



Insurance Sector Assessment
Bosnia and Herzegovina

INSURANCE SECTOR ASSESSMENT

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Abbreviations Used in This Report

BiH	Bosnia and Herzegovina
Federation	Federation of Bosnia and Herzegovina
FBiH	Federation of Bosnia and Herzegovina
RS	Republic of Srpska
EU	European Union
MTPL	Motor Third Party Liability Insurance
CPCU	Chartered Property and Casualty Underwriter
CLU	Chartered Life Underwriter
CIC	Certified Insurance Counselor
CIPS	Citizen Identification Protection System
EC	European Commission
USAID	United States Agency for International Development
FSVC	Financial Services Volunteer Corps
IAIS	International Association of Insurance Supervisors
GCB	Green Card Bureau

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Volunteer Participants

At the request of The Financial Services Volunteer Corps (FSVC), an assessment was made of the insurance sector in Bosnia and Herzegovina by two advisors during November 2003. One advisor is a Certified Public Accountant, former chief insurance regulator of the State of Alaska, USA and a former member of the National Association of Insurance Commissioners of the United States as well as a founding member of the International Association of Insurance Supervisors. This advisor has recently served as a special consultant to the Indian government insurance and development authority and a trainer to their supervisory staff. The other adviser is from the private sector insurance market with over 25 years of experience in senior management positions, is the past President of a U.S. subsidiary of an international insurance group and currently serves as a member of a Department of Housing and Urban Development consensus committee.



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Work Done

The process of the assessment consisted of a review of the structure and level of development of the insurance industry in Bosnia and Herzegovina as well as a general overview of the economic and political environment of the country. While some research was completed prior to arrival in Bosnia and Herzegovina, the majority of the assessment was carried out between November 10 and November 21, 2003 in country. The insurance laws currently in force in the Federation of Bosnia and Herzegovina and the Republic of Srpska were reviewed and interviews were conducted with representatives of the FBiH Commission for Insurance Supervision in Sarajevo and the RS Ministry of Finance, Insurance Supervision Unit in Banja Luka. The set of insurance legislation, developed under the auspices of the European Commission, was also completely reviewed.

Representatives of the supervisory offices were interviewed to ascertain the in-practice activities of the staff in implementing and enforcing the provisions of the existing law. An additional goal of the interview process was to determine the level of expertise in the commonly accepted analytical and examination procedures necessary to oversee, advise and regulate the insurance companies and their practices as viewed by the regulator. During the meetings with insurance companies, the focus was on the current market practices in risk management, investments, as well as the capabilities, obstacles and opportunities of insurance companies operating in Bosnia and Herzegovina.



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Introduction

Insurance, at its purest, is recognized as an effective way to spread risk, and as such a simple concept has worked for hundreds of years. However, for insurance to function properly, an insurance company must be in business and be financially able to pay out to subscribers in accordance with the terms of the original agreement (contract). Thus, solvency is the most fundamental and critical condition for all insurance companies. Insurance companies must abide by strict rules of conduct in remaining solvent; therefore, should be permitted only to invest prudently to assure the money will be there if and when it is needed. Obviously, “prudently” is a relative term. Regulators from around the world have spent countless hours deriving a set of basis concepts that, in their belief and in practice, provide guidelines as to what and how insurance companies should invest to pay future claims should they arise.

The International Association of Insurance Supervisors, a voluntary association of insurance supervisors from over one hundred countries, has developed Insurance Core Principles and Methodology. The introduction to this document states “to contribute to economic growth, efficiently allocate resources, manage risk, and mobilize long term savings, the insurance sector must operate on a financially sound basis. A well-developed insurance sector also helps enhance overall efficiency of the financial system by reducing transaction costs, creating liquidity, and facilitating economies of scale in investment. A sound regulatory and supervisory system is necessary for maintaining efficient, safe, fair and stable insurance markets and for promoting growth and competition in the sector. Such markets benefit and protect policyholders.”

These main areas were used to assess the overall state, from the policy and regulatory standpoint, of the Bosnia and Herzegovina insurance sector.



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Executive Summary

The legal framework for insurance in Bosnia and Herzegovina, as it currently exists, is not adequate. The Law in the FBiH is vague while the Law in the RS is overly detailed. Neither Law incorporates International Core Principles; and, furthermore, the two laws are not harmonized resulting in segmented and separate entity insurance regulatory schemes and markets. While the Laws drafted by the European Commission go far to remedy many of the existing problems, it does also create additional problems. The Laws address European Union Directives and attempts to create a single economic space in Bosnia and Herzegovina. However, keeping the two entity sets of laws ultimately defeats harmonization and compliance with EU Directives and international standards. Further, we anticipate that maintaining mirror image regulatory schemes will be very difficult.

Our review of the Supervisory Offices disclosed few, if any, attempts to enforce the Laws as currently written. In the FBiH, the Supervisory staff is not trained in financial, analytical, and examination skills. It is their own assessment that they do not have the authority to enforce existing Laws. The companies also expressed their feeling that the Supervisory Office was ineffective; although, they did feel that Laws were adequate as written if enforced. In the Republic of Srpska, the Insurance Supervisory Office is not an autonomous entity as it is part of the RS Ministry of Finance. Further, the staff is composed of only three individuals. One staff member is a trained actuary, while most of the other analytical and examination duties and responsibilities are left to independent resources. It is our opinion that the Law cannot be effectively enforced with their limited resources and lack of autonomous authority.

Based on reported data, the insurance sector comprises 2.7% of GDP compared to nearly 9% in the EU countries, indicating the insurance sector is underdeveloped. The depressed state of the economy has resulted in limited markets for insurance carriers. The majority of the activity in the market centers on the compulsory MTPL which accounts for approximately 60% of total premium volume. Based on the reported statistical data in the Federation, the MTPL appears to be a profitable line of business. No statistical data was available in the RS without prior official request to the Minister of Finance. In conversations with various companies however, they indicated that due to unfair competition the MTPL was not a profitable line of business. The interviewed companies do not appear to have reached the level of sophistication in the application of sound risk management and underwriting principles. The key problem areas include underdeveloped actuarial and underwriting professions and a low level of overall experience in the insurance business. Companies are limited in terms of investment vehicles; thus, most of their investments are in short term loans and real estate. While these practices are in line with existing Laws and some EU practices, there appears to be insufficient oversight and little detailed regulatory guidance.

The current state of the insurance sector in Bosnia and Herzegovina, therefore, seems to be fairly consistent and similar in scope to those of other emerging economies. The over-



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riding concern is to better regulate, supervise and enforce the current and proposed insurance legislation. No matter what else occurs in the short-term, the insurance sector must have effective supervision that includes active enforcement. The cornerstone of all insurance, solvency, cannot be assured without effective supervision and prompt, effective enforcement.

As a first step in this direction, the supervisory offices must be organizationally strengthened with the RS Supervisory Office becoming an operationally and financially independent agency. Supervisory Offices staff must be trained to increase their technical capacity in finance, analysis, and examination. Effective regulations that provide direction and assistance in interpreting the law should be developed. The Supervisory Offices must be given authority to enforce the pertinent legislation.

Properly trained and credentialed professionals under the direction of the Supervisory Office should conduct full scope examinations of companies as soon as possible and those companies that are in violation of the law should effectively be dealt with. The Supervisory Office Examination and Analysis manuals as well as clear reporting requirements should be developed with the assistance of international insurance agencies and organizations.

