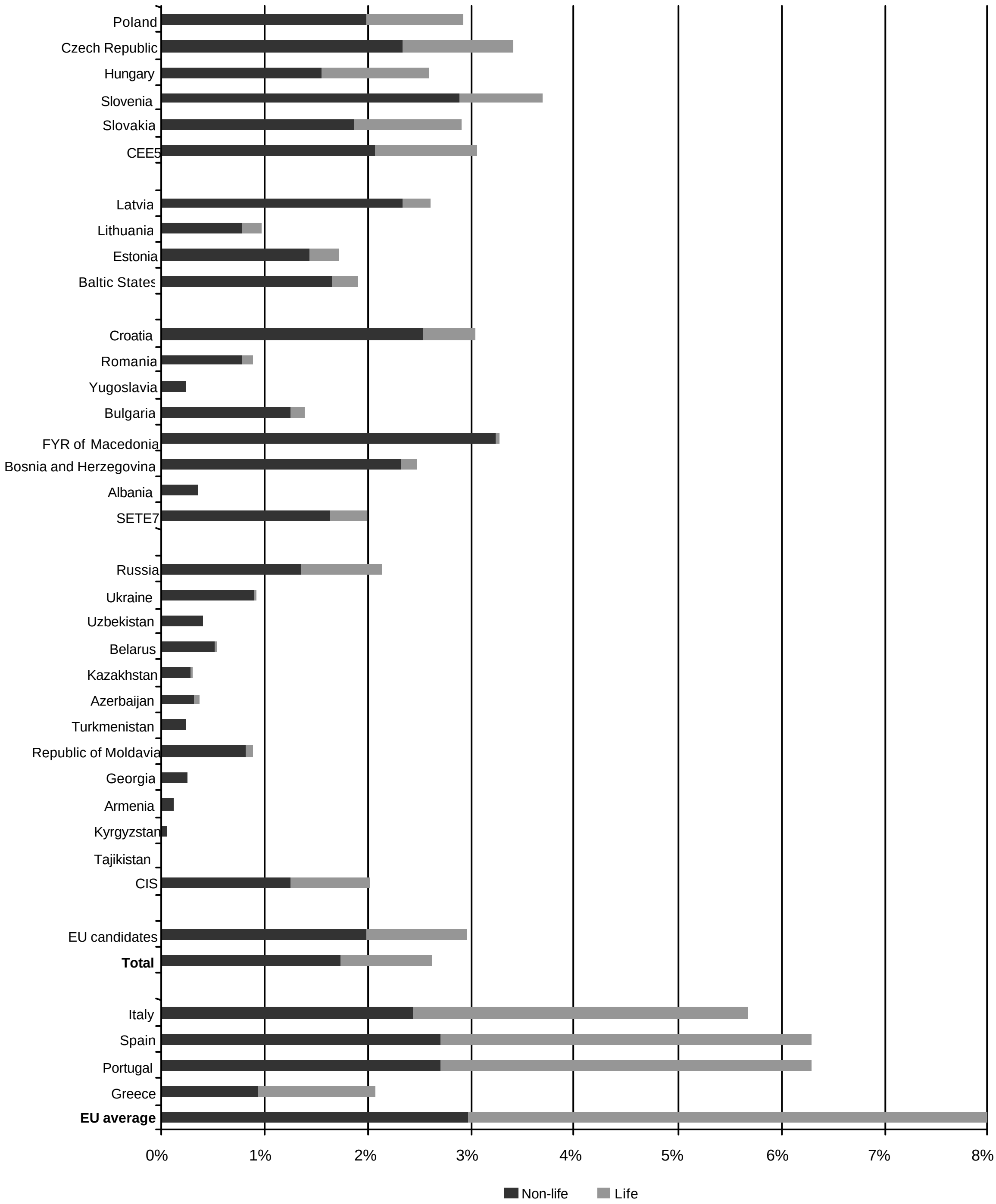
[3] Total insurance volume is therefore roughly the same as for Belgium or Brazil.

less than one percent, as do Romania and Lithuania.[4] Particularly in the Caucasus and the smaller Central Asian republics, the insurance industry is still at a very primitive stage of development.

In recent years, insurance penetration rates have risen steadily in almost every country. In particular, the high real growth rate seen in life insurance has resulted in a rapid rise in insurance penetration. This rise was not as steep in the non-life sector. Only in Croatia and Slovenia has the insurance sector has been growing more slowly than the economy as a whole since 1995, resulting in lower penetration.

[4] The low penetration rate in Lithuania is attributable to the absence of obligatory motor third party liability insurance.

Figure 1
Insurance penetration in Central and Eastern Europe 1999
(premiums as percentage of GDP)



Source*:* Swiss Re, *sigma* No. 1/2001

2.2.2. Dynamic growth of premium volume

Since the end of the transformation crisis at the beginning of the nineties, the insurance industry has experienced dynamic growth in Central and Eastern Europe. Life insurance registered – albeit from a low starting point – 17.4% growth after adjustment for inflation. This was almost twice as high as the annual growth rates among the EU member states. In non-life insurance the growth rate surpassed EU levels to an even greater extent, averaging 7.6% per annum. Life insurance benefited from tax incentives designed to encourage individual pension provision; while the main growth drivers in non-life were the introduction and expansion of compulsory motor third party liability insurance in addition to healthy demand for private health and accident insurance. In addition, the privatisation of often under-insured state-owned enterprises increased the demand for commercial and industrial property insurance.

Growth rates in life insurance, however, were highly volatile in some countries. Russia's life insurance market, in particular, was initially unpredictable, due to changes in tax regulations.[5] In the Baltic States, real premium volume declined sharply in the period up to 1996. Only after 1996 did the sector start to grow again, eventually returning to its 1993 level in 1999. Conversely, the CEE5 countries were able to enjoy relatively constant high growth rates throughout the nineties.

In non-life insurance the star performance came from the Baltic States, with average growth in excess of 21.5% per annum. Trends in the CEE5 countries and CIS region were similar, with average growth rates of 8.4% and 7.4% respectively. Only Southeastern Europe and the CIS countries suffered a brief decline in real premium volume in 1994 and again in 1998 due to political and economic crises.

[5] An estimate from AXCO in November 2000 estimates that only some 5% of Russia's life insurance volume meets international standards, while 95% is used exclusively as a means of systematic tax avoidance.

