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***Miro D. Sokić, PhD*** [1]
*Senior Solvency Risk Management Advisor to Actuarial and Solvency Risk Management Function, Dunav Insurance Company a.d.o.*

# INSURANCE COMPANIES AS INSTITUTIONAL INVESTORS IN THE REPUBLIC OF SERBIA

Insurance companies, through their function of a financial intermediary, namely, through the role of institutional investors, have one of the most significant impacts on the economic growth. In pursuing their core activity, insurers collect considerable premium assets. The source of collected funds also dictates the maturity of investment. Since the liabilities arising from property insurance are less predictable, the assets collected from this insurance line are mostly invested as short-term investments. The situation is quite opposite when it comes to life premiums were the investments have a long-term nature. The share of life premium in the total premium of insurance sector of the Republic of Serbia is increasing year-over-year, both in nominal and percentage terms and, inclusive of 31 December 2014, it amounted to respective 16.01 billion Dinars or 23%, compared to 6% of the total premium some ten years ago. In the developed EU countries, the share of life insurance in the total premium is about 60%. Consequently, the growth of life insurance premium is expected to continue in the next period, which will generate a realistic basis for a higher demand for financial instruments. In the years to come, this will affirm insurance companies as powerful institutional investors and potentially one of the major drivers of financial market development and economic recovery in Serbia.

**Key words:** *insurance companies, non-life insurance, life insurance, institutional investors, financial instruments, financial market development, feedback system, country's economic recovery*

1 e-mail: miro.sokic@dunav.com

## 1. Insurance Companies in the Role of Institutional Investors

The growing number and importance of institutional investors in the financial markets has occurred as a result of globalization, deregulation, competition, and the necessity to overcome the negative effects of the global financial crisis. Because of their opportunity to invest considerable financial assets in the financial markets, insurance companies already belong to the group of future significant high-potential institutional investors, particularly when it comes to financial investments in life business. The importance of insurance industry in the world is best shown by the data on the total premium earned in 2014. The analysis of the data on realised insurance premium collected in 144 countries has shown that in the past years, despite the global financial crisis, 88 countries have earned the total annual premium (life + non-life) in the amount of 4.778 billion $.[2]

***Table 1: Developments in major insurance markets in 2014. (in billion US Dollars)***

| Ranking by premium volume | | Life premiums | | Non-life premiums | | Total premiums | | Insurance penetration |
|---|---|---|---|---|---|---|---|---|
| | | USD | Change* | USD | Change* | USD | Change* | |
| | 2014. | | vs 2013. | | vs 2013. | 2014. | vs 2013. | 2014. |
| **Advanced markets** | | 2233 | 3,8% | 1707 | 1,8% | 3939 | 2,9% | 8,2% |
| United States | 1 | 528 | -2,5% | 752 | 2,6% | 1280 | 0,4% | 7,3% |
| Japan | 2 | 372 | 3,3% | 108 | 0,8% | 480 | 2,7% | 10,8% |
| United Kingdom | 3 | 235 | 0,5% | 116 | 1,7% | 351 | 0,9% | 10,6% |
| France | 5 | 173 | 6,5% | 98 | 1,0% | 271 | 4,5% | 9,1% |
| Germany | 6 | 118 | 2,3% | 136 | 1,3% | 255 | 1,8% | 6,5% |
| Italy | 7 | 145 | 22,7% | 49 | -3,0% | 195 | 15,0% | 8,6% |
| South Korea | 8 | 102 | 6,3% | 58 | 1,9% | 160 | 4,7% | 11,3% |
| **Emerging markets** | | 422 | 6,9% | 417 | 8,0% | 839 | 7,4% | 2,7% |
| Latin America and Caribbean | | 75 | 3,3% | 113 | 4,7% | 188 | 4,1% | 3,1% |
| Brazil | 13 | 45 | 5,4% | 40 | 6,5% | 85 | 5,9% | 3,9% |
| Mexico | 25 | 13 | 1,4% | 15 | -1,4% | 27 | -0,1% | 2,1% |
| Central and Eastern Europe | | 20 | -2,1% | 50 | -1,2% | 70 | -1,5% | 1,9% |
| Russia | 27 | 3 | 18,9% | 23 | -0,3% | 26 | 1,5% | 1,4% |
| Emerging Asia | | 275 | 9,9% | 190 | 14,6% | 466 | 11,8% | 3,1% |
| China | 4 | 177 | 13,4% | 151 | 17,4% | 328 | 15,2% | 3,2% |
| India | 15 | 55 | 1,0% | 15 | 4,8% | 70 | 1,8% | 3,3% |

2 Sigma magazine, World Insurance in 2015, Swiss Re, July 2015.

| **Ranking by premium volume** | | **Life premiums** | | **Non-life premiums** | | **Total premiums** | | **Insurance penetration** |
|---|---|---|---|---|---|---|---|---|
| | | USD | Change* | USD | Change* | USD | Change* | |
| | **2014.** | | **vs 2013.** | | **vs 2013.** | **2014.** | **vs 2013.** | **2014.** |
| Midle East and Central Asia | | 12 | 4,2% | 37 | 7,2% | 49 | 6,4% | 1,6% |
| United Arab Emirates | 42 | 2 | 12,4% | 7 | 10,3% | 9 | 10,8% | 2,2% |
| Africa | | 46 | 1,6% | 23 | 1,8% | 69 | 1,6% | 2,8% |
| **World** | 2 | 2655 | 4,3% | 2124 | 2,9% | 4778 | 3,7% | 6,2% |