The compulsory insurance system should be overhauled. Given the unfair competition within the MTPL and that rates are set based on old data, this line of business should be liberalized. Most importantly, the rate adequacy should be reviewed. A reliable database of registered vehicles and drivers should be developed. The current momentum in the CIPS program could be used for developing such a database.

Finally, educational opportunities should be provided to the sector. An inadequate supply of trained underwriters, actuaries, agents and brokers may be a larger problem in the future than it is now. It is therefore recommended that programs such as CPCU, CLU or CIC be established. An effective Association of Insurers would certainly benefit the industry.



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Existing Legal, Regulatory, and Supervisory Framework

The Federation of Bosnia and Herzegovina

The Property and Persons Insurance Law (Federation law) published in the Official Gazette of the Federation of Bosnia and Herzegovina No. 2/95 dated February 11, 1995 and the Amendments to the Law published in the Official Gazette of Federation of Bosnia and Herzegovina No. 6/98 dated March 9, 1998 were the pertinent documents used to assess the adequacy of the legal framework for insurance operations in FBiH.

The Federation law establishes the Office for Supervision of Insurance Companies in the Federation (Supervisory Office). This law charges the Supervisory Office with supervision of the operations of insurance companies in accordance with the Federation law and other regulations.

The operations and representation determined by the International Agreement on Traffic Liability Insurance of owners or users of motor cars is specifically left to the Bureau of Insurance of Bosnia and Herzegovina that later transformed into the Green Card Bureau of Bosnia and Herzegovina.

Industry Structure

There are currently eighteen insurance companies, excluding one reinsurance company, in the Federation of Bosnia and Herzegovina. All companies are essentially¹ private and there could be an oversupply of companies in the Federation. Ten companies are authorized to provide life insurance but only eight currently do and this line of business, according to Office of Supervision data, amounts to some 6% of all premium. Most² companies provide the compulsory MTPL insurance, while some focus solely on this line of business. It is therefore not surprising that MTPL constitutes some 60-70% of annual premium.

Admission

Although the Federation law provides for joint stock insurance companies as well as mutual insurance companies, only joint stock companies are currently authorized to do business in the Federation. The process for obtaining approval for the operation of a joint stock insurance company consists of the insurance company founders or their proxies submitting specifically identified information and documents to the Supervisory Office. Further, the insurance company is required to have specific amounts of stock capital at the time of incorporation determined by the type of insurance they will write. The Federation law permits the funds of the stock capital to be used for insurance company operations. This is not a usual or prudent practice.

¹ One company still has a 45% government ownership.

² There are companies, such as Grawe Osiguranje, that only offer life/annuity product.



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Since stock capital is fundamental to payment of claims by the company in the last resort, the Federation law should clearly state that the funds are to be protected and specify where they may be located. For example, a tri-party agreement between the Supervisory Office, a financial institution and the insurance company would assure the company does not withdraw and dispose of the funds. In fact, we were informed that a company did withdraw the funds after receiving approval for operations. No action was taken against the company. This can obviously reduce the claims-paying capability of the companies involved.

Interviews with the personnel of the Supervisory Office revealed that not all the information required by law is submitted for approval. Specifically, the financial statements of the founders and their mutual capital and management connections are not submitted. This information is a critical element in the supervision of who is allowed to do business in FBiH. Without the information and proper investigation of its accuracy and completeness, core principles of effective regulation are violated. The “Suitability of Persons – Fit and Proper” standards, including significant owners, board members, senior management, etc. is essential to assuring the appropriate integrity, competency, experience and qualifications of the persons allowed to do business in the Federation.

It is the position of the personnel of the Supervisory Office that they do not have the authority to require the information and certainly not to investigate its accuracy and completeness. Interviews with the Federation Office of Supervision disclosed that company general managers do not have respect for the Office since they are aware the latter does not have sufficient enforcement power nor do the supervisors believe they have the power to enforce directives.

Other required information, such as financial statements of founders and proposed products is not subject to investigation, in-depth analysis or prudent scrutiny. This is a significant flaw in providing an environment to protect policyholders and to encourage development of a healthy and dynamic business and investment market in insurance.

Reserves

The Federation law regarding provisions for reserves is vague and not sufficiently detailed as to protection of the funds or investment of the funds. For example, life insurance funds are to be “kept on a separate account” and are considered “savings”. The Supervisory Office does not have the technical expertise to determine propriety of calculations of reserves or the adequacy of the reserves. Insurance companies engaged in life insurance prepare a “document” on the formation, management and utilization of mathematical reserves. There is no regulatory review or oversight of this process.

Throughout the Federation law, references are made to obtaining an opinion from the Supervisory Office or to the Supervisory Office giving “opinions” or issuing instructions on key elements of operational and technical aspects of insurance company operations.



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The Supervisory Office personnel stated that they did not give “opinions” or other assurances regarding these matters.

Investments

Investments an insurance company may make are stipulated in the Federation law. The companies currently invest in bank deposits, real estate and short term loans. The Office of Supervision is aware of the investments and agrees with the practice. Insurance companies are obliged to invest the mathematical reserve life insurance funds into securities of the Federation in the amount of at least 30 percent of the total amount of the reserve. However, there are no securities in the Federation at this time. Even if such securities were available, this might not be a prudent practice in a country that is just developing its investment sector. Investments in loans with capital value and interest rates guaranteed by the Federation are permitted. There are no such investments available at this time.

Investments of funds in real estate, equipment and arrangement of the business premises and owners’ investments can be up to 50 percent of the security fund of the company. Investments such as these are, by their very nature, not liquid and can be subject to widely varying estimates of value. Such a large percentage of investment in real estate might be viewed as not prudent. Determining the proper valuation is not within the technical expertise of the Supervisory Office personnel nor do they feel they have the authority to challenge the valuations.

The investment practices raise serious concerns. Real estate investments are being made with no oversight; and, these investments may be significantly overvalued or undervalued. Cost value, even if fairly reported is not, however, an accurate indicator of market value. Real estate, by its very nature, is not liquid or readily available to pay claims. The opportunities for mismanagement or outright wrongdoing are great. The cost of the asset may be overstated in the accounting records, funds earmarked for construction or regeneration of maintenance may be diverted, ownership of the asset may not be in the name of the insurance company and the market value recorded may have no basis in fact. Short-term loans may be made without proper collateral. Terms of the loans may not be prudent or fair. Insider abuse can occur with immunity. Only proper, consistent, timely and fair oversight by the supervisory authorities can control such abuse and protect policyholders.

Examination of Insurance Companies

The interviews with Supervisory Office personnel included questions as to procedures and frequency of on site examination of insurance companies. The personnel indicated they did perform targeted examinations when their office review of the reports submitted by the companies indicated “unresolved questions”. Upon completion of the targeted examination, a report of their findings is prepared and presented to the director of the Supervisory Office. Follow up and enforcement of corrective measures suffers from the same lack of belief that the authority exists to take sure measures. There is no



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requirement for periodic full scope examinations. On site inspections of companies is, on the other hand, a core principle of an effective supervisory system.

The description of Supervisory Agency's examination procedures disclosed a lack of training in proper procedures and a basic lack of understanding of generally accepted examination and analytical procedures. Without proper and appropriate training and background of the examiners, procedures may be totally inadequate and, even if adequate, misinterpreted. Further, examination manuals, checklists and procedural guidelines should be used to assure consistent and fair examinations.

