

In order to foster better understanding and more efficient implementation of point 4, paragraph 2, indents 2) and 6), point 12, indents 1) and 5), point 13, indents 1) and 2), point 14, paragraph 1, indent 7) and paragraph 2 of the same point and point 18 of the Decision on Internal Control and Risk Management Systems in the Operations of Insurers (Official Gazette of the Republic of Serbia No. 12/07), in line with the core principles of insurance supervision promoted by the International Association of Insurance Supervisors (IAIS), the National Bank of Serbia has adopted this

GUIDANCE PAPER No. 3 ON MARKET RISK CONTROL AND COMPETITION IN THE INSURANCE MARKET

I. BASIC PROVISIONS

Addressees

This Guidance Paper is addressed to insurers.

Reasons for adoption of the Guidance Paper

The reason for the adoption of this Guidance Paper is the need for insurers to operate in accordance with the market principles.

Market game, which is gaining momentum as competition increases in the Serbian insurance market, will be the key determining factor of successful performance of insurers. Social elements, involvement of the State to cover losses and artificial support of certain economic operators were characteristic of the past times. Under the present circumstances, market laws are becoming key requirements which insurers must meet in order to ensure successful performance. The market, in other words the competitors and the consumers, are becoming the key factors that will determine which operators will remain in the Serbian insurance market and what their performance and success will be.

Compliance with legal norms and requirements of supervision authorities and other competent authorities is a necessary, but not sufficient, precondition for an insurer's survival and success. The key to success is responsiveness to consumers and their needs and wants and the perception of competitive edge by consumers and the general public. Such approach creates a sound, competitive market in which only the best are able to survive and thrive, while consumers, the economy and the society at large reap the benefits regardless of the outcome.

Objectives of the Guidance Paper

The National Bank of Serbia has published this Guidance Paper to safeguard the interests of policyholders and beneficiary owners and to enhance the quality of services rendered to them by insurers and other entities.

II. MODERN BUSINESS CONCEPT

In order to be able to comply with the above requirements and to adapt to new circumstances, insurers should base their organization, activities and overall business concept on market principles.

The modern business concept imposed on insurers by the market economy is based on:

- Environment analysis, market research, collection of all relevant information for business and decision-making and identification of all potential external risk sources (macro-factors and trends, regulations, consumer preference, competitors' actions etc.),
- Development of a market approach strategy based on information collected and analysis performed,
- Adaptation of the organizational structure, culture, corporate governance, financial management, human resources management and all other activities to the set goals and business models, in parallel with the development of an internal control system to ensure compliance with the defined models and attainment of the set goals, while at the same time preventing excessive exposure to risks of different origin,
- Development of information systems which will enable faster, more reliable and more meaningful two-way communication both within insurers and with external stakeholders, with a view to promoting corporate culture and support for decision making, on the one hand, and, on the other hand, providing full and objective information on all aspects of business operations, and primarily those of financial nature, to supervision authorities, consumers and all other stakeholders,
- Respect for ethical standards and principles of conducting business, i.e. corporate social responsibility for all actions.

III. ENVIRONMENT ANALYSIS AND MARKET RESEARCH

An insurer striving to be responsive to all stakeholders and to be perceived positively by the public should have in place a system for monitoring its business environment. The modern business environment is characterized by frequent changes, which makes adaptation an ongoing process. Insurers should gain insight into all economic, legal, legislative, political, demographic and other factors that may affect their operations and should be aware of the directions in which these factors are changing. The recommended environment analysis technique is SWOT.

Market research should enable an insurer to acquire information relevant for its business. With it, an insurer makes the first step in risk management: identification of all fields and factors that could adversely affect the insurer and its performance. The research and the accompanying analysis should focus on markets where insurance companies act as market participants, i.e. on the insurance market and on the financial market.

In the insurance market, insurers act as sellers of their insurance services. The purpose of research in this market is to determine the selling potential and to identify the types of insurance that could be sold, i.e. to understand customers' preferences in terms of insurance services and their costs and to assess the competition. In this market, research is very complex and insurers are not recommended to spend their own resources for this purpose. Instead, they should take recourse to outsourcing, having first analyzed the opportunities. This analysis should enable insurers to prevent the risk of inadequate market positioning and to devise an offering that would suit the consumers' needs.

Financial market research is increasingly gaining relevance as different financial instruments emerge that can be used for the collection of investment of financial assets. In any case, this activity can help insurers to comply with the requirements set by supervision authorities in connection with the depositing and investment of technical and guarantee reserves and more efficient asset-liability management, i.e. management of deposit and investment risks and risks of mismatched maturities and structures of assets and liabilities. In parallel with the analysis of macroeconomic trends, financial market research should provide information on potential exposure of an insurer to specific segments of market risk, i.e. interest rate risk, currency risk and equity and real estate risks.

