INSURANCE SECTOR IN SERBIA
Second Quarter Report 2006

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Insurance Market

General Indicators

Insurance sector has considerable influence on the development of the country’s economy and strongly contributes to the overall stability in the financial sector of the country.

Serbian insurance sector is still underdeveloped and according to the level of development it measures far below the average level reached in the European Union member countries. Domestic insurance market indicators that include ratio of total premium to GDP and total premium per citizen, attest to this fact.

Share of insurance premium in GDP in 2005 of 2.1% (1.7% in 2004), placed Serbia 58th on the list of all countries in the world. In the same year, Slovenia scored 5.7%, Croatia 3.2%, whereas the same indicator for the 25 member countries of the EU is as high as 8.4%. The highest share of insurance premium in GDP in 2005 was recorded in Taiwan, followed by the Republic of South Africa and Great Britain.

<table>
<thead>
<tr>
<th>Share of insurance premium in GDP in Serbia - 2005, in comparison to some other countries, in %</th>
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</thead>
<tbody>
<tr>
<td>Life insurance</td>
</tr>
<tr>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Great Britain</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
<tr>
<td>Malta</td>
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<tr>
<td>Slovenia</td>
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<td>Czech Republic</td>
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<td>Croatia</td>
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<td>Poland</td>
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<td>Hungary</td>
</tr>
<tr>
<td>Serbia</td>
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<tr>
<td>Greece</td>
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<tr>
<td>Turkey</td>
</tr>
</tbody>
</table>

Source: Swiss Re, Sigma No 5/2006

Premium-per-citizen indicator for 2005 of USD 64 or EUR 54 (USD 52 or EUR 38 in 2004) placed Serbia 63rd in the world. The highest score in the year 2005 was recorded in Switzerland (USD 5,558), followed by Great Britain and Ireland, whereas Slovenia with USD 978 and Croatia with USD 274 were placed 28th and 41st, respectively.
Although in 2005 both indicators (share of insurance premium in GDP and premium per citizen) improved compared to 2004, the insurance sector is still far from the level of development reached both by the EU member countries and the countries in the region.

According to the total premium, Serbia was placed 67th, with USD 480 million. The highest total premium was recoded in USA, Japan and the Great Britain.

The total premium on the global scale in 2005 reflected real growth of 2.5% compared to 2004. The premium growth for life insurance in real terms amounted to 3.9%, and for other types of insurance 0.6%.

Compared to 2004, high profitability of life insurance reflected real insurance premium growth on the largest insurance market – Western Europe. With other types of insurance profitability was lower as a consequence of 0.3% decrease on the largest non-life insurance market in the USA as a result of
enormous damages caused by the catastrophic hurricanes. Despite such world developments, non-life insurance premium in 2005 recoded positive real growth, due to macroeconomic indicators such as: solid economic growth (in 2005 real GDP growth reached 3.4%, reflecting 0.5% increase compared to 10-year average), modest inflation, growing but steadily low interest rate and well-performing stock exchange markets in Europe, Japan and the developing countries.

Market Participants

Insurance Companies

In the first half of 2006, the total number of insurance companies was 18, 15 of which engage in insurance activities only, 2 companies engage in reinsurance activities only and 1 company engages in both insurance and reinsurance. Of the companies engaged in insurance activities, 1 company engages in life insurance only, 7 companies provide non-life insurance only, whereas 8 companies engage in both life and non-life insurance.

Insurance companies are legally required to demarcate insurance and reinsurance activities, as well as life and non-life insurance activities before the end of 2007 and this fact would most likely lead to a change other status changes in the insurance companies (mergers and acquisitions) which will contribute to the consolidation of the insurance sector and change in the number of the insurance companies in the period ahead.

A breakdown by ownership shows that out of 18 insurance companies, 7 are companies are majority foreign (3 of which are well-known insurance companies that appeared on the domestic market through takeover of domestic private insurance companies), 11 are in majority domestic ownership, whereas 9 companies are in private ownership.