Table 1
Premium volume in Central and Eastern Europe

	Life insurance				Non-life insurance			
	USD million	Real growth over the previous year			USD million	Real growth over the previous year		
	1999	93-99	98	99	1999	93-99	98	99
Poland	1484	16.4%	18.2%	21.6%	3041	11.5%	6.5%	7.9%
Czech Rep.	576	10.2%	7.4%	29.3%	1231	9.6%	3.6%	4.1%
Hungary	507	16.0%	22.6%	21.6%	748	1.5%	3.3%	4.6%
Slovenia	159	26.2%	8.7%	12.1%	567	5.1%	4.7%	0.1%
Slovakia	207	17.5%	28.8%	19.3%	366	7.0%	13.3%	-7.5%
CEE5	2933	15.6%	16.9%	22.3%	5952	8.4%	5.8%	4.9%
Latvia	18	-1.2%	-6.1%	34.6%	145	24.1%	30.0%	3.3%
Lithuania	18	-5.5%	9.9%	9.7%	84	24.5%	61.0%	0.5%
Estonia	15	14.7%	48.7%	2.0%	74	15.1%	1.5%	2.4%
Baltic States	52	1.8%	13.6%	14.6%	302	21.5%	28.2%	2.3%
Croatia	96	22.5%	36.2%	12.0%	513	-3.7%	5.6%	1.1%
Romania	34	8.4%	55.2%	77.1%	246	14.8%	6.7%	29.7%
Yugoslavia	1	-7.2%	-25.7%	-20.3%	199	3.9%	0.9%	-9.0%
Bulgaria	15	-19.4%	17.1%	6.8%	154	4.3%	15.3%	35.7%
FYR of Macedonia	1	2.9%	5.7%	-8.8%	111	-0.6%	-1.3%	1.5%
Bosnia and Herzegovina	7	-	-	-	102	41.9%	22.1%	27.9%
Albania	0.03	-65.5%	-95.5%	60.6%	12.5	-7.3%	8.7%	19.8%
SETE7	155	9.6%	32.5%	24.5%	1378	3.5%	5.3%	8.2%
Russia	1440	16.5%	20.3%	54.3%	2476	7.1%	-18.6%	11.2%
Ukraine	6	-51.0%	-37.5%	-51.5%	276	8.8%	80.4%	21.3%
Belarus	1	-29.1%	-32.5%	-31.0%	56	22.7%	17.8%	61.3%
Kazakhstan	5	2.2%	-25.2%	24.4%	44	75.9%	28.5%	24.4%
Republic of Moldavia	1	-39.4%	-86.2%	-48.8%	9	6.1%	21.1%	-24.7%
Other CIS	3	NA	NA	NA	58	NA	NA	NA
CIS	1456	13.9%	16.3%	53.5%	2919	7.4%	-14.9%	12.7%
EU candidates	3034	15.9%	17.4%	22.9%	6654	10.0%	7.2%	6.5%
All countries	4596	17.4%	17.2%	32.1%	10 551	7.6%	-0.3%	7.4%
Italy	37 942	23.0%	37.6%	31.0%	28 707	2.9%	7.1%	5.2%
Spain	17 907	15.4%	6.8%	31.7%	16 138	3.9%	5.4%	9.1%
Portugal	3 807	24.0%	14.9%	32.0%	2 936	5.3%	4.9%	5.8%
Greece	1 426	9.9%	11.5%	28.3%	1 167	5.6%	3.6%	13.2%
EU-15	434 065	9.6%	5.8%	17.7%	268 666	1.6%	-0.3%	1.7%

Source: Swiss Re Economic Research & Consulting

2.2.3. Motor insurance represents most important segment

Given its low penetration, life insurance currently contributes only about one third to total premium volume in the region. This is substantially lower than in OECD or EU countries, where its share is 60% on average.

The comparatively high proportion of income spent on non-life insurance in CEE5 countries is largely due to motor insurance, which accounts for 50% (Slovenia) to 64% (Poland) of non-life premiums. Other important non-life lines in CEE5 countries are property and accident and health insurance, whereas liability, credit and surety are still under-developed.

Motor insurance has undergone significant changes in recent years. In CEE5 countries the number of cars per 1,000 inhabitants is rapidly approaching EU levels, while prices for new cars and spare parts – which are relevant for premium rates – reflect international standards rather than local costs of living, as they are generally imported. Minimum covers for compulsory liability insurance prescribed by law were raised in the nineties, which also led to higher premiums. Motor insurance business gained further momentum through the demonopolisation and deregulation of obligatory motor third party liability insurance (MTPL). Since the dissolution of Ceska Poijstovna's MTPL monopoly in January 2000, Slovakia is the only remaining country with a monopoly situation in motor insurance. The Slovakian government has also announced the dissolution of this monopoly with effect from January 2002. Except for Poland, where MTPL rates have already been fully deregulated, some forms of rate regulation often continue to exist for social reasons in an attempt to contain increases. Nevertheless, rates have risen considerably in most countries recently.

For Russia a different picture emerges as obligatory MTPL has not yet been implemented. AXCO[6] estimated in November 2000 that out of the 25 million cars in Russia only around 1.8% have any form of insurance cover, most of which through corporate arrangements. In other CIS countries, except for Armenia, MTPL is already obligatory. But its enforcement is still limited. In Azerbaijan only 39% of all cars were insured in 1999, and estimates for Ukraine range from 10 to 20%. Similar to in Russia, motor comprehensive coverage is so far hardly developed. The main customers are commercial enterprises buying policies for their fleet vehicles.