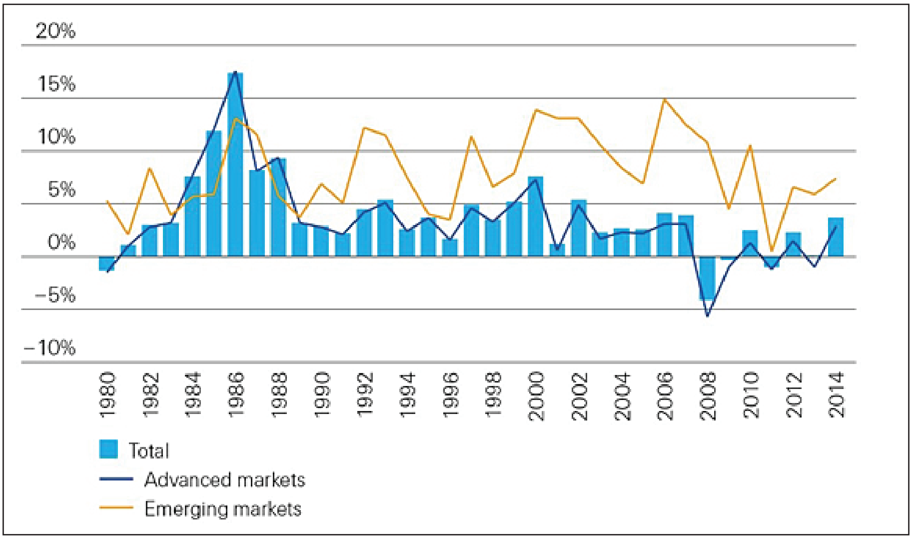
*Notes: * in real terms, ie adjusted inflation*
*Insurance penetration - premiums as a % of GDP*

*Source: www.swissre.com, New Swiss Re Sigma Study*

Through selling insurance policies, money is collected and subsequently channelled to the purchase of financial instruments of deficit subjects. By large-scale money exchange for financial instruments, insurance companies reduce transaction costs[3] for transfer of funds. Through selling their services (life and non-life insurance policies), insurance companies collect numerous but individually small amounts of money. However, these funds are concentrated and thus, generally, represent large funds that are available to the companies. Large amounts of money enable investment diversification i.e. the purchase of different financial assets, which reduces the total investment risk. The specific nature of instruments issued in insurance industry (insurance policy) limits insurance companies in the transformation of liquidity risk. The liquidity of insurance companies' instruments depends on the occurrence of the insured event and thus, the insurance policies are usually said to be characterised by a limited or total lack of liquidity. To achieve liquidity independently from the occurrence of an insured event is possible only in life insurance services with savings elements, through their surrender (to which policyholders are entitled if they have paid at least three annual premiums) and through the policy loan (when the insurer finances the insured by effecting the advance payment of a particular part of the sum insured, with a certain interest). A permanent percentage increase of insurance premium (except for the year of crisis, 2008), both in developed and emerging markets, is best shown in the figure below.

3 Reduced are credit rating assessment costs, costs for transfer of receivables, administration costs and other money transfer costs.

***Figure no. 1: Global premium growth in life and non-life business of developed and emerging markets in the period 1980-2014***




*Source: www.swissre.com, New Swiss Re sigma study*

Owing to numerous pieces of information collected to support the decision-making process in connection with acceptance of insurance and the investment of free assets, insurance companies facilitate more efficient capital allocation. Before accepting insurance agreement, these companies analyse the company applying for insurance and thus dispose of the details important for the market. Such information relates to financial strength, creditworthiness and other important economic market indicators of prospective insureds. In this way, insurance companies make a proper selection of the entities they will include in their business. Naturally, as a rule, insurance companies select successful firms and by investing their funds in attractive projects, they act as competitors to investment banks and facilitate the implementation of economic reconstructions. One of the EU Directives requires the provision of an equivalent level of protection for the collected information on individuals i.e. insureds.

This is for the reason of lifting particular barriers to the economic activities and preventing unfair competition. In other words, insurance companies strike balance between their business priorities and legitimate protection of the insureds to enable competitive business operation. There are different data indicating the role of insurance companies as financial institutions. One of such data is that, measured by the size of assets, insurance companies take the second place in the developed markets (e.g. USA, Germany, France, etc.), namely, they are preceded only by commercial banks.[4] Having in mind that the financial markets of countries in transition are insufficiently developed, it is clear that the influence of insurance companies as institutional investors will be improved by the economic and financial system reforms and by the reforms of insurance sector.

The role of insurance is also internationally important. A particular transaction between two partners operating in different countries, who do not know each other well, is often conditioned by a certain form of insurance. The need for credit insurance to support international trade represents a good example. Insurance also impacts national economy in international operations. The sale of insurance services abroad generates the inflow of money whereby international insurance transactions directly influence the payment balance of the country. In addition to lending activities, insurance is also important in the area of deposits, because the insurance of savings deposits increases trust and safety of savers in the banking system and vice versa.

Insurance companies constantly innovate and expand the range of their services. In non-life business, this includes the offer of new forms of cover (for the risks such as natural catastrophes and information technologies), whereas in life and health insurance, novelties result from the development of hundreds of new products. The introduction of intercompany agreements and new approaches used in offset arrangements improve claims settlement processes. Insurance companies also form special service centres. The function of these centres is to act upon complaints and provide advice to the insureds, mostly due to a communication gap. The importance of insurance industry is reflected in the introduction of a dialogue with numerous important subjects in the society: representatives of the government establishments, judicial and medical professionals, company owners and the like. Owing to the organisation of annual fora and presentation of specialised publications, insurance companies gather the mentioned subjects with the aim to exchange opinions and hold discussions about the problems the country is facing in its economy.[5]

One of the important roles of insurance industry in the developed countries is to provide technical and intellectual support to the development of insurance in the countries in transition. By achieving different forms of

4 Ljiljana Jeremić, M. Paunović, *Comparative Analysis of the Insurance Market in the European Union, Serbia and the Countries in the Region*, Singidunum revija 2011, pp. 57.