Although companies in majority foreign ownership have a small share in the insurance market both in total premium and in total capital (24%), they account for a s much as 84% of the live insurance market, whereas 2 major insurance companies account for 73% of the non-life insurance, as shown in the chart below.
Review of data according to ownership structure in Q2 2006

Stabilization of the insurance market and building of an adequate environment created conditions for attracting serious strategic partners, that would introduce new, high-quality products, prudent approach to capital and capital management, risk-management expertise to the domestic market. The stabilization of the insurance market will also have a direct impact on the improved financial performance of the insurance companies.

Other Market Participants

In addition to insurance companies, the sales network also comprises 39 legal entities, 68 natural persons – entrepreneurs, 1 tourist agency, and 2,724 natural persons holding a license to engage in insurance agency or brokerage activities. The quality and volume of the sales network will be considerably improved as a result of the new regulations allowing banks to sell insurance policies.
Insurance Portfolio Structure

On June 30, 2006 total premium payment stood at CSD 21.3 billion (EUR 248 million, or USD 311 million), whereas on June 30, 2005, it amounted to CSD 18.4 billion (EUR 223 million or USD 269 million). In first half of 2006 compared to the matching period last year the nominal growth amounted to 16%.

The breakdown of the total premium payment shows that the 9.7% share of life insurance in the first half of 2006 recorded a 2.7% growth compared to the matching period last year, bearing down on the 90.3% share of non-life insurance premium payment. Although life insurance premium payment recoded a 60% growth in the first half of 2006 compared to the matching period last year, coupled with a 12% increase in the non-life insurance, its share in the total premium payment of 9.7% (6.7% in 2005) still matches poorly compared to the European Union member countries where the life insurance premium payment comes around 60%.

Comparison between types of non-life insurance premiums makes it evident that over 80% of the premium payment was a recoded in the 5 major types: insurance against accidents, motor vehicle insurance, property insurance against fire and other hazards, other property insurance and insurance against motor vehicle liability.

In the first half of the year, the greatest share, as before, was recorded with the property insurance – 39.1% compared to 42.5% in 2005. Motor vehicle liability insurance recoded an increase from 25.9% to 26.6%, whereas kasko insurance recorded a growth from 11.6% to 11.8% which, taken together accounts for the increase from 37.5% to 38.4%. It can be concluded that the revenues arising from those two large types of insurance services are fairly leveled.

Voluntary health insurance premium recorded growth of 1.7% in the first half of 2005 to 2.9% in the matching period this year, reflecting its nominal growth of 98%. In view of the fact that developed countries are witnessing a trend of shifting the mandatory health insurance towards insurance companies and also the current weaknesses of the domestic mandatory health insurance system, it is likely that this kind of insurance will experience a strong development on the domestic market in the period to come.

Voluntary pension fund insurance, the so-called Third Pillar, is a type of life insurance that is domestically provided by 3 companies that are currently undergoing transformation into voluntary pension fund management companies. Although the voluntary pension fund insurance premium recoded a growth from 0.6% in the first half of 2005 to 1.8% in the first half 2006, as well as 233% growth in the period under review, it still has a very small share in the total insurance premium.
A high insurance market concentration is still very noticeable. On June 30, 2005, the 5 leading insurance companies according to the achieved premium covered as much as 87% of the market, and 2 of them covered 68% of the total premium and 73% of the total non-life insurance premium, whereas the following group of three insurance companies covered the remaining 19% of the premium, as shown in the table below:

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of companies</th>
<th>Total premium in CSD million</th>
<th>Share in total premium, in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>2</td>
<td>14,458</td>
<td>68</td>
</tr>
<tr>
<td>II</td>
<td>3</td>
<td>4,052</td>
<td>19</td>
</tr>
<tr>
<td>III</td>
<td>13</td>
<td>2,831</td>
<td>13</td>
</tr>
<tr>
<td>Total</td>
<td>18</td>
<td>21,341</td>
<td>100</td>
</tr>
</tbody>
</table>

