Insurance and reinsurance risk management in Albania

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Abstract

Risk management in insurance and reinsurance companies is a very important element, which enables the organization to meet its obligations to customers and to survive in the market place. In order to be managed properly, the risk must be first identified correctly. The damage must be assessed carefully and using efficient methods, for the evaluation to be more realistic.

This paper is the result of the use of several methods. Besides the theoretical and narration aspects, the paper also relies on the comparative method, as it addresses the practices followed by the Member States as well as Albania, a country that has recently adopted a new law, aiming to align its legislation with the acquis communautaire.

The study shows that the Albanian legislation provides the necessary guarantees to ensure that companies will manage risk in the best way possible and will create all the necessary structures for this purpose. In this regard, we can say that the alignment with the acquis communautaire has been successfully accomplished.

Key words: *risk, risk management, insurance, reinsurance, analysis, law, alignment*
JEL classification *K20*

Introduction

Insurance activity has had significant development in Albania, in recent years. This development is the result of several factors, among which we mention:

- The obligation, as stipulated in the transportation sector, to enter an insurance contract,
- The parties' awareness that the risks and their consequences are more affordable with the intervention of a provider, than by using their own funds,
- The variety of insurance offers available in the market.

Insurance is an area that has a very significant impact on economic development. The existence of an insurance contract allows an entity to benefit from a bank loan or to improve the standard of living, due to higher income. The stability of the insurance activity is also a stimulus for foreign investors in Albania.

The market and economic development as well as the need to align the legislation with the acquis communautaire, led the Albanian legislator to adopt a new law in May 2014. This law was prepared in collaboration with a group of experts and with assistance from the World Bank, and takes into consideration regulations determined at the European Union level, through several directives.

The article focuses on the treatment of new developments, in the field of risk management by insurance companies, discussed by the Albanian insurance legislation. It contains an analysis of the position held by the doctrine in the definition of risk management and its composing elements. The article also deals with the rules set by the Albanian legislator regarding internal measures, which should be taken by the insurance companies in the context of risk management.

Literature Review

Professor Xhevat Bakraçi (2007) provides this definition for risk management: "Risk management is the process of identifying, measuring, and economic controlling of risks that jeopardize assets, income, human life or commercial enterprises."

The international doctrine, French, for example, gives this definition for such risk management: "Risk management includes all techniques, which allow insurers to reduce costs of protection offered, including actuary techniques, premium determination, promotion of risk prevention, selection of customers, etc. (Aubert, 2013). "

There are several elements (BAKRAÇI , 2007), which the doctrine qualifies as necessary to manage risk properly (Guri at al, 2012):

- <u>Identification of existing risks.</u> This element allows the operator to adjust its offer to the market demands and the needs of the subjects. In cases when the risk has taken place and there are consequences, risk analysis allows the operating insurer to understand whether the conditions for him to pay are met, or if the damage came as a result of another reason, not covered by insurance. Appropriate risk identification helps the operator to assess whether, for a given situation, it is necessary to reinsure part of the contract.
- <u>Evaluation of the probability and potential losses in the event of the insured risk.</u> An insurer should recognize the dynamics of risks, the size and seriousness of potential damages. Assessment of magnitude of potential damages is necessary, because the method for handling small claims, which appear more often, and for handling larger damages are not the same.
- <u>Selection and application of effective tools, to cover the insured risk.</u> Risk management goes through the exercise of physical and financial controls. Physical control methods are available to the insured, as they relate to the actions and measures the insured can take to avoid or reduce the risk. Meanwhile, financial risk control is related to the provision of financial resources needed to cope with the consequences arising from damage.
- <u>The insurer must research continuously, in terms of exposure to risk and its resulting effects.</u> It must also evaluate for further decisions about the type of insurance it can provide, the amount of insurance it will accept, or reinsuring a part thereof. On the other

hand, the insured must also research, because different insurers offer different insurance fees and various insurance combinations.