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6 AXCO, November 2000

Figure 2
Premium volume by type of insurance in CEE5 countries 1999

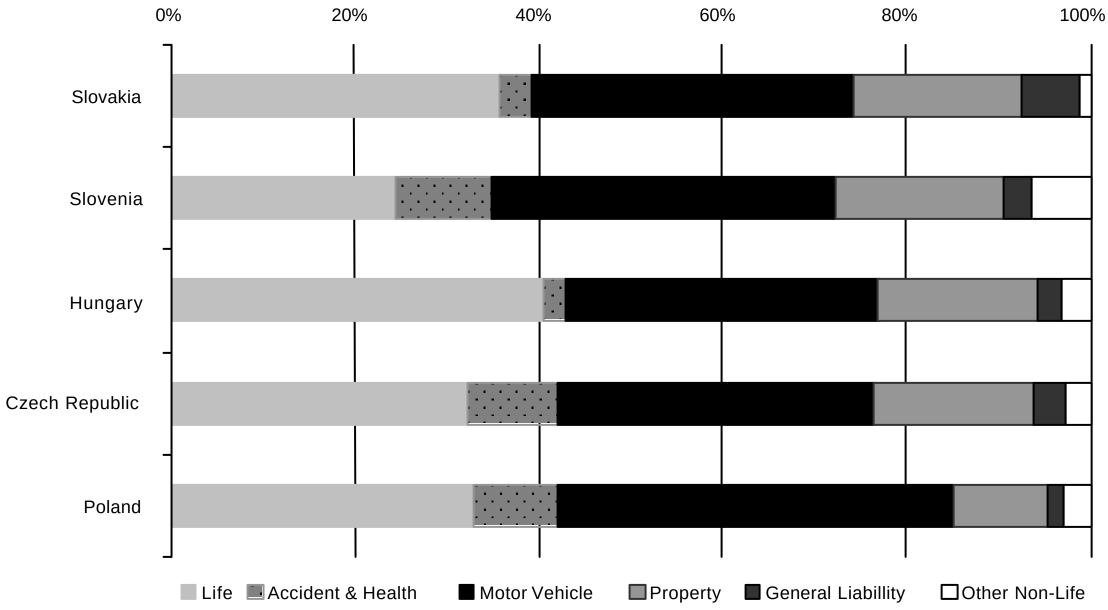
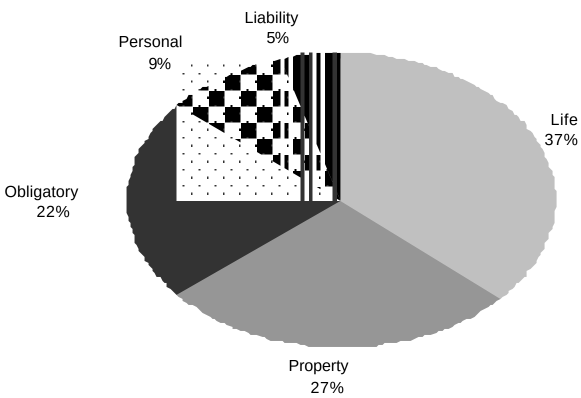


Figure 3
Premium volume by type of insurance in Russia 1999



Source: Swiss Re Economic Research & Consulting, based on data from national supervisory authorities.

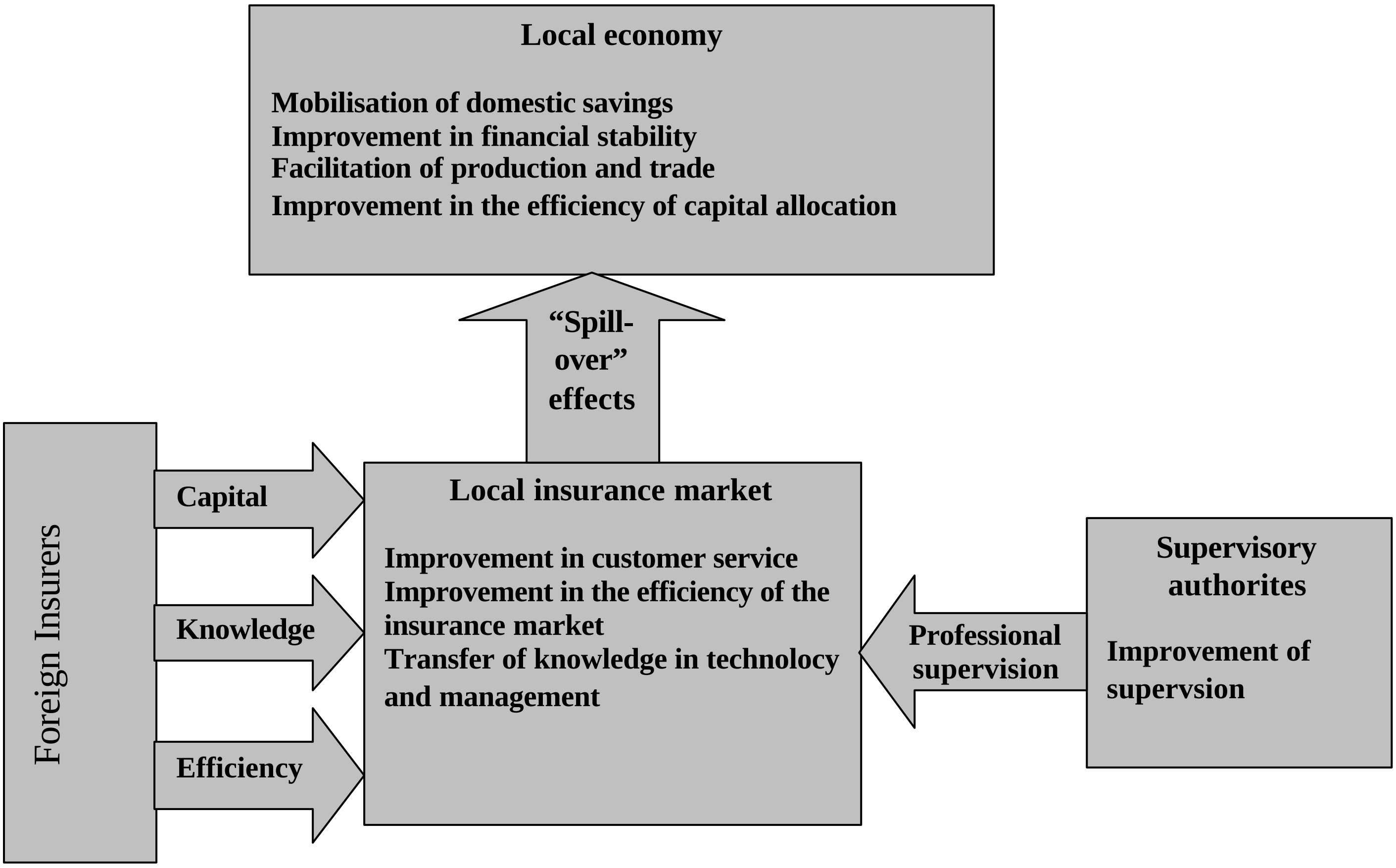
3. The role of foreign insurers

3.1. Benefits and challenges of market access liberalisation

The opening up of the insurance markets in emerging markets to foreign competition has long been a contentious issue. Numerous arguments, including the unfavourable balance-of-payment effect and the need to protect infant industries, have been advanced to justify measures to confine foreign inroads in the market. It is often the case of striking a fine balance between the stability of the insurance market on the one hand and ensuring efficiency and good value for consumers on the other hand.

3.1.1. Liberalisation enhances efficiency of local insurance market

Figure 4
Benefits of liberalisation for emerging market economies



Source: Swiss Re signa N°. 4/2000

The benefits of liberalisation are multi-faceted.[7] Foreign insurance companies can enhance the efficiency of local insurance markets by providing superior customer services, introducing new products and transferring technological and managerial know-how. Liberalisation increases competition and encourages a more pronounced specialisation according to comparative advantages.[8]

Due to their greater financial strength and risk diversification capabilities, foreign insurers also often have superior claims paying ability, which can help to enhance the financial condition of individuals, households and corporations in emerging markets.