The share of companies in majority foreign ownership in the total portfolio amounted to 9% in the first half of 2005, growing to 24% in the first half of 2006 reflecting the takeover of domestic insurance companies by foreign companies. These companies recorded strong growth trend both in the life insurance share in the total life insurance premium of all companies from 73% in H1 2005 to 84% in H1 2006 (40% of which pertains to 2 companies which contribute to total insurance premium of all insurance companies with only 7%), and also in the share of their non-life insurance premium in the total non-life insurance premium of all companies from 4% in H1 2005 to 18% in H1 2006.
Balance Sheet Total and Balance Sheet Structure

Balance Sheet Total

Balance sheet total, as an indicator of vitality in the sector, experienced a significant growth trend, swelling by 37%, from CSD 38.7 billion in H1 2005 to CSD 53.1 billion.

As shown in the chart above, the level of balance sheet total was unevenly distributed among the companies, reflecting a CSD 12 billion share of the 2 leading companies, followed by the next group of 2 companies whose balance sheet amounts to CSD 2-5 billion, whereas the remaining companies’ balance sheet was under CSD 2 billion.

Structure of Assets

Within the structure of assets of insurance companies on June 30, 2006, 37.3% refers to fixed assets (23.3% of which was real estate, and 13.2% were long-term financial investments), with the share of working assets at 62.7% (of which 23.4% refers to short-term financial investments and 22.8% to receivables in respect of premiums).
Structure of assets on 31. 12. 2004

- Real estate, equipment and investment real estate: 49.0%
- Long-term financial investments: 12.8%
- Receivables: 19.3%
- Cash and equivalents: 6.6%
- Short-term financial investments: 10.0%
- Other: 2.3%
- Cash and equivalents: 6.6%
- Receivables: 19.3%
- Short-term financial investments: 10.0%
- Other: 2.3%
- Real estate, equipment and investment real estate: 49.0%
- Long-term financial investments: 12.8%
- Receivables: 19.3%
- Cash and equivalents: 6.6%
- Short-term financial investments: 10.0%
- Other: 2.3%

Compared to June 30, 2005 when the share of fixed assets amounted 53.5% (of which 40.2% was real estate and the share of long-term investments was 12.4%), whereas the share of working assets was 40.2% (of which receivables amounted to 25.6% and share of short-term financial investments was only 11.8%), it could be concluded that the structure of assets saw a significant improvement, given that insurance market is largely dominated by the non-life and mostly short-term insurance.

It should be noted that real estate, machinery and equipment that previously that dominated in the structure of assets experienced a decline in the first half of 2006, giving in to short-term financial investments with 23.4%, reflecting a 172% growth compared to the H1 2005. This change was brought about by the change in regulations that now envisage the obligation for insurance companies to invest financial assets for the purpose of meeting the undertaken liabilities.
Structure of Liabilities

Within the structure of liabilities as of June 30, 2006, technical reserves accounted for 53.3%, and capital and provisions accounted for 35.6% of liabilities.

Compared to the structure of liabilities on June 30, 2005, when the technical reserves had the 50.3% share, compared to 38.6% of capital and provisions, it is clear that the insurance companies continued increasing allocation of technical reserves. Although both capital and provisions recoded a growth of 21.2% (from CSD 15.3 to 18.6 billion), arising mostly from additional capitalization of insurance companies in line with the legal regulations, their share decreased by 3% due to faster growth of technical reserves in the period under review by 39.4% (from CSD 20 billion to 27.9 billion). Such strong growth of technical reserves, coupled with adequate investments of such reserves is of greatest importance for the welfare of the insured.

Continued increase in technical reserves in the first half of the year which significantly outstrips the total premium increase of 16% in the same period has resulted largely from the uniform criteria for the calculation of technical reserves, as prescribed by the National Bank of Serbia, and also from strict supervision of the allocation of technical reserves. As a result, insurers have
accepted a good practice of realistically assessing these reserves and by doing so, protecting the interest of the users of insurance services.