An insurer should analyze other factors to identify potential exposure to other risks. Particular attention should be paid to the legal environment, meaning the legislative provisions and other regulations, as well as to the demographic environment and trends, particularly where insurers provide life insurance.

IV. MARKET APPROACH

Facts acquired through environment analysis and market research should provide an informational basis for decision-making, development of strategies and performance of relevant actions in their implementation.

A market approach strategy should be based on the key idea of the modern business concept, namely that the consumer is the key stakeholder of an insurer and that meeting the consumer's needs and wants results in the attainment of objectives pursued by the insurer as an economic operator, which improves its position in the market and its perception in the eyes of the public and produces positive financial effects in terms of higher market value and shareholder value. The alignment of interests of all stakeholders which occurs when an insurer focuses on the consumer and on highest-quality services that would meet his/her demands is at the core of this business orientation and organization model. Safeguarding of interests of policyholders and beneficiary owners, a responsibility which the supervision authority enforces, should become the guiding light of every insurer as a whole and its individual parts.

The development of a market approach strategy in fact implies the adoption of a number of strategies for each significant variable.

a. Insurance service

In the Serbian insurance market, third party vehicle insurance accounts for a dominant share. However, as there is an apparent upward trend in the shares of other types of insurance, the principle of voluntary insurance is expected to take center stage, all the more so because even in compulsory insurance policyholders are free to choose the insurer.

Insurers are therefore recommended to develop such service packages as will enable them to satisfy the customers' needs and wants identified in the market research mentioned above and position themselves favorably against the competitors, keeping in mind their ability to service their new products (a risk assessment should precede the introduction of every new product). These processes will be intensified as our citizens become more aware of the importance and advantages of insurance, as the demand for these services grows and as the level of requirements and criteria according to which policyholders will choose their insurers rises.

In this regard, it is vital to accurately define the terms of insurance, to set an adequate level of self-insured retention and to implement an appropriate co-insurance and reinsurance policy. It is also of crucial importance to observe the recommendations given by actuaries and to draft insurance contracts into a high level of detail, so as to safeguard the insurers from excessive exposure to investment risks.

Insurers are recommended to identify target consumer groups, i.e. groups whose requirements they can meet best, before defining the service package to be offered in the market.

b. Insurance tariffs and premiums

For the purpose of this Guidance Paper, insurance premium tariffs are deemed to be the price of an insurance service which an insurance company quotes in the market. Apart from its actuarial basis, a tariff policy or premium-setting policy should also take market factors into account.

Lower service costs may be a way to achieve a better market position and a higher share, but they can also entail excessive risk exposure. However, as the consumers' awareness develops, the cost factor will gradually lose importance and policyholders will be more attracted to high-quality service.

c. Intermediation in insurance

One specific feature of the insurance market is that most market transactions do not occur directly between the insurer and the policyholder, but through a network of intermediaries. Insurers are recommended to carefully set up this network, taking into account its importance, the quality level of services and possible effects on reputation, primarily the reputation of the insurer itself.

The network of intermediaries, i.e. the distribution channels, should adapt to the territorial distribution and other relevant characteristics of policyholders, so that

they could be used as a competitive advantage. In this context, it should be borne in mind that the operations of intermediaries directly impact an insurer's reputation, i.e. the perception of that insurer by its policyholders and by the general public.

Insurers should therefore specify in their internal procedures the relevant criteria for the selection of entities to be included in the networks of intermediaries and the criteria for contract termination, taking due account of the need to include only agents and brokers authorized by the National Bank of Serbia who are capable of performing operations on behalf of the insurer with highest quality and in line with good business practice and customs.

Under the risk management rules, insurers are required to control the operations of their agents and brokers, their debits and credits on "strict record" forms and the contracts they concluded on behalf and for the account of the insurer. Furthermore, insurers are required to control the way in which insurance products are sold by intermediaries. It is necessary to implement ongoing monitoring in order to secure favorable reputation for the insurer.

d. Advertising

Insurers are advised to advertise their services by themselves and not via their agents or brokers, to avoid misleading the customers. Particular emphasis is placed on the fact that entities which leased out the premises where an insurer's staff is selling policies or concluding insurance contracts do not have the right to advertise such insurance services. Insurers should inform their consumers through advertising or on their webpage about the names of the agents and brokers where their policies can be bought, thus guaranteeing that they have concluded agency or brokerage contracts with those entities and that such entities are authorized to perform the activity concerned.

Competent bodies of insurers should also control the costs of advertising, sponsorships and other promotional activities, especially as regards the sources of funding for such activities.

V. ADAPTATION OF ORGANIZATION TO THE NEW BUSINESS MODEL

Insurers should adjust their organizational structure, culture and all activities, in order to enable best implementation of the market approach described above.