Not only is foreign participation important in promoting financial stability, it is also imperative to facilitating the trade and commerce of developing economies. The availability of a reliable insurance sector has long been recognised as one of the prerequisites in attracting foreign direct investment. Globally active industrial and service companies expect their insurers to follow them and provide worldwide support.

Further, the participation of foreign insurers could improve the efficiency of capital allocation in emerging economies. Underwriting and investment decisions made by foreign insurers based on their international experience and best-practice considerations could send useful signals to markets for efficient resource allocations. The availability of these signals, particularly in markets where credit allocations are not completely based on economic considerations, is important in improving capital productivity.

These positive considerations have underpinned the liberalisation drive in emerging markets but the pace of market opening is far from even as there are still concerns over the potential pitfalls of greater foreign participation.[9]

3.1.2. National autonomy as a major concern

There are worries that selective marketing by foreign insurers could result in the neglect of some customer groups. Foreign insurers, which are generally more focused on high-value clients, could fail to provide insurance covers to certain customer sectors, particularly to lower-income groups.

Another often-quoted argument in favour of limiting foreign participation is that the market is already well-served by local companies and that further entrants could threaten the financial stability of existing companies. This, however, is best addressed by prudential supervision of the solvency of insurance companies and adequate liquidation rules to facilitate the proper exit of insurance companies.[10]

Another potential pitfall of liberalisation relates to the possible outflow of foreign exchange. There are concerns that increased market penetration by foreign insurers would eventually result in rising fund

7 The following discussion on benefits and concerns of foreign market participation is primarily based on theoretical considerations, in particular the work done by Harold D. Skipper: Foreign insurers in emerging markets: Issues and concerns, IIF Occasional Paper, Number 1, 1997.

8 see Kono, 1997.

9 see Skipper, 1997.

10 see Kono, 1997.

outflows over the longer term in the form of profit repatriation and overseas reinsurance. This, however, has to be balanced by other considerations. The immediate impact on the capital account will be favourable, as foreign insurers have to capitalise their new operations as well as invest in offices and equipment. Furthermore, the long-term outflow arising from profit repatriation and reinsurance abroad could be more than offset by other inflows. Foreign direct investment would benefit from the increased sophistication of the domestic insurance market. The improved competitiveness of domestic exports, in view of the trade facilitating effect of insurance, could also result in more capital inflows. Taking into consideration these factors, it is fair to conclude that the net impact on the capital account is likely to be positive.

Perhaps more disturbing to policy-makers in emerging markets is the prospect of over-reliance on foreign insurance capacity. There are worries that a sudden withdrawal of foreign insurers and capacity in times of conflicts could cripple local trade and commerce. Although this could easily be overcome by appropriate diversification strategies, this argument has resurfaced from time to time to justify more stringent regulations over foreign participation. As a result, political concerns over national independence may sometimes prompt governments to restrict foreign participation. regardless of its potential economic benefits.

Nonetheless, the overall, benefits emerging markets stand to reap from opening up their insurance markets to foreign participation should more than offset any negative considerations. Provided that liberalisation is being pursued against the backdrop of a solid set of prudent supervision, consumer protection and competition regulations as well as disclosure of information by the companies, the opening up of insurance markets should bring long-term benefits to emerging markets.

3.2. Progress on market access liberalisation in Central and Eastern Europe

The cornerstoneof reforms in the insurance sector in Central and Eastern Europe during the past decade have been the abolition of state monopolies, the liberalisation of market access for foreign insurers and the establishment of an effective supervisory framework for the insurance industry.

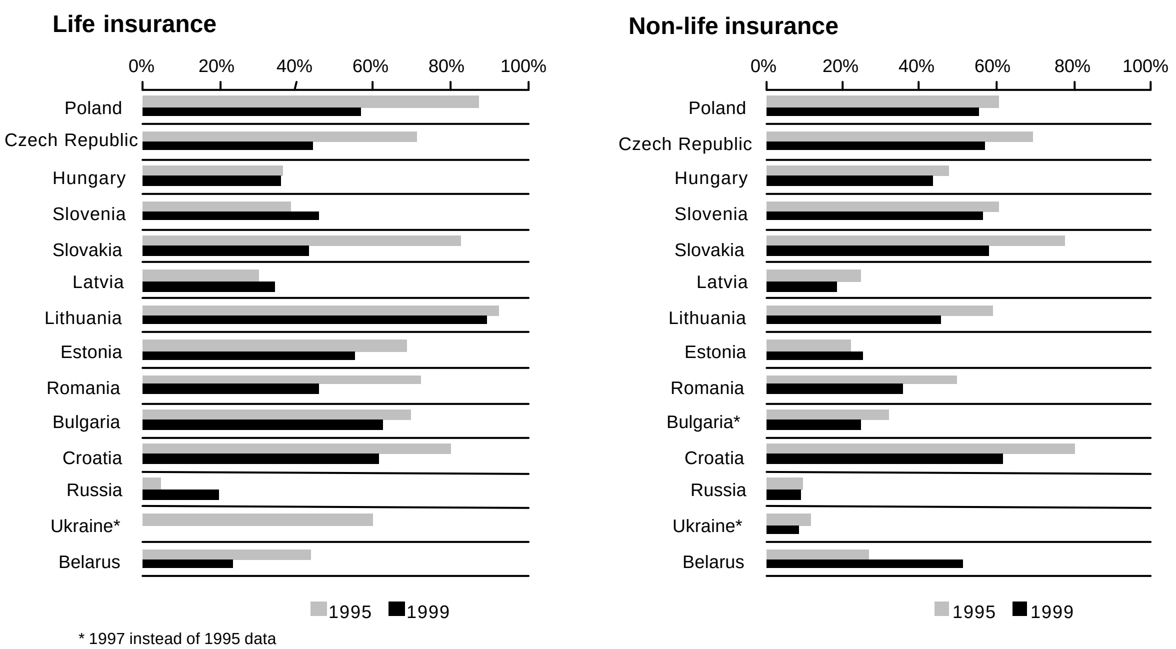
In the ten countries applying for EU membership – Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Romania – foreign investors are now free to acquire majority stakes in local insurance companies or set up their own subsidiaries. Selling insurance policies via branch offices, however, is not yet permitted in all countries. The freedom of services contained in the second EU directive – the option of selling insurance policies beyond national borders without having a corresponding branch office – is not yet allowed in the countries of Central and Eastern Europe, except in the case of marine and reinsurance business.