The structure of technical reserves has been conditioned by insurers’ portfolio structure, i.e. by the low share of life insurance in total portfolio of insurance companies. Unearned premiums (54.6%) make up the largest part of the technical reserves, which together with outstanding claims (26.9%) represent more than 81.5% of technical reserves.

In the period under review, unearned premiums registered an increase of 48%, mathematical reserve grew by 93% largely due to the growth of life insurance portfolio growth of 2.7% which will in due time bring about the changes in the structure of technical reserves by increasing the share of mathematical reserve.

On June 30, 2006, coinsurance, reinsurance and retrocession accounted for 11% of the technical reserves, whereas on June 30, 2005 the share was 7% reflecting increased share of reinsurance premium in the total premium, which is a positive sign, since good insurance implies well distributed risk and reinsurance.

Coverage of Technical Reserves

In order to safeguard the interest of policyholders and third party claimants and to ensure that the damages are paid out in a timely manner, it is not sufficient just to hold an adequate level of technical reserves, but it is also important that these be invested in a way that ensures that all assumed obligations will be settled as a whole and in due time, both at present and going forward. In order to be able to meet its obligations, an insurance company needs to invest funds based on the type of insurance it provides, taking into account the maturity of its obligations, profitability and dispersion of investment.

In the first half of 2006 technical reserves for *life insurance* were largely covered by securities issued or guaranteed by the government (as much as 62%), followed by deposits with banks which make up for 11% of the total coverage. As regards the coverage of technical reserves of *non-life insurance*, investment in deposits with banks was predominant with 20%, followed by cash in vaults, funds on bank accounts (19%), and claims in respect of undue premiums (18%).

In the case of companies that engage in *reinsurance*, the structure of technical reserves of non-life insurance is dominated by the unearned premiums financed by coinsurance, reinsurance and retrocession (46%), followed by securities (28%).

The analysis of the data on the investment of technical reserves of insurance companies in the period 2004 to June 2005 shows improved quality of
investment in terms of lowered investment in real estate and related persons. Also evident is the fact that the insurance companies were investing efforts to reconcile their investments with the strict NBS regulations passed with a view to customer protection and raising awareness of the importance of profit generating investments.

**Business Indicators**

**Solvency**

The solvency of the insurance companies depends on whether its technical reserves are sufficient to cover its obligations, and on whether guarantee reserves are at the level adequate for the protection of policyholders in the event of unforeseen operating losses and for offsetting losses that aren’t covered by the technical reserves.

Beginning with June 30, 2005 insurance companies in Serbia are required by the Law on Insurance to maintain guarantee reserves at the level above the solvency margin.

Subject to secondary legislation, drafted in conformity with the European Union directives, as of June 2005 the solvency margin has been calculated based on the criteria that take into account the type of activities in which insurance companies engage, their volume of operations and damage claims in the period of three years.

Solvency margin as of June 30, 2006 stood at CSD 9.6 billion reflecting a 19% increase compared to the matching period last year, whereas guarantee reserve of 17.2 billion increase by 27% compared to the same period last year. It should be noted not only that the guarantee reserve outstripped the solvency margin, but that the guarantee reserve grows faster than the solvency margin reflecting stronger position of insurance companies and more capacity to respond to unexpected losses.

**Liquidity**

Liquidity of the insurance companies, measured as the ratio of short-term assets to short-term obligations (including provisioning against future claims and provisioning against unsettled claims) grew from 0.95% in the H1 2005 to 1.29% in H1 2006.

Such growth in liquidity can be explained by an improvement in the structure of assets in the previous period, as explained earlier, since the insurance assets were transformed into more liquid forms of property (in H1
2006 real estate, equipment and long-term investments make up 36.4% of the total assets, compared to 52.7% in the same period 2005).