5 Ratko Vujović, *Upravljanje rizicima i osiguranje*, Singidunum University, Beograd, 2009, pp. 7.

cooperation, for example, through the implementation of training projects, technical support is provided i.e. a better access is ensured to the developing insurance markets. Insurance companies organise special courses and award tuition grants to future managers of insurance companies and thus indirectly facilitate insurance market development in the developing countries, and consequently largely influence their overall economic development.

The importance of insurance companies as institutional investors is increasing in proportion with the growth of national income of a particular country. Low income and poor living standards are the major causes of present low insurance penetration in the developing countries. In addition to the mentioned factors, high inflation has also considerably influenced individuals and companies to allocate their funds only to compulsory insurances. Demonopolization of insurance sector, implementation of necessary structural reforms, economic growth, and financial market stability represent macroeconomic assumptions for strengthening the position of insurance companies in developing countries.

On the other hand, lower operating costs, cheaper services, good level of information and engagement of highly professional staff in insurance activities will help insurance companies to gain a better position and greater importance in the financial market.

## 2. Business Expansion of Insurance Companies as Exponents of the Demand for Financial Instruments and Guarantors of Financial Market Development

In the beginning of this century, a common opinion was that the lack of demand for financial instruments is the major obstacle to the development of the domestic financial market. Despite the fact that things have considerably improved since then,[6] this opinion is still topical. In contrast to some other developing countries, in Serbia, institutional investors, as the main exponents of demand for financial instruments, have still not assumed the leading role in such development. As regards insurance companies, their inferiority to banking sector is evident considering that all of them put together manage the assets equal to those of an average bank. The other domestic institutional investors find themselves in similar situation.

Therefore, domestic financial sector is bank-centric, whereas the banks are notably commercially oriented (except for short-term investments in T-bills). Such situation does not provide for securities market development and without an appropriate demand, their expansion is pointless.

6 Since 2006, investment and voluntary pension funds have been established as the new exponents of such demand.

Inadequate investment structure of domestic insurance companies marginalises their investment potentials thereby diminishing the scope of collected funds even more. This means that in addition to the expansion of insurance industry, notably reflected in life business and growth of its mathematical reserve, domestic insurance companies must restructure their assets and channel considerably more funds to the demand for securities. Such demand pressure will encourage the offer and accelerate and improve the expansion of financial instruments. This is the only scenario that can be considered as an exit strategy regarding the financial market and institutional investors. Such scenario also entails active implementation of new Solvency II regime for ensuring continued financial soundness of insurance companies in terms of change in business and financial management and risk management. In this way, domestic insurance companies should develop as financial institutions with assets optimally allocated to cost-effective forms of investment, and be capable to restructure their portfolios and adjust them to the structure and maturity of liabilities, thus becoming one of the major players in the financial market. It is clear that no market can exist without concurrent presence of supply and demand and, similarly, the development of our financial market, that is, instruments and insurance companies or institutions is parallel and interdependent. Without a stable demand of domestic institutional investors, there is not much sense in the expansion of financial instruments which, otherwise, could lead to a so-called „balloon effect" and market crash.[7] On the other hand, if the development of insurance industry is not followed by financial market development, further accumulation of inadequate forms of assets and diminished profitability could occur due to high cash balances which may not be sufficient to guarantee the coverage of liabilities, particularly in life business. On the other hand, if the development of insurance industry is not followed by financial market development, further accumulation of inadequate forms of assets and diminished profitability could occur due to high cash balances which may not be sufficient to guarantee the coverage of liabilities, particularly in life business.

Therefore, the growth in supply of, and demand for financial instruments should be harmonized not only with one another but also with the transformation and reforms of the entire Serbian economic and financial system. This is the most appropriate answer to the question whether the expansion of institutional investors should precede or succeed the development of financial markets in terms of securities expansion. To that extent, institutional investors

7 Jeremić Z. and N. Uzelac, *Razvoj uloge osiguravajućih društava kao institucionalnih investitora na finansijskom tržištu u Srbiji*, the Belgrade Banking Academy and the Institute of Economic Sciences, Belgrade, 2007, pp. 232.

have advantage over investment funds since their core activity can be developed even before the expansion of securities, whereas the investment potential so accumulated may have a positive impact on such expansion. Naturally, this is important only as an initial impetus, but to represent the beginning of a long-term development, it will be necessary that the demand pressure for financial instruments stimulates their creation and thus makes an impact on further expansion of institutional investors. The success of this scenario depends on a set of elements connected with these parallel and interdependent processes. The experts of the Group of Seven most developed countries in the world and of Russia (hereinafter: „G8“) have systematised these elements with the help of the World Bank and the International Monetary Fund, as follows:[8]

1. Strengthening market infrastructure and debt instrument expansion, which includes:
- elimination of clearing and title registration weaknesses (centralized management),
- strengthening the supervision system of financial organizations,
- establishing primary dealer system (with the main role to insure continuous listing of government securities for the purpose of secondary market development; this is particularly important in relation to short-term government securities which are used by the Central Bank in the implementation of monetary policy and thus, this institution has the authority to license primary dealers and define criteria for such purposes; specialized banks, which meet such criteria, have a role of primary dealers; this is the practice of many countries in transition and is recommendable to be applied in Serbia, as well).
- securitization of receivables (there is still no securitization in Serbia, but there is a draft law on securitization); the traditional problem in relation to mortgage loans with an unreliable title registration system and legal difficulties in mortgage foreclosure certainly had an impact on this issue, as well; the global financial crisis which in 2008 emerged in the US mortgage market represents an additional warning and thus, this plan should be implemented with great caution.
- issue of local currency government bonds for benchmarking purposes.[9]

2. Broadening and intensifying the investor base, which includes:
- pension system reforms
- development of insurance industry
- creation and development of investment funds.