Methodology of research

The paper aims to analyze the position held by the Albanian legislator, as it regards the notion of risk management. The measures that the legislature shall provide to the insurers as obligatory depend on how risk management is conceived.

The analysis was performed taking into account various elements, starting with doctrinal definitions, models followed in other member countries and the domestic market. The undertaken study was qualitative. Its main focus is the law passed in 2014 therefore the time period includes most of the early 2000s, during which the Albanian insurance market saw great consolidation.

The goal of the study is analysis of the law nr. 52/2014 “On the insurance and reinsurance”, as it relates to the measures that insurance companies must take for risk management purposes.

This article analyses the measures taken by the Albanian legislator to obligate the insurance companies to exert care in the management of risk and in the creation of functional structures for these purposes.

Analysis

This section covers a description of the Albanian insurance rules for managing risks and creating a managing system by the insurance companies. Risk management is a much more significant part of the law nr. 52/2014 “On the insurance and reinsurance”, in comparison with the previous law, nr. 9267, dated 29.07.2004 “For the activity of insurance, reinsurance, and intermediation in insurance and reinsurance”. This is especially important due to the fact that good risk management provides more effective protection for the consumer and the development of safer activities by the operators in the market.

Law no. 52/2014 "On the insurance and reinsurance" defines Risk Management as "the totality of methods and rules used by insurance companies to identify, assess, monitor and manage the potential risks, in order to avoid financial losses". The law also states that an insurance company must establish a system of risk management, which has to do with the determination and control of risks, through its policies, enforcement procedures and setting limits for monitoring, controlling and, when necessary, changing the quality of the level of activities, based on the structure of the risks and income to be carried on future cash flows.

The risk management system serves to identify, assess, monitor, manage and report, on an ongoing basis, the risks faced or that may be faced by an insurance company, at the level of society as a whole and at group level.

Policies, procedures and enforcement, limits and activities related to risk management should be sufficient to manage different aspects of the risks, which are created during the activity of the insurance company. The Financial Supervisory Authority, states that "management risk system" "means a set of measures and actions that should be taken by the insurance company, namely:

a) Strategies that define the approach of the insurance company in determining specific areas of risk as well as legal and regulatory obligations;
b) Policies that set out procedures and other requirements that are required to be implemented by the Board of Directors / Supervisory, senior executives, leading officials and employees of the insurance company;
c) Processes to implement the strategies and policies of the insurance company;
d) Controls that ensure that strategies, policies and processes are in place, are supervised, and aid in the objectives.

When obtaining prior authorization for operating insurance activity, the company must submit, along with the application for granting the authorization, the document that creates and provides the functioning of the risk management system. The insurance company must create a system of effective risk management, based on the nature, scale and complexity of the activity of the company and the regulatory framework in effect.

The Board of Directors / Supervisors must clearly define the acceptable risk level and approve the company's overall business strategy, based on which the document on the risk management strategy is approved. This document should also contain the functions delegated by the society. Together with the level of acceptable risk, the Board should approve, with written documentation, the procedures to be followed in cases of deviation from the strategy of risk management or the level of accepted risk, clarifying any important matter that requires interpretation. Parts of the risk management system are related objectives, major principles and distribution of responsibilities to address the risk in all activities and organizational units of the insurance company, including its subsidiaries.

The policies adopted for the definition and classification of important risks facing the company must be reasonably foreseeable by type of risk and the acceptable levels for each type. The types of risks, which require policy definition and classification, include insurance risk, market risk, credit risk, liquidity risk, operational risk, reinsurance risk, and risks arising from relations within the group, with related parties, transfers or transactions.

The system of risk management would not be complete if it did not include processes, tools and models for the determination, assessment and reporting of risks, and plans to cope with unforeseen situations or plans of continuity of operations and crisis management.

The company must also create and establish procedures for regular review of the risk management system and the constituent elements in order to perform the necessary adjustments and improvements in a timely manner.