In CIS countries, except for the Republic of Moldavia, ownership restrictions for foreign insurers continue to exist. In Russia, the overall conditions for foreign insurers have changed since December 1999, and they are now able to acquire majority stakes in Russian companies. However, the activities of all companies funded by foreign capital are restricted to certain non-life lines of business and, overall, there is a limit consisiting of a specific quota on the level of foreign participation in the total capital of all insurance companies in the market.

3.3. Foreign insurers' presence in Central and Eastern Europe

In 1999, INSIG in Albania was the last comprehensive state insurance monopoly to fall in Central and Eastern Europe, and now there is open competition for customers in every market in the region. In recent years the former state monopolists have continuously lost market share, but almost without exception they are still market leaders in both life and non-life business.[11] Generally speaking market share among the leading companies has slipped below 60% in the life business, and below 50% in non-life. In Russia, and also in the Baltic States to some extent, the number of registered insurers has fallen sharply recently because of higher capital requirements and industry mergers and acquisitions.

Figure 5
Leading company's market share



Source: Swiss Re Economic Research & Consulting

During the past few years foreign insurers have expanded their market share considerably, exploiting the opportunities presented by the liberalisation of market entry and the privatisation of former state monopolies. Since the latter often still generate over half the premium volume in many countries, the market share of foreign insurers is heavily dependent on whether the former monopolist has already been privatised or sold to foreign investors.

[11] One exception is Hungary's life business, where a subsidiary of ING is now the biggest company.

To date, Hungary is the only country to have fully privatised its former monopolies with Allianz and Aegon having acquired the respective companies. Eureko's joint acquisition of a 30% stake in the Polish PZU group together with BIG Bank in 1999 is currently the issue of a legal dispute between the foreign investors and the Polish State Treasury, which holds the majority of the shares. In the Czech Republic, the government holds a minority share of 30% in Ceska Poijstovna, while the private investment fund PPF is the ultimate majority shareholder. Various foreign insurers are interested in acquiring a stake in this company. A similar situation exists in Slovakia, where Slovenska Poijostovna is still state-owned. In Slovenia the five state-owned companies still account for more than 80% of the premium volume. This is likely to change in the near future as Slovenia passed a law in March 2000 to privatise Triglav, Adriatic, Tilia, Maribor and Sava. In order to improve their competitiveness, Tilia merged with Maribor and Adriatic with the private local insurer Slovenica last year.

Insurers with significant foreign participation[12] already control a total of some 90% of the insurance markets in Hungary and Poland, while their shares in the Czech and Slovakian markets amount to 30-50%. Apart from the former state monopolies in these two countries and Slovenia, only a few small local insurance companies still exist in Central and Eastern Europe. The global insurance groups Allianz and Generali and to a lesser extent AIG have built up large networks both in life and non-life insurance. Additionally, the Austrian insurers Wiener Staedtische and UNIQA have become important players in Central and Eastern Europe. ING has a strong presence in life insurance, ranking among the top three companies in all markets except Slovenia, where it has not established any operations. Bulgaria and Romania, which long lacked economic and political stability, as well as a reliable regulatory framework, have so far attracted less foreign capital. Recently, however, these countries, too, have made significant progress, with the result that the first foreign insurers have entered their markets.

In CIS countries,with the exception of Moldavia, foreign investors have had limited opportunities to enter the market so far, or a greater exposure has still seemed either too risky or not very profitable.[13]

4. The impact of e-business on the insurance industry

The current advances in information technology mark the beginning of a veritable efficiency revolution in insurance markets. While actual translation into new solutions is still in its infancy, the effects of e-business are the subject of intense debate in the insurance industry. Many insurers are in the process of implementing the new possibilities provided by technology and testing innovative business models. Compared to long-established companies, the new insurers of Central and Eastern Europe have the advantage that they can introduce new business systems unencumbered by existing models

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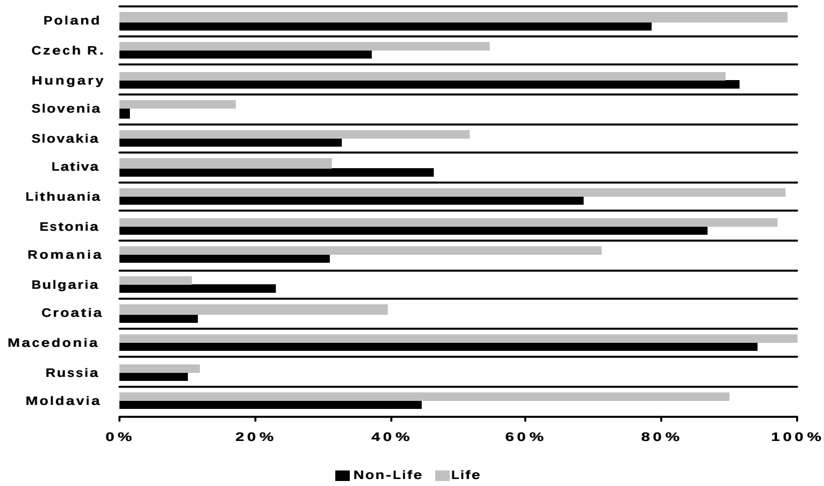
12 Foreign shareholdings in excess of 20%.

13 One exception is Moldavia, where Australia's QBE Group took over the leading local insurer in 1999.

Figure 6
Insurers with significant foreign participation



*includes insurer with foreign majority and minority shareholdings > 20% in 2000

Source: Swiss Re Economic Research & Consulting

4.1. E-business trends in insurance

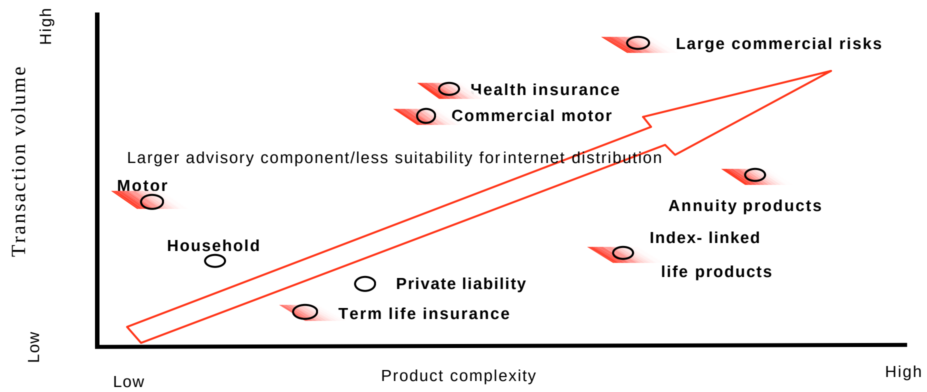
4.1.1. Online distribution of insurance policies will grow