8 G8 Action Plan for Developing Local Bond Markets in Emerging Market Economies and Developing Countries

9 Equity securities include a wide range of important issues, among which is the selection of an adequate mechanism for establishing (identifying) prices in the market as the basis for the protection of investors.

3. Other conditions, which include:
- ensuring appropriate database (elimination of information asymmetry),
- development of financial derivatives as a protection from interest rate and foreign exchange risk,
- regional cooperation ( in the beginning of 2009, the National Bank of Serbia hosted the First International Conference themed the Central Bank Role in Rating System Development. The implementation of this project has certainly contributed to the strengthening of information and safety of investors in the reduction of systemic risk ).

As it can be seen, the recommendations of G8 are highly relevant for Serbia, as well. This additionally supports the fact that only the parallel development of financial market, stimulated by the government as the major issuer of financial instruments and by institutional investors, as the main exponents of demand for such financial instruments, is the only proper exit strategy for addressing the existing problems. This also requires legislation which will, at a higher level of financial market and institution development, initiate the formation of high quality assets and open the possibilities for investments.

## 3. Strengthening the offer of Financial Instruments of the Government, Local Governments and Companies

By assuming and developing the activities of financial intermediation, insurance companies, as institutional investors, should assume and play an important role in the development of the financial market of Serbia. The pressure of their demand will stimulate the creation of financial instruments, thus encouraging both the government and private individuals to more extensively use such method for funding the development projects whereas, on the other hand, this will create the possibilities for investments of insurance assets, which in turn will preserve and increase their value. Government, municipal and corporate bonds will certainly have the advantage regarding investments.

### 3.1. Government Bonds

In Serbia, T-Bills are occasionally issued whereas the bonds of blocked foreign currency savings are present as long-term bonds. In 2009, different series of T-bills were issued with maturity dates of three, six and twelve months. In this way, the Government planned to refinance the budget deficit by offering to the investors a safe and reliable yield as well as high liquidity.

In any case, the domestic financial market lacks good quality government bonds which may become an impetus for its dynamic development. The appearance of such securities with different maturity dates would, for the first time, enable the definition of Dinar yield curve, whereas the investors, such as insurance companies, would be able to more adequately match their portfolios with liabilities. For the Government, in addition to financing budget deficit, this should be one of the ways to provide funds for the development projects and thus, the issue of government bonds on the domestic market is a plan that must not be abandoned. Maturity dates and other characteristics of such securities should be adjusted to current circumstances and possibilities.

The optimum solution for the development of debt securities is the introduction of representative debt securities (their yields would be used as reference values) which would be couponless, have maturity of up to three years, denominated in Dinars, and sold to the domestic investors.

### 3.2. Municipal Bonds

Municipal bonds, issued by local government units, are supposed to be the next important segment of financial instruments expansion. All investors whose primary goal is to protect their capital and achieve a relatively high interest rate and often tax-free income, will prefer this type of investment.

Municipal bonds are debt instruments issued by towns, municipalities and other local communities to raise necessary funds for the implementation of particular projects and for the covering of current budget deficit. By issuing bonds, authorities borrow money from municipal bond buyers with the promise to return the principal and earned interest on borrowed funds in a particular time period. The interest is often paid semi-annually, whereas the principal may be paid both at maturity and periodically.

Yield on municipal bonds is normally higher than the yield which would have been achieved by investments into government bonds or term deposits in the bank. In addition to attractive interest earned, in most of the cases the investor is exempt from taxation. Municipal bonds are traded in the secondary market so that the investors benefit from the liquidity this market provides. According to their maturity period, they can be short-term (maturity up to one year) and long-term (maturity longer than one year). Short-term bonds are mostly issued to cover current budget deficit whereas those long-term are used to finance big infrastructural projects.

Depending on the source of cash flow, we basically differentiate between two types of municipal bonds. These are:

- general obligation bonds
- revenue bonds.

General obligation bonds are characterised by the obligation of the issuer to repay the debt from any source of revenue of local government. Due to this clause, before such bonds are issued, a type of voter approval or public debate is usually held. Such bonds are called „voter-approved". Revenue bonds are municipal bonds that are issued to fund specific projects that generate their own revenue. This may be: construction of road infrastructure, parking garage, sewer system, water supply system and the like.

This letter type carries somewhat higher risk and therefore is insured by an insurance company which undertakes to pay the principal with the accrued interest in the event that an issuer is unable to do so. There are also bonds with special investment opportunities. One of them is the group of insured municipal bonds. An insurance company warranties to pay the principal and accrued interest if the primary debtor i.e. local government fails to pay them at maturity. There are also bonds that do not carry fixed interest rate. Instead, the interest rate changes in accordance with the change of the selected reference interest rate.

These are so-called floating rate notes. There are also bonds that do not make interest but are sold at a discount to their face value, and the investor is entitled to the full face value of the bond when it matures. These are Zero-coupon bonds. Particular bonds provide special benefits because they enable the investor to present the bond to an issuer and demand payment before the final stated maturity of the bond.

These are bonds with „put" clause. There is also a reverse possibility in which the issuer can retire the bond issue at any time and pay to the investors their money back. These are bonds with „call" provision.