The insurance company decides which structures to create, to manage risk by evaluating the company's size, risk profile and complexity of its activity. A structure, which has the duty to manage the risk, cannot exercise simultaneously the functions of internal audit. It can perform other controls, but in any case, should be ensured that the independence of business functions is safeguarded, conflicts of interest are avoided, the integrity of other control functions is ensured through additional control procedures and the ratio of checks and balances is maintained.

In assigning risk management structures, the Council of Administration / Supervision should consider the fact that the organization of these structures should allow the risk to be addressed at a group level, at the society level and business line level. The risk can also be treated in different categories depending on the risk, given the types of risk to which the company is authorized to perform the activity.

The risk management structure should take care that careful management of risk becomes part of the culture and working environment in the insurance company, whatever the level of organization, and not just within a level, but in an integrated way between different levels.

Exercising the functions of risk management also means that the responsible body ensures that all employees of the company understand their responsibilities regarding risk management through continuous training and communications, and for certain policies, through written rules.

Exercise of the functions of risk management also means that the responsible body to ensure that all employees of the company be clear on their responsibilities regarding risk management through continuous training and communications, and for certain policies, through written rules.

The risk management structure can take any information necessary for the organization of functional tasks. It is advisable that, regardless of whether the company has several structures charged with the functions of risk management, reporting situations and problems generated be centered on one unit or single leader, who will be able to assess these reports, create an overview of the risk management system and report, if necessary, urgently to the highest decision making level. Also, the structure responsible for risk management has the possibility to communicate with the Board of Management / Supervisory regarding the evaluation of exposure and measures to be taken for their administration, assessment of changes in the risk profile, assessment of risk events and the determination of appropriate actions, if necessary, to fix a situation.

The structure responsible for risk management supports the Council of Administration / Supervisory in fulfilling their responsibilities for risk management. It defines the risks facing the company, and then evaluates, supervises and assists in effectively managing and handling the set of risks.

Risk management requires appropriate structure to assess the overall risk profile of the insurance company and its paying capabilities both at the society and at the group level. Assessing risk and solvency is an integral part of the business strategy of the insurance company, is consistently considered in the company's strategic decisions and is an integral part of the statutory audit opinion. The risk assessment is done by considering the risk environment within and outside the insurance company, examining the risks as soon as possible, according to the territorial unit and by line of business.

The structure responsible for risk management examines the risks arising from patterns of presentation of awards and other incentives, and regularly performs stress tests and scenario analyzes. It regularly assesses the effectiveness of the risk management system and its function, as well as the implementation and overseeing of the necessary improvements.

Changes in risk profiles and other elements, related to the risk, with which the company faces, are constantly reported and documented by the responsible body for the Council of

Administration / Supervision. The risk management structure also reports significant changes in the risk management system, undertaken by it in order to improve the system. Finally, the structure has an advisory function about important decisions dealing with operational and strategic issues, and in order to make decisions on mergers and acquisitions or investments and major projects.

In risk management within a company, along with the structure responsible for performing this function, the Board of Directors / Supervisory must ensure that the insurance company has systems and functions suitable for risk management and it must supervise the risk management system in order to ensure that the system functions objectively and in accordance with the objectives.

The Board must approve the risk management policy and support the creation of a culture of risk management in the society. It has to examine and change the risk management policy at least once a year and whenever that is deemed necessary.

It is duty of the Board to ensure that the insurance company performs, at least once a year, the assessment of the risk and solvency, in addition to the minimum requirements of the legislation.

Finally, the Board must establish and ensure the compliance function as advisory body on issues of compliance with the relevant legislation and to assess the impact that changes in the regulatory framework may have on the company's operations.

The structures or committees that advise or are entrusted with risk management are created by the Council of Administration, which defines the composition, objectives, tasks, responsibilities, powers, organization of meetings and reporting. The Council also regularly reviews the regulations of these structures, to see if any changes are necessary.