Solvency Standards

The combination of poorly written laws regarding permitted investments, the lack of investments vehicles, as well as an ineffective and a poorly trained supervisory staff, result in having no legitimate means to assess the solvency of a company. Commonly applied analysis procedures simply do not apply. This is a violation of the most fundamental principles of insurance and must be addressed. The legislation developed under the EC will introduce more prudent criteria for solvency standards. However, these standards are meaningless unless there is proper supervision and enforcement. It is probable that some companies will not be able to meet these standards.

Liquidation Procedures

The provisions of the Federation law do provide for liquidation of companies. However, the Bankruptcy Rules apply to insurance and reinsurance companies. The scope and time constraints of our assessment did not permit a review of the Bankruptcy Rules to ascertain if the unique aspects of insurance and the protection of policyholders are properly addressed. Other jurisdictions around the world have special liquidation laws due to the unique nature of the business of insurance and the primarily need to protect the policyholders. Unlike commercial companies, insurance companies must put their obligations to the policyholder first over all other claims. These obligations may be long tailed (be in place for many years before the claim is made). Individuals who are highly trained should oversee the liquidation process not the judicial system. This is an area that should be more comprehensively explored in the very near future.

Data Accuracy

Since the determination that a targeted examination should be made is based on the data submitted by the companies, the completeness and accuracy of the data must be validated. There does not seem to be any systematic validation of this data or even validation of the definition of terms used. Although published data indicates that compulsory motor third party liability insurance is profitable, interviews with company personnel consistently maintained this type of insurance is not profitable. Further, there appears to be inconsistencies in reporting data for compulsory insurance. Full coverage (noncompulsory) may be reported as property coverage or included in the compulsory insurance data. This, of course, distorts comparisons and data reliability.



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Accordingly, published data on the performance of companies, total income, breakdown of income, expenses and profit, net income, premium written, efficiency of liquidation of claims and so on should be viewed with great care and conclusions drawn from this data should be prefaced with caution as to the reliability of the underlying data.

Consumer Protection

A core principle of effective supervision is that the *“supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction. The requirements include provisions of timely, complete and relevant information to consumers (policyholders) both before a contract is entered into through to the point at which all obligations under the contract have been satisfied.”* Significantly, there are no policyholder protection provisions in the law.

Companies do not appear to have internal mechanisms for dealing with policyholders' questions or concerns. In addition, the supervisory entities do not have fully staffed, knowledgeable and empowered departments to deal with consumer complaints. Such a department is essential to even the disparity of power between the consumer and the insurance company. As a result of the lack of mechanisms to resolve complaints, complaints often are either not resolved or wind up in litigation. Supervisory staff informed us that people come to their offices but there is nothing they can do to help the consumer. The judicial system in Bosnia and Herzegovina is very inefficient, corrupt, and often incompetent. The consumers therefore often opt to accept payouts significantly lower than the actual material damage incurred³.

³ It is therefore not surprising there is a relatively high domestic claims payout rate in Bosnia and Herzegovina. The key concern is therefore the amount paid out.



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The Republic of Srpska

The Law on Insurance, which was published in the “Official Gazette of the Republic of Srpska” (RS Law), was the pertinent document used to assess the adequacy of the legal framework for insurance operations in the Republic of Srpska.

The organization of the regulatory scheme provides that the Insurance Supervisory Unit is part of a division within the Ministry of Finance. As the Minister has the final authority, the Insurance Supervisory Unit can only make recommendations and has no independent authority and enforcement power. In this case, supervisors may be subject to political pressures. It was noted during the interview process that politics plays a key role in the lack of enforcement. Current or former politicians may have financial interests or key management roles in insurance companies. This applies to the Federation of Bosnia and Herzegovina as well. This lack of autonomous authority is a significant shortcoming for the creation of an effective regulatory scheme.

Industry Structure

As in FBiH, mutual companies are permitted but only stock companies exist. Currently, there are nine companies licensed in the RS. One company provides life insurance; the remaining companies provide compulsory and other non-life insurance lines. All but two companies are privately owned. According to the Insurance Supervisory Unit staff, approximately 75 percent of the market is compulsory (including noncompulsory full coverage). The noncompulsory lines are not developed. Considering the low per capita income and economic conditions this is not surprising.

Admission

The RS law provides for three licenses; life, non-life and reinsurance. No new licenses have been issued in the past two years. During the same time period, two licenses have been revoked for non-compliance with tariffs, inappropriate expenditures and not paying liabilities. Licenses to conduct the business of insurance are issued by the Ministry of Finance. The Ministry has never rejected any applications for licenses. The RS Law requires that founders of the insurance company submit certain documentation. The Insurance Department personnel stated that they verify the accuracy and validity of information submitted and notify the applicant if additional information is needed.

The Insurance Supervisory Unit personnel review the police and courts dossiers to assure that the applicants for the license were “fit and proper” (a fundamental requirement of international standards for insurance supervision). They pointed out that the courts were responsible for forged documents and if data is verified and confirmed with the courts, this documentation is valid to the Insurance Department Insurance Supervisory Unit. The verification process is done through soliciting the experience of the applicants, family history, status in society, and the opinions of citizens as to whether the person can be trusted. These procedures would not meet the requirements of International Insurance Core Principles as promulgated by the International Association of Insurance



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Supervisors⁴. Supervisors require the applicants to open their history, conduct and their personal and professional activities to complete scrutiny and independent verification.

Since one of the three staff members of the Insurance Supervisory Unit is an actuary, the technical expertise exists to review the conditions of insurance and fees (premium) proposed for all types of insurance for which the company is licensed. The extent to which a review is done was not ascertained and should be reviewed in the near future.

Solvency Standards

As discussed in the section on the Federation, poorly written laws on permitted investments, very limited permitted investments and lack of investment vehicles along with inadequately trained staff, makes any attempt to assess solvency of a company very problematic at best. Again, the commonly used tools to assess solvency do not work.

Liquidation Procedures

The liquidation process is out of the hands of the Insurance Supervisory Unit. The process goes through the courts. Again, due to time limitations, this process was not reviewed and should be reviewed in the very near future.

The initial capital requirements are established by the law (founding assets). The RS law requires that in the course of the company's business activities, the permanent assets cannot be smaller than the amount of the initial capital. However, no provision is made as to how these funds will be protected. Further, it appears non-pecuniary deposits may be made by the founders but are expressed in money⁵.

Management structure

The RS law is quite detailed as to description of the management structure of an insurance company. The management structure is prescribed along with the duties of each structural element. Such detail in the law can be limiting in a changing economic or business environment in that it has the force of law and would require a change to the law if circumstance warranted change. Further, the company is only as reliable as the people who hold the positions. Since the current laws do not provide for application of fit and proper standards, questions are bound to arise.

The RS law also defines revenue, expenditures and profit. Distribution of profit is also prescribed. Again, such detail may be limiting for the reasons cited above. Such detail could be provided through regulations or directives of the Insurance Supervisory Unit if authority was granted for such duties.

⁴ The IAIS requires that the regulator investigate applicant's personal life, criminal record, positions held as an officer in a company with troubling records, etc. The core principles require that a person is 'fit and proper'.

⁵ Please see comments in the Federation of Bosnia and Herzegovina section on protection of initial capital in the *Admission* section.