***Table No. 2: Comparative analysis – general obligation bonds vs. revenue bonds***

| CHARACTERISTIC | GENERAL OBLIGATION BONDS | REVENUE BONDS |
|---|---|---|
| Issuer: | Government authorities and local governments i.e. towns and municipalities. | Government authorities and local governments i.e. towns and municipalities. They are issued to raise funds for the particular project. |
| Backed by: | Creditworthiness and solvency of issuer (local government). | Revenues generated by the project. Due to uncertainty, this type of bonds is insured by major insurance companies. |
| Voter approval: | Required by a bond referendum. | Voter approval not required. |
| Special types: | Double-barrelled bonds have unlimited guarantee of local government and a direct financing source in the budget. | *IDRB- Industrial development revenue bonds.* Bonds for industry development. Backed by commercial loans.<br>*Special tax bonds.* Bonds backed by special government taxes such as customs, excise taxes on oil, tobacco and the like.<br>*Moral obligation bonds* are backed by regulatory and moral obligation of the government to, if necessary, pay for the liabilities of the local governments. |
| Analysis factors: | - Attitude of local community to borrowing?<br>- Creditworthiness.<br>- Demographic characteristics.<br>- Tax policy<br>- Government assistance | - Economic feasibility<br>- Are benefits from borrowing higher than expenses (interests)?<br>- Preparation of feasibility study<br>- Debt coverage ratio |

*Source: www.bif.rs, Business and Finance*

The fact remains that local government units in the region still do not sufficiently use the possibilities of acquiring additional funds by borrowing through the issuance of municipal bonds. These bonds may have a very wide purpose. The collected money is mostly used for the construction of local infrastructure such as sports facilities, roads, schools, hospitals, communal infrastructure and the like. Currently, in the USA, they are used to finance environmental protection projects and invest into renewable energy sources. Additionally, they are important because they enable local citizens to invest, with their own money, into their own town or municipality and, in addition, to get a favourable interest. Moreover, the yield on municipal bonds is also attractive for institutional investors (pension funds, banks), and particularly for insurance companies which may appear both as investors and insurers insuring the yield of revenue bond buyers.

Thus, acting both as investors and insurers, insurance companies have the most favourable position because they can buy series of revenue bonds at lower prices. The advantage of municipalities in borrowing through issuance of municipal bonds also lies in the fact that an interest rate is lower compared to credit borrowing and there are tax reliefs and increased accountability of the government representatives due to very high transparency of the entire process. The construction of a better quality infrastructure of local government increases local living standards and creates conditions for a faster development of a real sector through a higher inflow of foreign investments. In addition to realistic effects, local government bonds may also produce positive marketing effects on local government which, after the issue of own securities, will be placed at the focus of professional public and thus gain a particular competitive edge over other local governments in the country and the region.

The municipal bonds have particularly gained in importance in the conditions of global financial crisis and capital deficit. Today, a global trend for the local government is to give more freedom to local authorities in relation to money spending and collection of additional capital. Majority of developed municipalities in the EU countries and the USA resolve their problems by issuing own securities i.e. municipal bonds.

According to the Law on the Market of Securities and the Public Debt Law, there are no legal obstacles for more active role of Serbian municipalities in issuance of municipal bonds. Nevertheless, in practice this is not the case. The main problems lie in the lack of interest and knowledge on the part of local governments as well as in the requirement of the Ministry of Finance for the issuance of a licence. Also, the fact that towns and municipalities in Serbia do not have their own but state-owned assets represents a huge problem. The very essence of municipal bonds is their low-risk characteristic, since they are backed by the entire assets and budget of municipalities. If municipalities were the owners of their property they would not need the license of the Ministry of Finance.

Although it may seem paradoxical at first, a negative impact of the global financial crisis and shaken confidence in financial institutions may actually stimulate full affirmation of municipal bonds model. Namely, the uncertainty of financial markets results in increased interest rates due to the increase in premium risk required by the creditors. Thus, we find ourselves in the situation that the municipality, which was paying the annual interest rate of 5%, now pays 10% or 15%, which considerably enables investments in local infrastructure. Added the lack of new financial inputs due to the finalization of privatization process and still limited potentials of foreign direct investments due to problems with corruption and low business competitiveness index, the issue of municipal bonds may become a right solution for impoverished and strained budgets of municipalities and towns.

To that extent, Inđija municipality made a pioneering attempt in 2005 and faced numerous problems, notably in terms of defining the legal owner of municipality assets. A water supply project should have been financed with the interest of 5 - 5.5%, however, eventually, loans were sought from business banks with annual interest of 8-9%. In the meantime, the Law on Local Government was changed ,[10] but still no desired progress has been made.

### 3.3. Corporate Bonds

The third important segment relating to the development of offer in the Serbian bond market, which is also yet to be expanded, are corporate bonds. Amidst the negative effects of the global financial crisis to which the most solvent domestic companies, including insurance companies, are not immune, a forgotten financial instrument – corporate bonds – are increasingly being placed in focus.  This type of security was very popular way of borrowing among companies in 1980s, but the economic collapse in 1990s has pushed this instrument into obscurity.

Today, this is slowly changing and is best shown by the fact that in the last couple of months, particular companies have issued corporate bonds, whereas many companies plan to collect necessary funds in this way. The first company in Serbia to start issuing corporate bonds was *Telefonija*. *Tigar* (157.5

10 The Law on Local Government („Official Gazette of RS“, No. 129/07), in Articles 12 and 15, stipulates that local government units shall have the capacity of a legal entity and shall have their own assets which can be independendly managed by their bodies.

million Dinars, and in addition to *Wiener*, the buyers were *Takovo osiguranje* (Takovo Insurance) and *Komercijalna banka (*Komercijlana bank*)*) and *NLB bank* (461 million Dinars with the fixed interest rate of 5%) followed suit.

Corporate bonds represent securities issued by a company for a certain term that is longer than two years which, after expiry, generates a certain yield for a buyer. The main advantage of this instrument is that the issuer and buyer can agree on the conditions and security. In a bank-centric economy, such as Serbian, corporate bonds may compete well with loans and thus influence their price and the price of equity in general.