The insurance company must document each stage and action of the risk assessment process and the performance of stress tests, in such form that the documentation user arrives at the same conclusions. The company presents before 31 May each year, to the Financial Supervisory Authority, the annual report on the assessment of the society’s risks and on the stress tests.

The annual report on risk assessment must include the following elements (AMF Board Regulation, 2015):

- The main results and methodology of the assessment process of the risks to which the insurance company is exposed;
- The basic assumptions used to carry out the stress tests and their results;
- Assessment of the exercise of responsibility by the relevant structures for risk assessment and monitoring;
- Recommendations that have been made, remedial measures determined on the basis of the recommendations, and the level of implementation;
- The minimum level of capital in relation to their risk profile.

The information presented in the report is discussed at the insurance company level and/or the group level, if the insurance company is part of a group. The report should explain the risk management framework, the categories of risks, the reporting framework, the administration of capital, the plans for the continuity of operations and facing the unpredicted situations. Finally, the report must give some recommendations and measures to be taken.

Comparison

Insurance companies operating in the Albanian market, despite the fact that they may have contracts in different parts of the country, have a limited impact on the market as a whole and this can be observed in the large number of companies operating in market: 3 companies licensed in the field of life insurance and 9 companies licensed in the field of non-life insurance. So, in total, 12 licenses have been granted for a population of nearly 3 million[1]. Only one of these companies is part of a group. Therefore, opportunities to expand operations or to establish reinsurance structures are scarce. Reinsurance in Albania has had a limited development and, currently, there is only one reinsurance company operating in the domestic market[2]. The main focus of this organization is the reinsurance of contracts entered into by the other companies that operate in the market. The lack of offers in this sector of insurance activity is the result of not only the company's financial inability to create a reinsurance structure with their funds, but also the result of the local market mentality. Presently, in Albania, insurance activity is exercised only by the companies created for this purpose, unlike other European countries, where insurance activity is also exercised by banking entities.

France is one of the European Union countries, where banking entities also propose insurance contracts. One case of particular interest is the Credit Agricole bank, which has created within itself an insurance structure covering bad loans, for which customers present danger of not being able to comply with the terms of repayment. In the case of Credit Agricole, the bank has established a subsidiary with the goal of insuring loans granted by various structures of the bank. Compared with other banking structures, in various countries of Europe, Credit Agricole presents a particular bank structure, as it is organized at several levels, which have certain dependence from each other, but, are simultaneously independent. Each of these local banks possesses part of the capital of the Credit Agricole holding company which is the highest central structure and federates all local banks. The creation of the central structure provides stability as it is this structure, which coordinates the activity between local banks and serves as a point of contact and representation to foreign structures and to third parties. The subsidiary created by Credit Agricole in France, for proving insurance on the loans given by the bank, is called Caisse d’Assurances Mutuelles du Crédit Agricole (CAMCA) and has several insurance criteria (Jahollari, 2012).

CAMCA applies to certain categories of creditors, who may require personal or business loans and have a high ability to repay. To this point applies one of the principles governing the activity of insurance, under which companies choose to insurance those entities or facilities for which the probability of realization of the insured risk is not too bad. To determine whether a loan would fall into the category of loans secured by CAMCA, the bank conducts a thorough analysis of several factors, the most important being the ratio of income and assets of the entity to the liabilities, within a certain period of time (mostly one-year period). Among these obligations can be other loans that have been taken and are being repaid, fiscal obligations, pensions in favor of dependents etc.

[1] Referring to the Statistical Institute, the Albanian population in January 2016 was 2 886 026 inhabitants - http://www.instat.gov.al

[2] The data were made public by the Financial Supervision Authority – http://www.amf.gov.al.

CAMCA ensures repayment of 100% of the outstanding liability from the client. So, there is no threshold below which the bank must withstand the loss of its funds.