Compared to books, CDs, travel, software & hardware, toys and online stock trading or banking, development of the Iinternet in the worldwide insurance industry has been somewhat cautious. There are a host of special factors which make the online selling of insurance products more difficult:

- They are less standardised
- They can be quite complex
- They are usually taken out (i.e. purchased) infrequently
- Regulatory hurdles

Insurance products differ in their suitability for marketing on the Internet. It depends chiefly on how much advice is required. The more complex the product and the bigger its financial scale (transaction volume), the greater is the client’s willingness to pay for advice (Figure 7). Products that are particularly suited to Internet distribution are those that can be described and rated using a small number of parameters, such as motor, private liability, homeowners, household contents and term life insurance.

Figure 7
Determinants of suitability for online distribution: transaction volume vs. complexity



Source: Swiss Re, Sigma No. 5/2000

Despite the obstacles mentioned, Internet insurers are expected to gain market shares especially in the above mentioned personal lines, which account for about one fourth of total premium income in Europe. In 1999, only 15% of all Europeans had an Internet connection. Only 1% of customers used the Internet to find out about or to purchase financial services, however, far less than 0.1% of premiums were generated via the internet. By 2005, about half of Europeans will be online and the percentage of clients using the Internet to find out about or to purchase insurance and financial services could rise to 20%. Premiums generated via the Internet would, therefore, come to USD 4 to 7 billion in Europe, equivalent to an average online market share of 3-5%.

4.1.2. The internet – much more than just another distribution channel

The use of internet technologies in the insurance industry is not just limited to distribution, it also has a fundamental impact on almost all other production areas. Products that are not necessarily suitable for online marketing can still benefit from the huge opportunities for quality and service improvements presented by e-business:

- If clients already have extensive product and risk expertise, the Internet can still be used as a marketing tool, despite high complexity and transaction volume. “Internet team rooms”, for example, could support the consulting and negotiation process.
- Policy administration or claims settlement can benefit from online support: For example, a client may seek independent advice when choosing a private health insurer, but still be prepared to use online facilities to process and settle doctors’ bills.
- Brokers can use e-business solutions to bundle together the needs of a large number of clients, handle the administration themselves, and then forward the data to the insurer.

- Modern communication technologies allow more personalised products, faster response times, greater flexibility in insurance covers and better support for risk management.

4.2. E-business models

Based upon changes in technology, several new business models have developed around the globe. Most of them are in the field of insurance distribution, but also innovative business models with respect to the complete value chain are being developed. Since a large number of new companies and business concepts are coming onto the market at the moment, the following overview does not claim to be comprehensive.[14]

4.2.1. Different business models for Internet distribution are being developed

Table 2
Business models for Internet distribution

Model category	Business models	Examples
Insurance company websites	Online sale of traditional products	renins.com GeneraLife.com WebInsurance.com Progressive.com
Financial portals	Portals for financial services and/or insurance	Wingspan.com Ilife.com eBanka.com (planned)
Point-of-sale portals	Websites linked to specific events	AutoByTel.com BabyCenter.com
Aggregators	Independent price comparisons	InsWeb.com Quicken.com Quotesmith.com QuickQuote.com LowestPremium.com EHealthInsurance.com Einsurance.de
Online risk markets	Online markets for exchanging risks or entire risk portfolios	GRX.com CATEX.com CreditEx.com TradeWeather.com
Reverse auctions	Insurance clients put their requirements out to tender	insureXL.de

Source: Swiss Re Economic Research & Consulting

[14] Further descriptions of e-business models in the insurance industry can be found in “Internet Insurance Distribution”, Conning & Company, 2000 or “The Internet and Financial Services”, Morgan Stanley Dean Witter January 31, 2000.

Almost all insurers now have a website providing information on the company, its products and contact details. Companies such as Winterthur with WebInsurance in Europe or Progressive in the US go one step further, allowing users to take out insurance cover online as well. Progressive even offers a facility for comparing quotes with those from competitors.

The attraction of internet distribution to clients is limited if they have to spend a fair amount of time familiarising themselves with each website. A number of all-inclusive financial portals take advantage of a regular flow of visitors to their website, and offer standard websites for financial and/or insurance products. The idea is to develop a brand name that becomes a byword for finance and/or insurance products on the Internet. This encourages repeat visits, so that clients who use this website to perform their bank transactions online, for example, might decide to use the opportunity to take out insurance cover at the same time.

Apart from the possibility of marketing insurance products complementary to other financial services, websites are also used that are linked to certain events where insurance is called for. Such point-of-sale portals try to reach possible insurance clients at the point when a need for insurance is generated. Examples include online car or real estate markets, as well as websites based on themes such as “Starting College”, “Career Change”, “Weddings” “Parenthood” or “Retirement”. Such point-of-sale portals are a good opportunity for insurers to target their products effectively at potential clients. At the same time they take into account the common argument that insurance products are sold rather than bought.

The business models described above all have the same drawback: the Internet client is usually not able to compare quotes from several insurers easily. “Aggregators”, also known as navigators, supermarket sites or malls specialise in providing quotations from different insurance companies for comparison purposes. The service is often supplemented by general information on insurance products as well. Some aggregators, such as InsWeb, Quicken Insurance, Quotesmith and eHealthInsurance, already have four or five years’ experience in operating this business model.

A new type of business model has recently emerged in the business-to-business segment, known as online risk markets. These internet providers act as brokers between trading partners - usually insurers, reinsurers and large corporate clients – looking to swap large risks or entire risk portfolios. Examples include the providers Global Risk Market Place, INREON for reinsurance and CATEX for catastrophe risks, both of them relatively new ventures.