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Reserves and Investments

Computation of reserves and specific types of reserves are prescribed in the RS law. The assets of an insurance company represented by the founding capital assets, the safety reserve assets, preventive fund assets if the authorized body so decides, reserve assets for mass and catastrophic claims, and assets of transferred non-distributed profit are required to be on accounts and in short-term investments in the Republic of Srpska. The investment guidelines prescribe the companies to invest in bank deposits and short-term loans. Compared to the Federation, the RS law appears more prudent. While this appears to be prudent investing from a conservative point of view, the opportunities to invest are highly limited and restricted.

Overall, the RS law provides a good list of responsibilities for supervising insurance companies' investments and other critical areas. The list is not complete but is a good start.

Supervisory Capacity

The flaw in the supervision lies in the compliance with the responsibilities. The Insurance Supervisory Unit has only three staff members; an actuary, the director and an experienced legal person who has other duties within the RS Ministry of Finance. Further, as discussed earlier, this organization is not autonomous, they can only make recommendations. Their recommendation must move "up the chain" of authority. The opportunities for political pressure and undue influence are great.

The staff of the Insurance Supervisory Unit indicated that, in their opinion, the current situation (noncompliance with the law) is a result of the war⁶. There were no examinations of the companies during the war and companies did business as they wished. It is their opinion that it will take three times as long as the war lasted to harmonize the companies with compliance.

Due to the limited staff, reliance must be placed with independent auditors and actuaries. These professionals do not always agree. Interestingly, the auditors are hired by the companies and approved by the Insurance Supervisory Unit while the Ministry of Finance hires the actuaries. This reliance on external resources may increase the cost of regulation.

Examinations are conducted on the companies for solvency. The external auditors do the analysis of submitted data and develop targeted examination as well as full scope examinations lists. The staff indicated that full scope examinations take three to four days. This is a very short time frame to conduct an examination in accordance with generally accepted auditing standards. Properly conducted examinations more typically take from a few weeks to several months depending on the complexity of the company's

⁶ The concern here is why are non-compliant companies still operating if deficiencies were identified in the post war period.



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activities and level of cooperation of the company. Examinations of Bosnian companies would probably take a few weeks.

Basically, the insurance laws of the Republic of Srpska, as written, are overly detailed while significant regulatory areas are not addressed. The authority for supervision is fragmented and not autonomous. As a result, effective regulatory compliance cannot be achieved. Although the staff of the Insurance Supervisory Unit feels that they know what takes place in 70 to 80 percent of the companies, the limited resources and lack of cooperative efforts between the hired professionals indicate that much could be going on without the knowledge of the Supervision Office. On the other hand, the fact that the majority of the premium is compulsory and violations to existing law are prevalent would give added support to the point that the Office of Supervision may know what is going on but is not supervising.

Although the use of independent auditors and actuaries is appropriate in regulatory schemes, their work must be supervised and under the control of the regulators. A staff of three with only one trained individual cannot accomplish proper oversight. Further, the staff responsible for overseeing hired professionals must be trained in the areas they are overseeing, for example, examinations of financial information and supporting data.

Consumer Protection

As in the FBiH insurance law, there are no policyholder protection provisions in the law of RS. The reality is reflected in the same way as in the Federation. To repeat, a core principle of effective supervision is that *“the supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction...The requirements include provisions of timely, complete and relevant information to consumers (policyholders) both before a contract is entered into through to the point at which all obligations under the contract have been satisfied.”*

Market Data

There was no financial and market data provided to us during the assessment⁷. If such data does exist, the same caution regarding reliance on the data and drawing conclusions based on the data must be made as was made regarding the Federation data.

⁷ Data was not available without prior official request directed to the Minister and subject to his approval. The same procedure is applied to all external requests.



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In summary, the existing Federation and Republic of Srpska laws governing insurance and insurance operations are not adequate, as written, to provide for a healthy and dynamic insurance industry that can contribute to the economic growth of FBiH and RS and provide protection and economic security for citizens through existing or potential insurance products.

The supervisory staff charged with enforcing the laws and protecting the policyholders is untrained and lacking in appropriate technical education. It should be noted that certain staff members were clearly eager to obtain the necessary training and experience. The frustrations of some of the Federation staff members with their perceived inability to enforce the laws were, in some cases, clearly evident. Frustrations were also evident in the RS although for different reasons such as lack of independence.

To conclude, the combination of laws (which are not always clear), the lack of experienced, properly trained personnel and the personnel's perception that they do not have the authority to intervene or take action to enforce the laws results in effectively no regulation in the common usage of the term.



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Observations on the Proposed Insurance Legislation

No discussion of the insurance sector in Bosnia and Herzegovina would be complete without recognition of the efforts of a project funded by the European Commission and subcontracted to IKRP Rokas & Partners. The preceding discussions were based on the laws, as they currently exist in FBiH and RS. Many of the recommendations are equally as important under the proposed law. For example, the need for a properly trained, experienced and empowered supervisory staff. The proposed law would eliminate some of the current problems such as the lack of autonomy for the RS Insurance Supervisory Unit and the admission requirements for inter entity insurance operations.

The proposed laws, however, provide for a three year transition period to institute an independent Supervisory Agency. Interviews disclosed that the RS Ministry of Finance Insurance Department is requesting only a six month transition to allow it to hire staff and conduct other administrative tasks associated with establishing a new institution. The RS Minister of Finance, on the other hand, is asking for a five year transition window. Every effort should be made to achieve the six month transition. The sooner the process of instituting proper and independent supervision is begun the better.

Unfortunately, a major problem would be continued; that is, the continuance of two separate insurance supervisory entities. The proposed law provides for entity “mirror image” laws and a state level Commission to, among other things, mediate between the two entities. Such structure, as it is based on entities and not on the entire country, does not meet the EU standards. This issue is very important when Bosnia and Herzegovina supervisors apply for membership in international insurance associations. Moreover, in practice, the introduction of people enacting the law on a day-to-day basis will inevitably introduce differences. Moreover, there is a potential problem with the interpretation of the proposed legislation. First, the proposed legislation will be translated into Serbian for the RS, Bosnian and Croatian for the Federation; this increases the risk of a consistent translation/interpretation. Second, even if translated into one language there is always a potential interpretation issue. Further, the costs of two supervisory entities will increase the costs to insurance companies and ultimately the consumer.

The proposed legislation is, however, viewed as compromise legislation from a political perspective. During discussions, company officials, for the most part, supported the proposed law. Some concerns about the two-entity approach were expressed. Most of the interviewed companies indicated a preference for a state-level supervision, especially if inter-entity provision of insurance is allowed. Most interviewees felt that supervision will be merged within the next three to six years. It is not known whether this will in fact occur. The interviews disclosed that comments and suggestions offered by the companies were not always incorporated in the draft laws. For the numerous reasons cited in this report, we feel that it is imperative that the merging of the entity based supervision to a country based supervision be given the highest consideration and priority.



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The RS Ministry of Finance Insurance Department personnel stated support for the law and participated in its drafting. According to them, the companies were contacted for input but did not adequately respond⁸. They have shared the draft law with the companies and have indicated that, for the past year and a half, they have worked with the FBiH to clear up problems. The proposed law is the result of these consultations.

Discussions with the personnel of the Supervisory Office of FBiH revealed that they did not feel they had much input and that their suggestions were not incorporated. They stated that they never received the manuals prepared to assist the supervisors. The personnel were concerned with the two-entity supervision envisioned to continue.