*Telefonija* was the first to issue 50 million Dinar worth long-term corporate bonds in June 2010. A total of 5000 bonds were issued, each nominally worth 10.000 Dinars and with 4-year maturity and interest rate of 7.5% plus 12-month EURIBOR, denominated in Euros. These bonds were issued to a known buyer, insurance company *Wiener Städtische*. In the first year, the buyer received only the interest, whereas in the remaining three years, until the maturity date, principal was disbursed. The funds were used for the completion of gasification project and a new issue of securities, worth about 1.5 million Euros, is planned. The main objective of this issue is to make *Telefonija*, in addition to the regional leader in the segment of telecommunications and information technologies, one of the leading domestic gas distributors. The second issue should be open market, which will additionally stimulate the secondary market development, this being particularly important for the development of capital market and possibility to be liquid. The issuer of corporate bonds is satisfied because he has come to the new source of financing under more favourable conditions than those of a bank loan. Now the issuer does not have to target only banks and may agree on the conditions he finds satisfactory. On the other hand, issuance of these bonds makes room for insurance companies, pension funds, and investment funds to invest their assets and get higher yields than those from the bank savings. Regardless of the aforementioned benefits, Serbia is only beginning to develop this instrument. How much we lag behind the region in this area is best shown by the fact that Serbian corporate bond market is worth some tens of millions of Dollars whereas the value of Croatian market is couple of billions of Dollars. To achieve this level in collecting funds through corporate bonds, large companies, that are market leaders in their industry, should start issuing corporate bonds. The characteristics of such bonds are annual interest rate of 7.75%, quarterly annuity payment which includes interest and related part of principal as well as „put clause“ after the expiry of the first year. „Put clause“ means that the buyer can request the payment of his bonds at any time, without having to wait for the maturity date. Each bond has 20 coupons which the issuer will purchase based on Euro equivalents in Dinars at the mean exchange rate of NBS, upon maturity of each coupon.

Companies should be at the forefront of this development in order to enable cheaper funds for themselves i.e. use positive effects of financial leverage and also be protected against the impact of drop in share prices, which makes this type of financing less attractive. In this segment, Serbia also lags behind other countries in transition. For example, in Croatia, corporate bonds have been traded in the market since 2002 and currently there are some thirty issuing companies.[11] Market development in relation to corporate bonds depends on the following factors:

- stable macroeconomic environment,
- sound companies taking the role of an issuer and institutional investors,
- support of the government and competent authorities in relation to securities.

Unfortunately, corporate sector in Serbia cannot boast many good quality companies. To make their number higher and to enable the existing ones to generate funds, the development of debt instruments is necessary, as the borrowing from banks is becoming increasingly unfavourable.

## 4. Insurance Companies as the Generators of Financial Market Development and Economic Recovery of the Country in General – Feedback System

Insurance companies are financial intermediaries which, in addition to assuming different actuarial risks, as aforementioned, also collect funds and allocate them for the purpose of achieving the highest possible yield in the financial market.

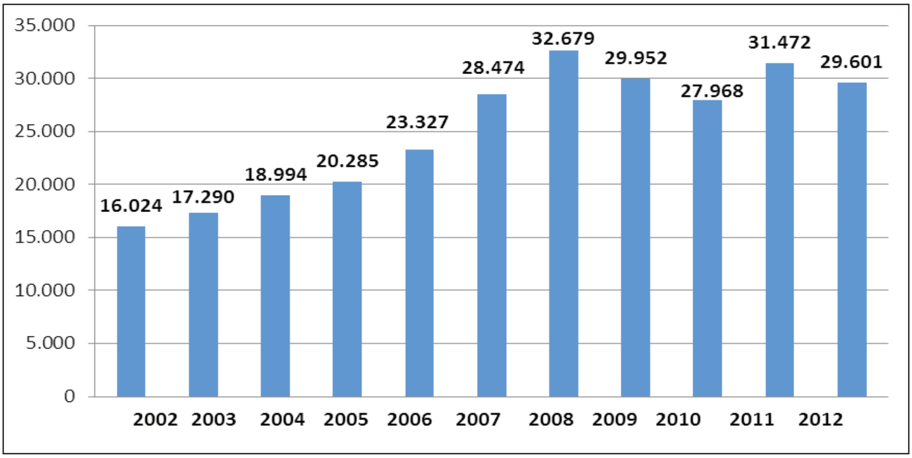
It should be pointed out that insurance companies fall in the group of non-deposit financial institutions, along with pension and investment funds. They are more similar to pension funds since they mostly obtain funds on contractual basis, through periodical payments within a particular time period and thus, the revenue stream is safer compared to deposit institutions, whereas the risk of sudden drawdowns and outflows is lower.

Insurance sector in Serbia has still not managed to become a mobilizer of savings, notably due to the underdevelopment of life assurance and, as such, it directly influences the development of economy, financial market stability and economic growth of the country.

The charts below show the trend of Gross Domestic Product in the last ten years as well as the trend of the total premium in the Serbian insurance market.