A major element in the range of risks to which an insurer is exposed in its business operations is the risk of misunderstanding, or the risk of inadequate adaptation to the circumstances and customer preferences. This risk results in inadequate market positioning and failure to meet the objectives.

All functions of an insurer that take part in its business activities should be aware of this. Corporate culture, organizational structure and human resources management should be such as to allow every employee to understand his/her duties and responsibilities and their relevance in the pursuit of the insurer's objectives. This will enable the employee to perform his/her duties in the most adequate way, thus serving the interest of the customers (policyholders), which, as has already been pointed out, is also in the interest of the insurer and its owners and employees. Organizational structure, corporate governance, plans of activities etc.

should be aligned with and be subordinated to the defined business concept. Every decision that has been made and every activity that has been performed should be subject to detailed analysis to determine its repercussions on the market position of the insurer and on the interest of its policyholders.

Once they understand the importance of establishing such relations with the customers, once they become aware that their customers' interest is their best interest as well, insurers and all their staff will focus all their skills and actions on safeguarding the policyholders' assets they have been entrusted with and on protecting the policyholders' present and future interests. Thus insurers will both comply with the supervision requirements and create loyal customers in the market – the greatest competitive advantage and the key to success in business.

The internal control system plays an important role in this process because it has to ensure the implementation of this concept and the achievement of strategies and plans, as well as to prevent any irregularities and illegal action in business operations, inadequate level of information, all kinds of inefficiency and excessive exposure to risks. Insurers are called upon to remember the importance of early warnings in the detection and prevention of harmful effects of excessive exposure to various risks and the importance of preventive action, in which an adequately organized internal control system is invaluable.

VI. INFORMATION SYSTEMS

Information systems should be developed as a follow-up on information collected from external and internal sources. An efficient information system ensures that all information is timely and in suitable form transferred to all places where decisions are made and where strategic activities are performed. Apart from providing support in decision-making, information systems should also support communication within the organization and assist in the preparation of information to be presented to the public.

Information system development is the responsibility of the highest hierarchical levels of an insurer's management. An information system should be supported by an adequate computer network and software packages. Investment in technical equipment should be reasonable; in this context, it is vital to ensure that the equipment is used for designated purposes, i.e. to ensure the attainment of the objectives of the system, while at the same time providing maximum data protection.

It is recommended that insurers shape their information systems according to the classic model involving four subsystems:

The first subsystem is internal reporting, i.e. horizontal and vertical two-way communication within the organization. A particularly important segment of this subsystem is the accounting information system, which should ensure proper accounting for business changes and reliability of information provided by the accounting department to internal (and through them external) bodies. Furthermore, the competent bodies of insurance companies have the opportunity of using this subsystem for maximum dissemination and reinforcement of corporate culture and building of the desired corporate identity and at the same time to detect organizational weaknesses;

The purpose of the second subsystem, the research subsystem, is to include in the information system any data from the environment that may be relevant to the

insurer, i.e. to acquire external information by means already described and to include it in internal information flows;

The third, analytical, subsystem should convert all relevant data from internal and external sources into decision-making information and direct these to the locations where decisions are made. This subsystem can also have integrated decision-making models, i.e. it can function as a *decision support system*. The use of these mathematical computing models is highly recommended in investment decision-making. Preferably, this subsystem should include electronic databases as its separate segments. These databases should be accessible to all employees who need them and should allow for easy data retrieval. The data contained in such databases, particularly those in connection with customers, should be protected from all forms of abuse;

The fourth subsystem should be focused on informing all interested external bodies on the business operations of the insurer, i.e. on timely presentation of relevant and reliable data on the insurer in the required form.

VII. ETHICAL RESPONSIBILITY

For the purpose of establishing and maintaining favorable business reputation, insurers should observe ethical standards and principles and be accountable to the customers and the public for their actions. Accordingly, they should pay particular attention to the consequences their actions produce for the market and for other market participants and exert efforts to avoid any negative effects in terms of disloyal competition or failure to meet any obligation assumed toward the policyholders.

The principle of ethical responsibility also applies to all employees of insurers, who are expected to perform all activities conscientiously, in line with the interests of the insurer and its customers. The internal control system is responsible for ensuring compliance with this principle. Adoption of ethical codes is also recommended.

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Responsible, transparent and market-oriented insurers of good business repute which operate in a competitive and modern market are the aim pursued by the National Bank of Serbia in the field of insurance supervision. Such insurers and market will give our citizens access to higher-quality insurance services in connection with various risks, while at the same time enabling them to lucratively invest their free assets with absolute certainty that their interests will be safeguarded.

The National Bank of Serbia, as a supervisory body, will not enforce this Guideline in insurers, but the implementation and proper understanding of the Guideline will, however, result in improvements in other fields under direct and indirect supervision and prevent situations in which insurers might be subjected to specific supervision measures.