There are still areas that are cumbersome and inefficient. Obviously, the provisions for interaction between the two supervisory agencies add to the length and complexity of the law. Other topics such as the responsibility for approving a license to conduct the business of insurance should be vested with the Insurance Supervisory Agency. The procedures for liquidation of a company do not fully provide for the unique nature of insurance contractual obligations and the marshalling of assets to fulfill those contracts. The provisions for reorganization measures are a welcomed addition.

The inclusion of provisions for an Ombudsman is a step in the right direction. Further provisions to protect the policyholder and the general public should be considered such as requiring companies to have a formal process for resolving policyholder complaints or concerns as well as a department within each supervisory unit to assist consumers with their complaints and concerns. The use of the Ombudsman should be the last resort, not the courts.

Unfair trade practices are a critical area of concern and perhaps should be addressed in greater detail in each proposed Law.

The provisions for acceptable investments are a vast improvement over the existing law. However, proper and effective supervision over the appropriateness of the investments must be continually enforced.

The laws as proposed do not seem to reflect insights from financial, insurance or business professionals. Such insight would have gone far to clarify some provisions of the proposed laws. If the proposed laws are enacted, they should be reviewed for refinements from the onset. Laws should not be viewed as “written in stone”. Rather, they should be an evolving set of requirements regularly reviewed toward improvement of the regulatory environment of the industry.

⁸ According to the RS Insurance Department, round tables were organized to provide an opportunity for company input.



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The Actuarial Profession in Bosnia and Herzegovina

Presently there are only two trained actuaries in Bosnia and Herzegovina, one each in FBiH and RS respectively. An insurance company employs the actuary in FBiH while the other actuary is a staff member of the Insurance Department in the RS Ministry of Finance. Clearly, there is a need for additional actuaries. The Supervisory Office in FBiH should have a staff actuary, at the minimum, to assess the adequacy of company established reserves.

As the companies sophisticate and consider offering new products and, more importantly, if there is a movement away from prescribed rates on the compulsory MTPL, the actuarial services will be very important. Companies will need not only to revisit their rates on non-compulsory lines of business in the future but also should do so currently. Obviously, the expertise of actuaries is critical to the development of reserves for life companies and companies offering a combination of life and savings products. Although life products are still not very developed⁹, the actuarial science is vital and very valuable for prudent management of these lines of business.

However, underwriting expertise will be as, if not more, important in growing the insurance market. Once proper and accurate data is captured by the company and then at the supervisory level, actuarial and underwriting services will be very valuable.

The educational program under way in Federation is a good approach to meeting the needs for actuaries. Whether such a program is developed and administered by a university should not be a prime concern. Interviews revealed that potential students from the RS are discouraged to enter this program because the latter is not associated with a university¹⁰. The prime consideration should be that the students receive certification that will be recognized internationally. For this recognition, all the elements of the program must be reviewed and approved by qualified actuaries whether associated with a university or not. Professors associated with a university that are not trained in the specific areas of actuarial science thus add no value. Consultation with international actuarial associations would be of great assistance in assuring certification meets international standards.

⁹ Only eight companies offer life products in the Federation and several in the RS.

¹⁰ Certificate programs are not as valued as university degrees in Bosnia and Herzegovina



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Market Overview

Based on reported data¹¹, the insurance sector comprises 2.7% of Federation of Bosnia and Herzegovina GDP¹² compared with nearly 9.0% in the European Union countries indicating the insurance sector is underdeveloped. The depressed state of the economy has resulted in limited markets for insurance carriers. The majority of the activity in the market centers on the compulsory Motor Third Party Liability which accounts for approximately 60 percent of total premium in the Federation and the RS. Based on the reported statistical data in the Federation, the MTPL appears to be a profitable line of business. No statistical data was available in the RS although the Office of Supervision verbally confirmed a similar situation existed there.

In both entities, conversations with various companies indicated that, in contrast to the reported data and possibly due to unfair and deceptive competitive practices, the MTPL was not a profitable line of business. This significantly raises concerns about the reliability of reported data. The companies interviewed do not appear to have reached the necessary level of sophistication in the application of sound risk management principles to truly assess the profitability of the MTPL and other lines of business.

Other problematic areas, in addition to the previously noted underdeveloped actuarial profession, include an underwriting profession and overall low level of insurance experience within companies. Companies are limited in terms of investment vehicles, thus most of the assets are invested in short-term loans and real estate (in the Federation). As noted earlier, it appears that there is insufficient supervision of these activities.

It could be noted that the general development of the entire financial services sector will have a positive impact on insurance since, in most developed countries, banking, insurance and capital markets are all inter-related and dependent upon each other.

The war years, 1992-1996, had a significant effect on premium. When the war ended in 1996, the premium volume was reported at only 15% of the pre-war level. In the post-war years of 1996-1999, there was a resurgence of the insurance sector. By year-end 1999, premium growth resulted in the attainment of 41% of the pre-war premium level but slowed after 1999 to only 2.2% from 2000 to 2001. Currently, it has been reported that the insurance sector accounts for only 2.7% of GDP in Bosnia and Herzegovina. The contributing factors to the decline in growth rate after 1999 are still at issue today:

- General state of the economy
- Minimal per capita increase in the GDP
- Net loss in total population in Bosnia

¹¹ The reader is again cautioned that statistics may be unreliable as there is little verification of the underlying data.

¹² According to a Swiss Re Sigma Report, No.8/2003, BiH neighbors Croatia and Serbia-Monte Negro insurance sector amount to 3,16% and 2,24% of GDP respectively. EU ascension countries such as Slovenia, Czech Republic, and Slovakia have relatively more developed insurance sectors with 5,05%, 3,99%, 3,38% of GDP respectively.



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- Current unemployment rate of 40%
- Little attention paid to the sector by the government
- Oversupply of insurance carriers

The lack of governmental attention has made it difficult for the insurance sector to move forward. There are few incentives or tax advantages for individuals or families if they choose to purchase insurance. A significant percentage of total premium is in the compulsory MTPL and the “dumping” of premium has slowed the overall growth rate. The minimal number of investment opportunities bears witness to the fact that the banking and investment sectors are vital to the growth of the insurance market.

But, despite these obstacles, there are positive indicators for the development of the insurance sector. First, mandatory insurance requirements do assist in the development of a more competitive environment. Competition will increase the segmentation of product lines and ultimately affect rate levels as long as the latter is not prescriptive. Second, pension and health care reform is currently being considered which will create a need and perceived value for voluntary benefits that may not be provided by the national programs. Such reforms, as in other countries, will increase the opportunity for increasing insurance sales. Third, there is a greater global awareness of the need to supplement state and private pension programs with additional savings. This is also true in Bosnia and Herzegovina. As the economic state of individual citizens improves, life insurance will, therefore, be given a greater impetus in the future with the sale of annuity products as well as other investment instruments that include death, disability, personal accident and cash accumulation benefits. The process of moving the insurance sector from a small to a significant percentage of GDP will, in all likelihood, be an evolution and not a revolution.

As of November 2003, eighteen insurance companies operate in the Federation, excluding Bosna Re, and nine in the RS. The 2002 statistics that are available indicate a larger number, but two companies were placed in liquidation in the Federation during 2003.

Based on reported data, the total insurance premium in BiH amounts to approximately Euro 136 million. More than half of the premium, however, amounts to compulsory MTPL insurance. The RS data is not published for public consumption. Interviews with Ministry of Finance Insurance Department officials and companies in the RS indicate, however, that the situation is similar to the Federation.