However, CAMCA repays the unpaid portion of the loan, only when there are no other guarantees that can be used by the bank. As a rule, in any case, when a person or a corporation takes a loan at Credit Agricole, it gives the bank different guarantees, which can be personal guarantee (through a third party), or material (in the form of property, etc.). If, for one reason or another, these guarantees are not enough to cover the unpaid portion of the loan, the bank requests its subsidiary, CAMCA, to pay this amount as execution of the insurance contract.

Such a system presents the advantage of broad customer recognition, as the insurance company has the opportunity to get full details on the client's situation. The bank, which seeks to provide loans, meets the requirements set by CAMCA and provides comprehensive information of the client's situation, since it collects a broad set of documents in the context of lending. Obtaining complete and accurate information allows the insuring company to calculate costs and probabilities of the harmful events that would prevent repayment of the loan, thus avoiding mistakes in data processing and risk calculations.

Despite being part of the same group, the bank and insurance company, CAMCA, work independently. They have their own funds and separate balance sheets. Problems faced by one structure do not prevent the operation of the other structure.

Discussion

The Albanian insurance market is a relatively new market, compared with other regional countries. The Civil Code of 1929, adopted at a time when Albania had acquired some sort of political stability (after declaration of independence in 1912 and the end of the First World War), does not deal with the insurance contract specifically.

The communist government, created after WWII, regulated insurance activity with a series of bylaws, issued during 1945-1955. However, during communism, insurance activity in Albania had very little developed, as private property almost did not exist and people possessed much less wealth than nowadays, for which they would need to enter an insurance contract.

The first law regulating insurance, reinsurance and intermediation in insurance and reinsurance, was approved on 29.07.2004, very late date compared with other countries of the region and the European Union.

Given the lack of experience of Albanian lawmakers in the field of insurance, we can say that the law adopted in 2014, is a well thought law, providing a series of measures aimed at protecting consumers and avoiding situations unfavorable to the development of the activity of the insuring company or infringing of its financial stability. The law expanded the powers of the Financial Supervisory Authority, which can intervene not only in the event that an insurance company begins to encounter difficulty (as provided by the law of 2004), but even before the appearance of these difficulties, in the event that through exerted controls, the Authority finds various indicators that warn about the rapid entry of the company in financial hardship.

Conclusion

The quality of a law and the measures it provides, are noticed by analyzing several elements:

- Firstly, the manner of its compilation: whether the wording of the law leaves room for different interpretations or creates gaps, which create difficulties to understand and implement it.

In this respect, the law no. 52/2014 "On the insurance and reinsurance", does not present special difficulties because its compilation and selection of terminology was done in collaboration with the World Bank as well as considering the terminology used at the European Union level. Finally, the opinion of representatives from insurance companies was also taken into account and they were consulted before sending the draft law for approval.

The Financial Supervisory Authority has approved a detailed set of regulations for the technical aspects for which the legislator has decided to provide through issuing bylaws.

- Secondly, the difficulties of implementation by the subjects. Objections, which companies can file for reasons related to their organization or as a result of additional costs that may arise, are not analyzed for the purpose of this article. Other elements though have had consideration, for example, the law has provided relatively long periods of adaptation to the new rules, from 6 months to 24 months. This timeframe gives the companies an opportunity to choose the most convenient time to budget the necessary funds to cope with the additional costs. The companies also have sufficient time to establish internal procedures and to create qualitative and functional management structures.

In this respect, the law has considered the different situations in which companies are operating in the market, having provided some opportunities for the organization's risk management structures, depending on the size of the company.

Finally, the law has considered the functioning of the market in the European Union, foreseeing how companies will operate when Albania becomes a member of this structure.

This assessment remains however incomplete, because some of the terms of adaptation to the new rules have not yet been completed (the law entered into force in July 2014), and there are no statistical data for controls, which are exercised by the Financial Supervisory authority for this purpose.

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