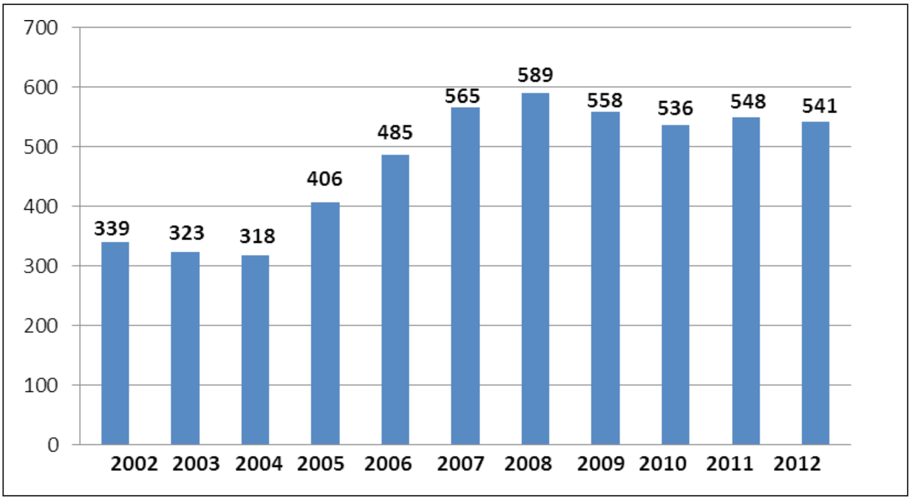
11 www.zse.hr

***Figure no. 2: Trend of Gross Domestic Product in Serbia 2002–2012 (in million €)***




*Source: www.rzs.stat.gov.rs, national accounts*

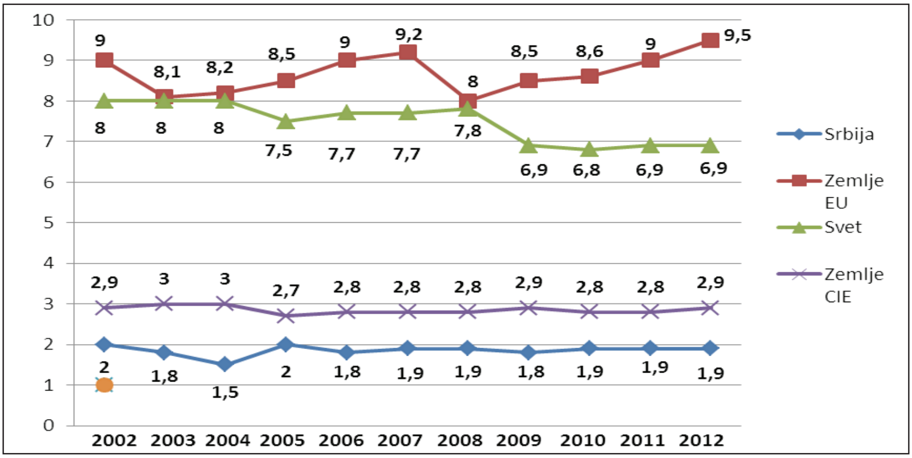
***Figure no. 3: Trend of total insurance premium in Serbia 2002–2012 (in million €)***




*Source: www.nbs.rs, operation of insurance companies, Insurance Sector 2002-2012*

We can see that the growth trend was mostly stable until the beginning of the Global Financial Crisis. These two graphic indicators may be realistically interpreted only when the analysis includes the third indicator of the insurance premium share in the Gross Domestic Product in Serbia, EU countries and also globally.

***Figure no. 4: Trend of insurance premium share in Gross Domestic Product***




*Source: www.sigma.re, sigma news*

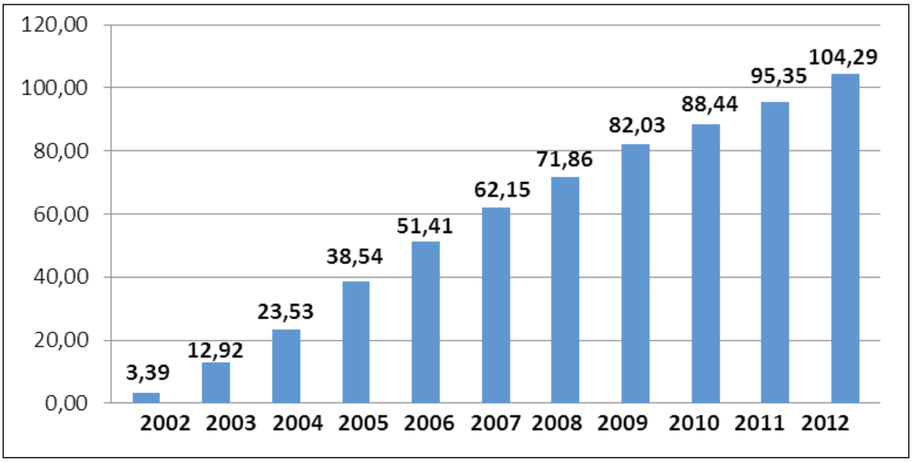
We can see that the premium share in Serbian Gross Domestic Product is about 1.9%. In the rest of the world, this percent is about 7.5%, and in the European Union about 9%. This is why insurance sector has a considerable potential for further growth of insurance premium and approach to the developed countries.

This will make the role of insurance companies in Serbia multiple. In the continuing trend of total insurance premium growth in Serbia, life insurance premium will, naturally, prevail.

Owing to life insurance growth i.e. life risk transfer to insurance companies through life insurance premiums, and owing to the mortality tables and actuarial methods, coupled with relative predictability of liabilities, the total available funds of insurance companies that can be invested in the financial markets will increase.

The share of life insurance premium in the total premium of this sector in the Republic of Serbia is increasing annually, both in nominal terms and in percents, and inclusive of 31 December 2014 it amounted to respective 16.01 billion Dinars or 23% compared to 6% of the total premium as it was some ten years ago.

***Figure no. 5: Trend of life insurance premiums in Serbia 2002-2012 (in million €)***




*Source: www.nbs.rs, Operations of insurance companies, Insurance Sector 2002-2012*

Chart No. 5 shows permanent growth trend of the absolute life premium amount in the last ten years and its increase of approximately thirty times (in 2012, it was about 104 million Euros compared to 2002, when it was about 3 million Euros). Nevertheless, life insurance premium growth trend as the most important item of life insurance has still not been exhausted. It should be borne in mind that in the developed EU countries the percent of life premium share in the total premium is about 60%. Consequently, in the next period, it is expected that life premium growth continues whereas additional 3-5 billion Euros will be collected which, in addition to already initiated incentives in the form of tax exemptions asked from the Government, will create a realistic basis for increased demand for financial instruments and financial market development.