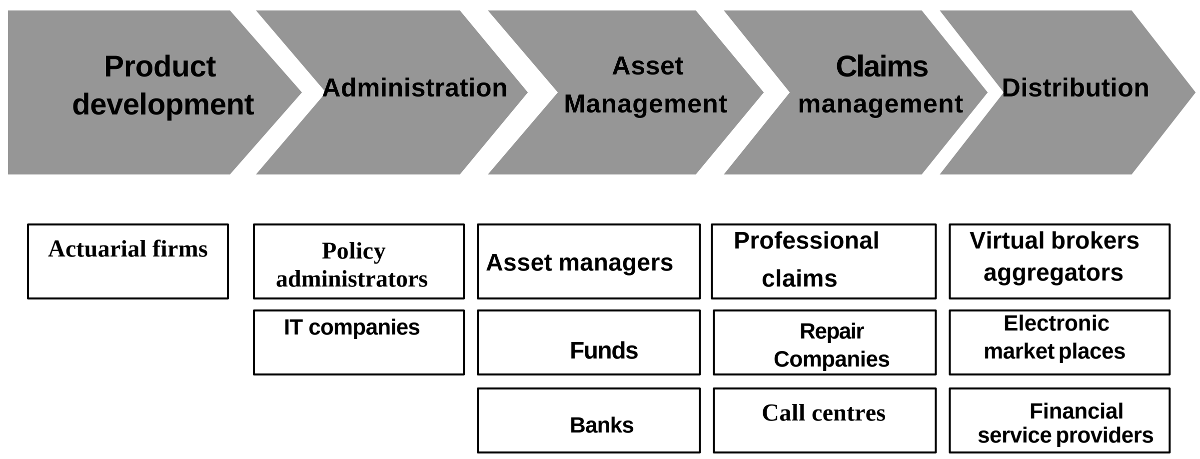
Insurance clients may also use the Internet to place a large risk themselves. These “reverse auctions” are particularly suited to big corporate clients who put their insurance requirements out to tender and then select the most competitive offer. A purchasing group could also use this facility as well: an automobile association, for example, looking for the cheapest insurance cover only for its members.

4.2.2. E-business leads to automation and facilitates the break-up of the value chain

Traditional insurers perform almost all stages of the value creation process themselves: underwriting, distribution, administration, claims settlement, asset management. Rising cost pressure will force them to review their fully integrated business model. New information and communication technologies are making it easier for insurers to break up the value chain and outsource indvidiual functions to specialised providers. This would allow insurers to concentrate on those links in the value chain where they enjoy a comparative advantage. National borders are becoming increasingly unimportant, so that labour-intensive tasks can also be performed in low-wage countries.

Many specialised providers already exist or are currently being set up in many countries. Companies such as AnnuityNet pursue a pure Internet strategy and offer products developed specifically for Internet distribution – in this case index-linked annuities for the most part. In addition to supporting clients when deciding which fund products to choose, they offer the possibility to change fund products during the term of the policy. Therefore the policy is flexible and can be changed at any time. The administration of the changes are handled via the Internet. Business models are therefore possible where clients can directly influence their policy online, for as long as it is in force. Clients also are able to change their own address details, policy deductible or other risk-related data.

Figure 8
Specialised providers exist in virtually all steps of the value chain



Source: Swiss Re Economic Research & Consulting

In the B2B segment, in particular, business models that simplify the administration of insurance policies have emerged. Winterthur-Columna, for example, has developed a system that allows medium-sized companies to administer their own pension scheme contracts, with the insurer automatically adjusting the premiums and benefits. In addition to allowing flexible and easier administration of policies the Internet also allows insurance companies to consider outsourcing the complete administration process. The US company Mynd, for example, provides various back office functions for insurers.

Insurers may also offer the reporting of claims through the internet. Clients are able to track the progress of claims settlement online. Besides insurance websites there are several specialised companies that offer such possibilities. Dekra, a German specialist in the field of monitoring the technical security of cars, offers insurers the possibility to manage their motor claims online. On this website, insurers, garages, clients as well as lawyers have access to information on the stage of their claims settlement and can manage their claims. Another example is Cybersettle, a US company that tries to settle disputes between lawyers and insurance companies regarding liability claims.[15] Lawyers and loss adjusters can secretly submit their proposals for the level of compensation via the internet. Cybersettle then compares each side's proposal. If they are within a defined bandwidth, the system calculates a mean value in order to reach a settlement. The participants agree beforehand to accept any such arbitration settlement as binding.

Another interesting development is being pioneered by various start-up companies, such as Ineas in Europe or GeneraLife in the US. These insurers sell traditional insurance products via the internet, but use e-business technology for consistent outsourcing. Both companies operate with a very small workforce. Their actual core competence is the design and structuring of products, as well as operating an internet sales platform. All other tasks are outsourced to specialist partner companies. Their main aim is to achieve efficiency benefits and offer clients additional services. Although such companies have not managed to acquire significant market share to date, they do present a threat to established insurers because of their potential cost advantages.

4.3. How does e-business affect competition?

4.3.1. E-business lowers market entry barriers

In the past, enormous investments were needed to build up a distribution network with agents or brokers. For that reason, established insurers were generally well protected against new competitors. Now the Internet provides new companies with instant access to the insurance market at an affordable cost. Newly established insurers are not burdened by legacy business systems and are able to exploit modern information and communication technologies in order to set "best practice" benchmarks for the entire industry. In addition, market transparency is improving, since product and price information is more readily available through the Internet. Lower market entry barriers and higher market transparency are combining to intensify competition and force prices down.

[15] Around 99% of all liability claims in the US are closed by reaching a settlement. This procedure incurs average costs equivalent to 13% of the premium volume or 20% of the claims.

Even if e-business lowers market entry barriers, start-up companies, in particular, need to become sufficiently well known and build up client confidence. New companies need to build up this goodwill from scratch, and this usually involves high advertising and marketing expenses. Insurers with an established brand name therefore have a competitive advantage, as they naturally command a greater degree of confidence. ‘Lateral entrants’ from abroad or from other industry sectors who already have a well-known brand name can break into the domestic insurance business with the help of the Internet. These companies could set up new, efficient e-business systems, without the burden of legacy systems or conflicts with other distribution channels.

4.3.2. The Internet provides saving potential in all fields of the business process

In non-life insurance about two thirds of the premiums generated are used to pay claims. One third is used to cover the expenses of an insurer. On average, a third to a half of these expenses belong to distribution of insurance. Policy administration and claims settlement each accounts to one third to one fourth of the insurers expenses. The internet provides potential for cost savings in all of these fields. It can be used to sell policies online and therefore save commissions for agents or brokers. In the field of policy administration savings potential comes from using e-business to automate business processes. Better data analysis may improve risk selection, while the detection of insurance fraud and tighter control by partner companies can help to reduce claims and claims settlement costs.