Profitability of companies is difficult to truly assess as some companies have not established proper claim reserves or expense loads for other reserve funds that are required. As noted earlier, in the absence of a viable direct action process, some companies are able to reduce claim settlements since the insured have little alternative. Third, the loss triangles have not had sufficient time to develop.



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MTPL

The compulsory Motor Third Party Liability insurance is the dominant segment in the insurance sector of Bosnia and Herzegovina with more than half of the market share. With the passage of the MTPL legislation, a formal vehicle registration process emerged. To receive an annual registration certificate, it is necessary for the owners of motor vehicles to have each vehicle inspected and to show proof of insurance coverage. The passage of such legislation did provide an impetus for the insurance sector but it also introduced a major problem within this market segment.

A “take all comers” approach does not allow companies to underwrite new business. The current laws provide a prescribed rate all carriers must use but this rule is frequently violated. There is a system of prescribed discounts that can be then applied on renewal; but, in order to attract customers, many companies offer a discount for the first year of registration. Only annual payment of the compulsory insurance premium is allowed, but many companies do not comply with this rule. Compulsory auto policies cannot be canceled mid-term for non-payment of premium so the exposure, despite non-collection of premium, still exists. Each vehicle must be inspected prior to receiving an initial or annual registration. Yet, breaches of these procedures have occurred and resulted in unfair competition and illegal trade practices. These include, but are not limited to:

- Significant discounting of new business premiums rather than use of the prescribed rate
- Utilization of installment payment options rather than annual pay
- Offering to reimburse owners of vehicles for the cost of inspection/re-inspection fees
- Offering of free gas coupons to attract new customers
- Offering of free car washes to attract new customers

Such practices have resulted in numerous companies reevaluating their policies and choosing to also violate the law in order to compete and retain their current policyholder base. Companies that want more stringent regulation to create an even playing field have informed the Offices of Supervision of these activities. Five market leaders in FBiH have filed a petition to the Office of Supervision and indicated those companies that violate the law (seven companies). The supervisory authority, although having confirmed this petition, has done little to enforce the rules. This has resulted in:

- Inadequate premiums being charged on new business
- The use of non-compulsory physical damage results to offset liability loss ratios
- Insurance company acquisition of inspection facilities to assist in the sale of insurance
- Increased number of uninsured vehicles or increase in company risk without offsetting premium
- Insufficient reserves for future losses

A letter authored in early 2003 by the Federation Office of Supervision asked companies to comply with the law. There has been some progress toward compliance but most practices still persist.



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International Claim Obligations

The Green Card Bureau appears to be under qualified management and serves a key role in the insurance sector. There was not enough time to fully explore the opportunities and obstacles of the GCB but it is believed that continued improvement will be made in the overall compliance of Bosnian companies with respect to their obligation to properly settle international claims. Effective leadership of the GCB, effective monitoring by the London based GCB association, and the strengthening of the number of Bosnian insurance companies will give added impetus to the improvement.

Competition

Since the compulsory MTPL line of business mandates the use of a prescribed rate on new business and comprises more than half of the market, there is a disincentive to create a competitive marketplace as the usual path of development in a more sophisticated market is for each company to set its own rate so it can ensure profitability. Unfortunately, there are no incentives in BiH since companies providing MTPL can not differentiate themselves. It appears that the level of competition, even on non-compulsory lines, is minimal¹³. Most companies seem content to offer similar products/services with little price variation resulting in too many companies competing for a limited market. The market is heavily prescriptive. It is advised that it change in the near future to become less restrictive from a marketing, underwriting and rating perspective.

Reinsurance is mandated over prescribed limits rather than allowing companies to choose the amount and type of reinsurance, again reducing competitive pressures. Bosna Re is the only reinsurance company in Bosnia. More competition in the reinsurance market would create a freer market economy as well as more options for insurance companies. Additional competition would in turn reduce the potential credit risk.

Risk Management and Reinsurance

Pre-war liabilities are a concern for certain companies. The team informally suggested a few reinsurance options for one of the companies that could assist in smoothing out balance sheet results while prior liabilities were being settled. Effective use of reinsurance and various alternative risk transfer options have not been widely explored for unique situations. It is important to verify that the current reserves and IBNR loads on pre-war liabilities are properly set¹⁴ and that they contemplate the settlement times for those losses still in litigation.

Risk Management and Reinsurance is underdeveloped because the market is heavily prescriptive. Bosna Re appears to be well managed and has strategic alliances with many internationally respected reinsurance companies and brokers.

¹³ The level of competition does not have much to do with the number of companies.

¹⁴ Since this company has prewar liabilities and lawsuits, the question is whether it has taken account of inflation and brought those reserves up to real KM.



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The term risk management is used in Bosnia to denote more underwriting activity than the traditional risk management techniques. The major risk management strategy is risk transfer through the use of reinsurance. Other risk management strategies, such as avoidance, elimination, reduction and retention are only minimally used. These risk management principles will develop over time as the insurance sector becomes more developed.

The companies appear to have little expertise in setting rates for non-compulsory lines of business. It was indicated that actuaries must certify rate levels. Whether actuarial services are being employed or not was not verified in the scope of the assessment. Nonetheless, there appears to be a deficiency at both the regulatory and company level in both entities in verifying the adequacy of rates due to a shortage of qualified actuaries.

There is a prescribed rate for the MTPL compulsory coverage. It was mentioned that the rate was a pre-war rate and, more than likely, inadequate. Premium volume by line of business may not be sufficient to be adequately used for rate models. This dumping, or discounting, of premium for the MTPL business further fosters the theory that there is a rate adequacy problem.

Insurance management does not appear to have the underwriting expertise to properly manage a company based on EU or American standards if the market was less prescriptive and if direct actions and societal conditions were similar to those evolving globally. A more comprehensive underwriting discipline is needed. There appears to be little direct correlation between loss data, rate adequacy and underwriting standards. Each is a separate component in the profit management of a particular line of business. Currently, highly prescriptive compulsory laws, coupled with structured reinsurance requirements do not create a need for sophisticated underwriting. It appears that there is very little underwriting judgment exercised.

A more sophisticated underwriting discipline will more than likely come from an increased level of education on the part of the risk managers and from a less prescriptive approach on the part of legislative and regulatory bodies. Increasing underwriting expertise through education as well as an evaluation of the changing conditions in Europe should be considered.

General Level of Professionalism

It appears from brief conversations with company representatives in the Federation that an estimated 40-60% of the companies are either professionally managed or have the capability of being professionally managed with a proper level of supervision. Even in what appears to be well-managed companies, our feeling is that there is much to be done to enhance the general level of insurance knowledge and expertise.

Current law does not provide for agent licensing nor does the insurance environment provide educational opportunities to supporting professions. Any agent activity would be



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outside of the current regulatory environment. Other major findings in this area include the lack of other certification programs such as the CPCU/CLU/CIC¹⁵ and that an association of insurance companies does not appear to be professionally and actively organized. Further, qualified asset managers do not exist in Bosnia and Herzegovina.

¹⁵ These certification programs would provide the necessary underwriting skills in BiH



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Recommendations

The recommendations that follow are based on an impartial assessment of the insurance sector in Bosnia. It is fully understood that not all the recommendations can be acted on in the short-term nor is it known if the recommendations will ultimately be appropriate based on the strategic direction of the insurance sector. Rather, the recommendations are listed as a source, albeit not the only source, for resolving some of the issues that emanated from the assessment. They are not listed in any particular order or priority. However, some of the following recommendations are so fundamental and critical that the urgency of their implementation is not in doubt.