**Automobile Liability**

Given that this type of insurance dominates the domestic insurance market, and includes the largest share of policyholders (approximately 1.8 million) and potential claimants, as well as the fact that majority of the closed insurance companies used to engage in this type of insurance, the public sentiment regarding insurance services in Serbia is build largely based on this field of insurance.

Mandatory automobile liability insurance is still regulated by the old Law on Insurance of Persons and Property.

The adoption of the new law on mandatory insurance will mark the completion of the regulatory framework. In the meantime, the National Bank of Serbia together with the Association of Insurance Companies in Serbia has undertaken a number activities aimed at improvement of this segment of insurance, by introducing new, hologram protected, standard insurance policy forms printed by the Institute for Manufacturing of Banknotes and Coins. This new standard insurance policy form will be adopted by all insurance companies. The adoption of the new uniform insurance policy form with security features is aimed at securing improved client protection and mitigating risk of double policies.

On June 30, 2006, 11 companies were engaged in providing mandatory third party motor vehicle liability insurance.

Although the monthly data provided by insurance companies testifies to the improved damages repayment, this area still leaves a lot of room for improvement.

Portfolio concentration is present in this as well as in all other types of insurance with two largest companies accounting for 54% of the market.

**Customer Protection**

With a view of realization of one of its strategic objectives in the field of insurance – protection of interest of policy holders and third party claimants, the National Bank of Serbia organized a specialized organizational unit devoted to the safeguarding of customers’ interests. The new organizational unit became effective in 2005 and immediately took an active part in the consideration of claimants’ complaints and mediation with a view to more effective
disbursement of claimants’ damages from the insurance companies and avoidance of long and costly court procedures.

So far the Customer Protection Unit received 436 complaints, 418 of which were resolved immediately; whereas the others were referred to mediation procedure (the first such mediation procedure was held in December 2005). There were 16 mediation cases, 14 of which were resolved to mutual satisfaction, 2 failed and 2 were rescheduled.

Also, the National Bank of Serbia organized its Info Centre, responding so far to over 4,000 phone calls mostly related to mandatory automobile liability insurance. The Info Centre responds to free phone calls to the following phone number 0800-111-110.

The above activities aimed at the restoration of trust in the insurance sector are mostly post festum activities, pertaining to the monitoring of fulfillment of undertaken obligations towards clients. Such activities mostly refer to the timely communication of relevant information, as well as implementation of mediation procedures in which both parties agree to resolve the dispute at hand. Apart from that, the National Bank of Serbia insists also on good management practices and observation of the transparency principle in all operations of the insurance companies in terms of issuing and implementation of relevant internal regulations, drafting of clear regulations under which policyholders can exercise the rights stemming from the concluded insurance agreements and also provision on all purchase sits the proper information on the insurance agreement requirements and the rights stemming from such agreements. The National Bank of Serbia is also investing great efforts into strengthening of the customer protection function and enhancement of its pro-active role in safeguarding of the interests of insurance policyholders and all insurance beneficiaries.

**Conclusion**

The National Bank of Serbia embarked on the insurance sector reform in order to provide for high quality insurance services and overcoming of cumbersome inherited problems. The undertaken tasks regularly call for designing of prudent and wise solutions under constant pressure from both public and also interested parties against which NBS has undertaken rather unpopular supervision measures.

The National Bank of Serbia had so far undertaken a number of activities towards:

- stabilization of the insurance sector by: a) eliminating from the market those insurance companies that have misused insurance funds; and b)
improving insurance sales network quality (by allowing banks to sell insurance policies as of October 2006);

- strengthening of the corporate governance and transparency of operation in the insurance companies;
- customer/claimant protection;
- restoration of confidence in the insurance sector.

Given the status of the insurance market in the first half of 2006 and also the fact that 3 foreign insurance companies appeared on the domestic market by purchasing majority shares package of the domestic private insurance companies, it could be concluded that the positive development trend in the sector of insurance started in 2005 would continue with wider range of services offered to the citizens. This conclusion is only confirmed by the interest expressed by the leading European insurance companies in the privatization of the DDOR insurance company.