4.3.3. Considerable margin pressure on traditional insurers

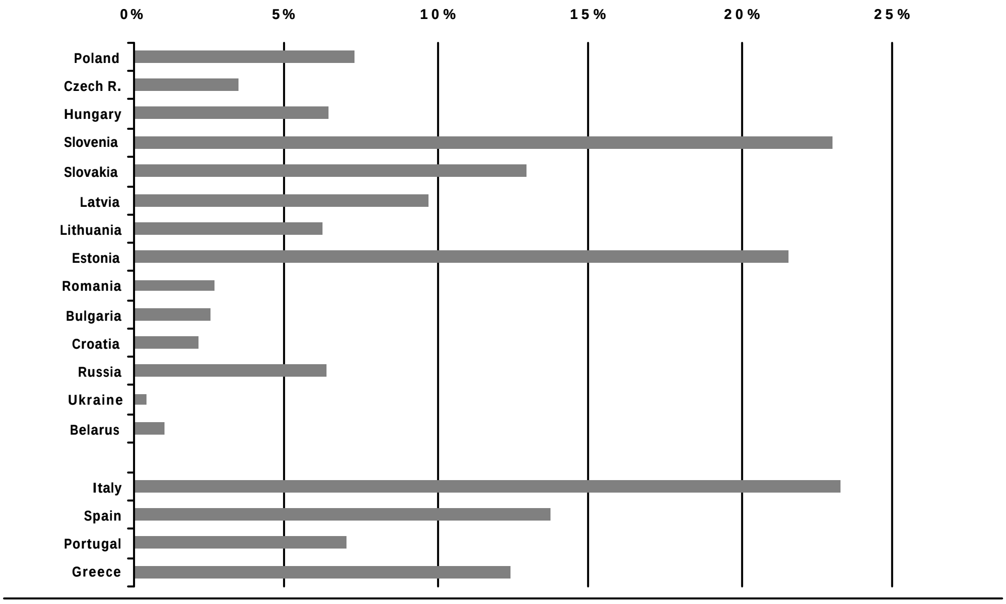
Since an online-insurer has lower costs he could provide insurance for a lower price. This puts pressure on traditional providers to react and also reduce their premiums. Without any adjustments to the cost structure, this premium reduction pushes up the combined ratio. A reduction in the underwriting result would lead to a significant decline in profits. The margin pressure forces traditional insurers to implement sweeping cost-cutting measures.

4.4. E-business prospects in Central and Eastern Europe

In Central and Eastern Europe, personal insurance is sold primarily through company branches and tied agents. In commercial lines, brokers have established a dominant position in Hungary, the Czech Republic and Slovakia. Bancassurance is being developed but thus far has gained momentum only in the Czech Republic. E-Commerce could be an interesting option for newcomers who are unwilling to bear the high investment costs of setting up a large branch or agent network themselves.

E-business activities of insurers in Central and Eastern Europe are still in their infancy, but initial steps have been taken by a few companies. In Hungary, the Allianz subsidiary, Hungaria started to sell motor, life and home insurance via the Internet in November 2000. The company reacted quickly to a change in Hungarian law in October 2000 which made electronic signatures acceptable in insurance contracts. Hungaria intends to offer online obligatory pension fund schemes and voluntary pension savings programs. In the Czech Republic, the Internet bank, eBanka, launched operations in 1998 and was acquired in 1999 by Ceska Poijstovna, the leading Czech insurer. The Internet bank plans to offer the insurance products of its parent company, but so far Czech laws prohibit contracts to be concluded electronically. In Russia, Renaissance has invested in the resources and marketing needed for Internet sales, given its potential. In August 1999, there were already 3.1 million active Internet users in Russia, particularly among those who are more prosperous and better educated and also have sufficient resources for purchasing additional, voluntary insurance. The highest proportion of the population with Internet access is in Slovenia and Estonia. Internet penetration of 21.6% is closer to figures for Germany or Italy than its Eastern European counterparts. Companies in Estonia view the Internet as an effective sales tool for personal insurance lines, in particular. Insurers are offering products for Motor Third Party Liability insurance (MTPL), comprehensive coverage, travel and personal accident insurance on their websites.

Figure 9
Share of population with internet access (mid-year 2000)



Source: NUA, ITU, RIS

5. Conclusions

Efficient insurance markets are an essential basis for the transition countries in Central and Eastern Europe to achieve integration into the global economy and sustainable, strong economic growth. Compared to its importance in Western European countries, the insurance industry is under developed in central and eastern Europe. The proportion of income spent on non-life insurance in these countries is 1.7% or 55% of Western levels, whereas life business expenditure is only equivalent to 15% western levels at less than 1% of income on average. In the CIS states and most of the southeastern European countries, in particular, development of the insurance industry is still at a very primitive stage.

The deficit in insurance penetration is slowly being corrected. The insurance industry has enjoyed dynamic growth since it overcame the transformation crisis at the beginning of the 1990s. In the ten countries negotiating entry in the EU — Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia — the insurance sector is developing on an increasingly solid regulatory and macroeconomic basis. Reform of the supervisory framework in these countries is in line with EU standards and, in this respect, Hungary and Poland are the most advanced countries. Establishing an efficient insurance sector in the CIS states and some southeastern European countries, on the other hand, is proving more difficult. Both regulatory conditions and the investment environment still require considerable improvement. The main reform areas involve the introduction and expansion of compulsory motor third party liability insurance, the tightening of minimum capital requirements, effective supervision of insurance companies and market entry liberalisation for foreign investors.

With their capacity, superior financial strength and know-how, global insurers play a key role in establishing an efficient insurance sector. Despite the economic benefits of market liberalisation, opening the insurance markets is often a contentious issue. While the countries applying for EU membership have largely liberalised market access for foreign insurers, restrictions still exist in the CIS. Exploiting the opportunities presented by liberalised market entry and the privatisation of former state monopolies, foreign insurers have rapidly expanded their activities in Central and Eastern Europe. In some Eastern and Central European countries (eg Poland and Hungary) as well as in the Baltic states, insurers with significant foreign participation already control more than half of the insurance market. By contrast, local insurers dominate the market in the CIS states, as they do in most southeastern European countries. This is due mainly to market entry restrictions and the higher risk of investing in these markets.

Together with globalisation, IT progress is a major driver behind the structural change in the insurance industry to enhance risk transfer efficiency. E-business opens up new ways to reduce costs while lowering market entry barriers and facilitating the break-up of the traditional insurance value chain. Insurance clients will benefit from greater transparency, lower prices and improved services – not just in the sales area, but also in claims management. New business opportunities will arise for focused and niche providers, even from other sectors. In central and eastern Europe, a few companies have broken ground with e-business activities. Following the rapid transformation of the insurance industry over the past ten years, the management quality and sophistication of IT systems can be considered comparable with Western insurance companies. As in the case of western Europe, traditional insurers will face growing competition from alternative suppliers who will exploit the advantages and opportunities provided by new technologies to offer lower priced insurance online.

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