It would also be appropriate to consider how the recommendations fit into the strategic goals of government and the private sector. The current legislation governing the insurance sector does not go far enough to stimulate these goals. But, the proposed legislation, supported by the recommendations in this section, should:

- Ensure a healthy environment to the citizens for personal protection
- Provide a healthy and growing business sector within the country
- Assist in the development of a stronger financial services sector in BiH
- Increase both domestic and foreign investment in BiH
- Increase the percent of GDP coming from the insurance sector, and
- Contribute to the ultimate application standards for entry into the EU

It is not known if a strategic business plan exists for the financial services sector. If such a plan does not exist, it is strongly recommended that one be drafted. This plan would give much needed support to the sector and its stakeholders¹⁶.

The best legislation still requires the political will to allow for independent and unbiased supervision. Every effort should be taken on the part of the insurance sector to increase the knowledge level of government officials and increase their awareness of how a professional insurance sector can protect the citizens, provide a dynamic business environment and stimulate domestic and foreign investment.

- *Supervisory Offices need to secure a general commitment from key government officials that the Office of Supervision will have the authority to properly regulate, enforce and supervise the sector.*
- *Also, there is a need to develop a plan to increase insurance knowledge and awareness.* The insurance companies can conduct a public education campaign with their marketing resources. The Supervisory Offices need to increase awareness of the importance of insurance sector to creating a stable and attractive environment for foreign direct investment (FDI) among government officials. European Union accession countries are good resources for this process.

¹⁶ A Poverty Reduction Strategy Paper (PRSP) team may be contacted in this aspect.



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The current legal and regulatory framework for insurance activities in FBiH and RS is very poor. Considering the present environment, it would be doubtful if any reputable international insurance company would consider doing business in Bosnia and Herzegovina or if knowledgeable and reputable companies would choose to purchase insurance from some of the existing companies. This is not to infer that there are not some very reputable and well-run companies in Bosnia and Herzegovina. Rather there are no **regulatory assurances** that the companies are properly run, solvent and able to pay claims if and when they may come due. However, much can and should be done to improve this situation.

First and foremost, the insurance supervisory arms in both FBiH and the RS must be organizationally strengthened. Both entities must have autonomous organizational status with the clear authority to enforce the existing laws. Although there may be changes in the existing laws, albeit necessary ones, the changes will be meaningless if there is no clear authority to regulate and ensure compliance by all companies and if there is no **will** and authority to take the necessary enforcement steps. This authority must be understood and accepted by the present staff, the companies, the courts, the ministries and the people purchasing insurance. Consumers must be aware of their rights and companies are obligated to bring them to their attention. A fully integrated consumer services unit must also be an integral part of each supervisory entity. The process of strengthening the staffing should include this unit from the onset.

A combination of government directives and law changes is necessary. In addition to autonomous status for the regulatory arms, they must be given the authority to develop regulations that provide direction and assistance in interpreting the law as it is currently written. There must also be the authority to enforce the law with sanctions for non-compliance. Immediate action should be taken to accomplish these directives and changes in the law regardless of the status on any proposed major revisions to the laws. Again, without the authority to enforce the law, compliance with the law will be, at best, problematic. If the authority already exists then it must be clearly communicated to all parties.

It is vital that Bosnia and Herzegovina work toward State Level Supervision. While the proposed legislation is viewed positively, it does not provide for such a provision. **The State Level agency should have, as one of its goals, a plan to develop consensus for a revision to the new legislation, including a national level of supervision.** It is the opinion of this team that a national level of supervision is the only truly effective means to supervise and regulate the insurance industry.

Concurrently with addressing the legal framework, **the staff of the supervisory offices in FBiH and RS must be strengthened and trained.** Clear job requirements and descriptions as well as performance standards should be developed and adhered to. As neither entity will have the time or the capacity to develop such standards on their own, it



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is strongly recommended that international resources be requested and utilized. This process must start as soon as possible.

It is highly recommended that the actuarial¹⁷, analytical and examination capabilities of the regulatory authorities be strengthened. New qualified staff must be added as needed. Every effort should be made to recruit and hire trained regulators already familiar with examination and analytical techniques as well as the insurance industry.¹⁸ There are guidelines for the training necessary to properly perform examinations and conduct appropriate analysis. International resources such as the International Insurance Foundation, the National Association of Insurance Commissioners and the International Association of Insurance Supervisors could be approached to assist in these tasks.

Until a properly trained staff can be in place, the use of independent auditors and actuaries should be employed. The independent staff should be charged with training the supervisory staff. During this transition stage, “shadow” regulators should be brought in from other countries to supervise the work of the independent experts. It is entirely appropriate for the companies to be assessed for part of the costs associated with this process. Funds not used by the Supervisory office in the past could also be used to meet these costs. Further, there can be no better use of the funds, either domestic or from donor agencies, than to assist in strengthening the supervisory entities to insure the compliance with the proposed law underwritten by the EC.

Full scope examinations of companies should be conducted as soon as possible. Since the staff of neither entity is adequately trained to conduct full scope examinations in accordance with international professional standards, independent credentialed auditors should be engaged to perform the examinations and report directly to the Directors of the Supervisory Office and Unit. Again, this would be a very appropriate use of funds. The environment as is currently structured will not change on its own. Significant, forceful and definitive measures must be taken to erase the ills that currently exist in order for the proposed law to be enforceable and meaningful. The full scope examinations in accordance with international standards performed by independent credentialed auditors would be a significant investment. The investment, however, would be a one time cost directed to correct the existing problems immediately and completely.

If the costs cannot be borne by the industry, other modes of international assistance could be sought at the Supervisory Agency level. There are many foreign companies operating in Bosnia and Herzegovina. These range from Austrian and German to Slovenian, Croatian and Serbian. Supervisory Offices or even the future State Agency should request the Supervisory Agencies of the noted countries to jointly conduct examination on a consolidated basis or these companies could provide assistance in this effort as long as

¹⁷ This mainly refers to the FBiH as the RS Insurance Department has a trained actuary.

¹⁸ We understand that this may be difficult given the lack of experienced regulators as well as uncompetitive salaries in the Supervisory Units.



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their efforts are such that no hint of cover-up exists. The foreign resources can be “shadowed” by local Supervisory Agency staff who will, in turn, immensely benefit from such examination. A time table of one year should be the maximum to have the examinations well underway.

Companies found to be in significant violation of the law should be put in liquidation after being given a reasonable time to correct the non-compliance with the law. Those companies found to be in violation of the laws should be informed of the violations and given a reasonable time to correct them. “Reasonable time” will, of course depend on the nature of the violations. Some violations can be corrected in a relatively short time, while others will require longer periods of time for correction. The point is that companies move promptly and decisively to correct the violations to the satisfaction of the supervisors. For those companies that do not implement corrective measures or are in significant violation (such as no reserves or bogus assets underlying the reserves) should be ordered to stop doing business immediately. If the violations are still not corrected in a reasonable time, the company should be put into liquidation.

Some violations are so egregious that continuation of the status quo is to condone abuse of the people who have entrusted their money to a company. Further, the properly managed companies are penalized in the market place. It is to condone looting.