Analysing the securities portfolio of insurance companies in developed countries, it can be concluded that insurance companies invest their funds mostly in bonds because they entail less risk but also a lower yield. To minimize the risk to the greatest possible extent, the insurers largely invest in government bonds. With such investments, companies are granted particular tax reliefs in most of the countries. On the other hand, the Government guarantees the safety of such investments with its authority and its tax system.

Investments of insurance companies dealing with non-life insurance differ by their structure from the investments of life insurance companies. This is because these companies do not only observe credit and interest rate risk but also pay attention to liquidity, since payments are more frequent and higher than the payments in life insurance. For the said reasons, these companies have to keep a considerable amount of funds in highly liquid assets (cash, T-bills and commercial papers...). In addition to settling liabilities to the insureds, the other motivation for operations of insurance companies in the financial market is profit-making i.e. the return on investments. In life insurance, a part of profit is distributed to the insureds (through the payment of sums insured), and this certainly influences the company competitiveness. All this improves sales of insurance.

Eventually, we can say that regardless of the sources of funds the insurance companies use, such funds should contribute to a higher demand for financial instruments[12] (like corporate shares of export-oriented, profit-generating companies, municipal and government bonds) and the development of financial market in general.

Higher demand for corporate shares of export-oriented profit-generating companies (such as *Tarkett d.o.o. Bačka Palanka, Sunoko d.o.o. Novi Sad, Fertil d.o.o. Bačka Palanka, Hemofarm a.d. Vršac, Tigar Tyres d.o.o. Pirot*) will initiate selling of shares in the financial market to the interested bidders which are, in Serbia, insurance companies. In this way, the companies will have access to cheaper sources of funds for the purchase of raw and processed materials as opposed to the loans taken from banks, whereas insurance companies will invest funds that generate higher yields than those invested in bank deposits. Consequently, the companies will increase production and export, generate higher foreign exchange inflow and will be able to timely pay out corporate shares with related profit. Insurance companies may sell liquid shares at any time and thus prevent the insolvency risk. And further, by expanding the scope of business in order to satisfy the needs of domestic and foreign market, the companies make room for additional demand for insurance services (insurance of property, production machinery, transport, information technology, new employees) whereby the feedback system is fully affirmed. This is just one of the levers which accelerate the financial market development where the Government also plays an important role. To surmount bank-centricity of the domestic financial system, with the unequivocal support of the Government, insurance companies need to be able to freely invest funds allocated to cover technical and guarantee reserves.

12 Shares of the most liquid companies such as *Naftna industrija Srbije a.d. Novi Sad, Telekom Srbija a.d. Beograd, Telenor d.o.o. Beograd, Tarkett d.o.o. Bačka Palanka, Sunoko d.o.o. Novi Sad, Fertil d.o.o. Bačka Palanka, Hemofarm a.d. Vršac, Tigar Tyres d.o.o. Pirot, A.D. Imlek Padinska Skela, Airport Beograd, Energoprojekt Holding* and others.

In other words, insurance companies would appear in the financial market as an additional source of funds and as a creditor offering more favourable conditions than the banking sector. This would provide new source of financing for economy, whereas companies would improve and expand the structure of their own revenues. Such solution would not be fully in accordance with the provision of Article 5[13] of the Law on Banks, and conditions would be created for increased competition in the financial market. Lending to businesses by insurance companies is allowed in many countries. Directive "2009/138/EC" (Solvency II) insists on the rule that in investments, advantage is given to safety over profitability. The focus is on such type of assets and instruments the risks of which can be identified, measured, monitored, managed, controlled and properly reported. Member countries are recommended to enable "freedom of investment" and not to require from (re)insurance undertakings to invest in any particular categories of assets. In the case of Germany, this area is regulated in more detail by the Regulation on the Investment of Restricted Assets of Insurance Undertakings, which even allows granting loans to subsidiaries of insurance companies as well as advance payment (payment appropriation) of own insurance policies. Taking into account the experiences in the developed EU countries, the supervisory authority i.e. the National Bank of Serbia, in correlation with the Serbian market players, should keep track of the application of regulations within the solvency domain in EU countries and also define its own regulations in accordance with the development level of insurance industry, development level of financial market, purchasing power of population, and the general strength of economy.

## 5. Conclusion

In view of the overall financial and economic situation in Serbia, it is obvious that the impact of insurance companies in the financial market is much weaker than that in the developed countries. Nevertheless, in the next period, based on the experience regarding the development of this type of insurance in the last ten years and its 23% share in the total premium compared to the 60% average in the developed countries, life insurance premium is expected to grow whereas additional 3-5 billion Euros are expected to be collected. If added the initiative of insurers for tax relief on this type of insurance, a realistic basis will be created for even higher demand for financial instruments and greater development of financial market. Government bonds, municipal bonds, corporate shares of profit-generating companies and shares of export-

13 Article 5, paragraph 2 of the Law on Banks, according to which „No person other than a bank shall engage in granting loans and issuing payment cards unless autorhised by the law"

oriented companies will be in the focus of investment of insurance companies as institutional investors. The room for strengthening investment activities of insurance companies is quite certain. All of the above will create realistic assumptions for the affirmation of insurance companies as strong institutional investors which, in the future, may become one of the main generators of financial market development and general economic recovery of Serbia.

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*Translated by:* ***Zorica Simović***