Concurrent with training of the supervisory capacity, procedures and formats must be developed for reporting by companies. The basis of reporting must be stipulated and consistently applied so the company reports are uniform. Analysis and examination manuals must be developed to assure consistent and proper procedures are utilized, which are in line with EU standards and professional norms.

International institutions, especially regional supervisory agencies, may be able to share their experience, and even capacity, procedures, reporting requirements, and examination manuals. As the level of training progresses, the level of expertise will increase thus allowing more advanced analytical tools to be employed.

At the same time **an educational process should be undertaken** directed at the companies to clearly communicate that enforcement of laws will be the norm and that consistent compliance will be required. Formats for reporting, basis of reporting and content of reporting should be clearly communicated as well as timing of reports. It is the companies’ responsibility to know the laws they are subject to, it is the regulators responsibility to assist compliance by providing guidance as they enforce those laws.

Undoubtedly, some companies will attempt to bring pressure to forestall or eliminate all these efforts. However, properly run companies will welcome consistent enforcement since unfair trade practices and unfair competition will be lessened. These companies have no reason to fight supervision as the latter evens the playing field for all. Lack of supervision hurts properly run companies. One of the interviewed companies



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substantiated this fact. When the Supervisory Office of FBiH issued a directive, top management of the company insisted on full compliance with the directive. Compliance hurt their market share as other companies continued to flaunt the law and thus had a market advantage. This also gives credence to for the need for effective supervision.

Once the supervisory staff is empowered and training is under way, the compulsory insurance system should be overhauled. As discussed in this report, the profitability of compulsory insurance is uncertain. Varying opinions were supplied by published data and interviews with company officials. At a minimum, there are known abuses in the system. It is doubtful that companies engaging in such practices are operating within the law or complying with in other areas of the law such as establishing proper reserves, processing claims and meeting their obligations under the contracts of insurance.

In addition to abuses in the system, commonly used insurance practices are not employed. The rates are set based on old and/or questionable data. Rates are set by government mandate. The lack of reliable databases makes rate setting difficult. With a reliable database, rates can be set that reflect reality. Underwriting should be encouraged and companies allowed to develop tariffs that are supportable and return a reasonable but not excessive profit. Drivers should be rated and tariffs reflect the drivers' driving. With proper supervision, rates should be market driven.

Any violation to the mandatory legislation such as premium discounting, offering of payment options, etc. should be brought to an immediate halt regardless of which legislation is in effect¹⁹.

Given the importance of MTPL in the insurance sector and the need for a reliable and up-to-date database, it is recommended that, once it is established, the state-level Commission and/or the entity Supervisory Offices utilize other government institutions and public programs such as the Ministries of Interior and CIPS program, to create a state-wide database of registered vehicles and driver records. Such a database could be used to combat fraud and eliminate many unregistered vehicles²⁰. As renewal of vehicle registrations and driver licenses are currently underway (until June 30, 2005) this initiative should commence as soon as possible.

The lack of accurate, verified and consistent data is a major stumbling block for effective supervision, companies and other interested parties. Immediate steps should be taken to define the data that needs to be captured and how the data is to be presented in the RS and the FBiH. Data currently provided in FBiH must be verified and assurance of consistency obtained. This could and should be done through periodic, full scope examinations. It will take time to develop a reliable and statistically valid database but the effort is in everyone's best interest.

¹⁹ This was the single biggest complaint noted by the companies interviewed.

²⁰ Unofficial estimates, during interviews, indicate that some 30% of vehicles in BiH are uninsured



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The insurance sector should work as closely as possible with the banking and investment sectors to develop short-term, intermediate and long-term investment instruments in order for companies to comply with existing Laws and especially the proposed Laws if they are enacted.

A taxing methodology must be put in place that is fair and as free of manipulation as possible. We were informed that taxation is on the basis of profit. Clearly, this provides opportunities for judgment as to what becomes “profit”. A more conservative estimate of reserves will lower profit. Reserves could be just overstated one year to affect timing of the recognition of profit. Greater spending on administrative and other items will lower profit. Lower interest charged on loans will lower profit. Efficiently managed companies are penalized for their efficiency– they are more profitable, therefore, they pay more tax. A system based on a flat percentage of premium earned is fair, cost effective and easily administered. Such systems are widely used. Taxation could also be used for stimulating the purchasing of long-term insurance products such as life insurance.

An important aspect of insuring public trust in the insurance industry is the proper oversight of the solicitation of insurance. The proposed legislation includes a Law on Intermediaries. **Supplemental legislation requiring education opportunities for agents, brokers, and other supporting professions should also be given a priority.**

Although the current prescriptive laws, coupled with structured reinsurance requirements, do not create much need for sophisticated underwriting, future underwriting needs will be greater. It is recommended that two strategies be considered for the development of this profession. Both strategies should be at the company level and funded by the companies. First, work should begin on the development of an underwriting program which could be certified. It could be patterned after the CPCU, CIC or CLU programs in America or European programs. A second strategy would be for BiH companies to establish relationships with foreign companies and/or consultants that can immediately evaluate current practices and develop training modules for current and future use. The modules could be web-enabled and supplemented with face-to-face training. These programs could include some other risk management strategies such as avoidance, elimination and retention, which are presently only minimally used. As these will slowly be introduced slowly into the market, effective coordination with sound underwriting strategies should be more than beneficial.

There were several references made to the presence of an Association of Insurance Companies in the Federation. It should be verified how active this association is and what would be required to institute a state level Association. In the short-term, for a nominal cost, insurance companies could provide the necessary resources in lieu of hiring a staff. A well-managed association could have assisted the companies in their current efforts to secure effective regulation of the MTPL. **In the future, the value of such an association will be to bring a unified voice to the State Level Agency for legislative matters.**



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Bosnia is small enough to allow for more effective communication between industry segments than in larger countries. Membership should be voluntary but open to companies from both entities.

Insurance companies must sell the value of personal and commercial coverage. An objective assessment by the companies of consumer needs should be undertaken to determine which current and future needs can be satisfied via insurance products and services. Companies feel they have the adequate skills or can quickly gain them to develop new products. An assessment, however, of market needs, should be completed before any products are developed.

Business practices and business ethics may or may not be legislated. However, the incorporation in the proposed laws of the core principles of fit and proper and conduct of business is to be commended. In the spirit of the proposed legislation and the long-term insurance sector goals, it is highly recommended that the entity Supervisory Offices mandate all insurance companies to develop and implement sound Corporate Governance Policy and Code of Ethics.

An in-place, empowered and properly trained supervisory staff is imperative and must come before the market can grow in a responsible way. To grow the market without proper oversight will result in even greater opportunities for unscrupulous persons to loot premiums paid in good faith by the citizens of Bosnia and Herzegovina. The confidence of the people has been shaken enough by non-payment of claims and widely varying premiums. This trend should not continue.

Improvement in the economic conditions of the people will provide the opportunity for companies to develop new products and people to purchase insurance products. Improvement in the regulatory environment will attract international insurance companies willing to partner with in-country companies. Other businesses will come that are willing to purchase insurance for their operations from Bosnian companies.

With the will to move forward by all areas of government and the market, Bosnia and Herzegovina can become a model of progress in the insurance sector.



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APPENDIX



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List of Interviews Held

Branislav Bilic, Director, *FBiH Bureau for Insurance Supervision*
Anita Putica, *FBiH Bureau for Insurance Supervision*
Snjezana Ostojic, Legal and Licensing Department, *FBiH Bureau for Insurance Supervision*
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