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## BACKGROUND AND EFFECTS FOR FINANCIAL INSTABILITY OF INSURANCE ORGANIZATIONS

**Objective.** *The purpose of the article is to identify the main conditions of financial instability of insurance companies and its consequences.*

**Methods.** *During the study methods of theoretical generalization and comparison, analysis and synthesis are used.*

**Results.** *The article reviews the causes of financial instability in the insurance market of Ukraine, analyzes risks that are presented in the activities of insurance companies and their consequences. On the basis of these studies identified innovative directions to overcome financial instability in the insurance field.*

**Academic novelty.** *The driving factors for insurance companies at the present stage, generally the causes and consequences of financial instability in the insurance market are highlighted.*

**Practical importance.** *Results of the study will improve the system of operation management of insurers, which in turn will avoid financial instability insurance companies and reduce their losses.*

**Key words:** *insurance organization, financial instability, risks, losses, life cycle.*

### Formulation of the problem and the necessity of research

With the gradual development of the national economy, its transformation and the approximation to European standards insurance sector is one of the key areas of accumulation of financial resources. Insurance companies accumulating funds of their customers can become powerful institutional investors. They can solve a number of socio-economic problems of the state to ensure its development.

Crisis in financial and real sectors of the economy slow down the development of the insurance market. However, in crisis conditions there is a chance for activity continuation in the market only for the most financially stable and able to pay companies.

During financial instability at the Ukrainian and world markets the scale of unprofitableness and bankruptcy of insurance companies increased. This causes the necessity of research of prerequisites of insurers instability, risk evaluation in their activity, identifying the effects of the crisis for this type of business. The results of research is important for insurance companies to overcome the financial instability in their activities, including the development scenarios depending on the economic and political situation in the country.

### The analysis of the last researches and publications

The investigation of the problem of crisis in the financial sector and insurance market was made by the leading ukrainian scientists-economists. Among them: O.

Gamankova, N. Dobosh, V. Plysa [1], R. Picus, V. Furman and others. The authors offer a variety of directions to overcome instability in the insurance market of Ukraine. Thus I. Taranskyy, O. Duma and L. Sopilnyk consider effective application of marketing and logistics solutions for the insurance market of Ukraine during the financial crisis [2]. V. Koval proposes applying complex of insurance products as a tool to overcome the crisis. A. Boyko in his studies notes that optimization of insurance portfolio of the company can provide its financial stability [3].

Each of the authors propose their own vision of financial instability of insurance companies, its background and effects. Most publications expose only certain aspects of the processes that characterize the insurance business in conditions of instability.

The main objectives of the article are:

- summarizing the directions of the development of insurance business in financial instability;
- definition of the prerequisites and effects of financial instability in the activities of insurance companies;
- selection the ways to overcome the crisis in the insurance business.

### **The main material of the investigation**

Financial instability in global and national markets caused a difficult situation in all parts of the financial system. This caused to the non-solvency, unprofitability and bankruptcy of enterprises and financial institutions. The significant impact of the crisis experienced the banking system of Ukraine. At the beginning of 2012 eighteen Ukrainian banks were in liquidation. Their debt to depositors amounted to about 2.5 billion UAH. Problems in the insurance market of Ukraine also became aggravated. In 2009 the bankrupts became 25 insurance companies of Ukraine. These processes continue until now.

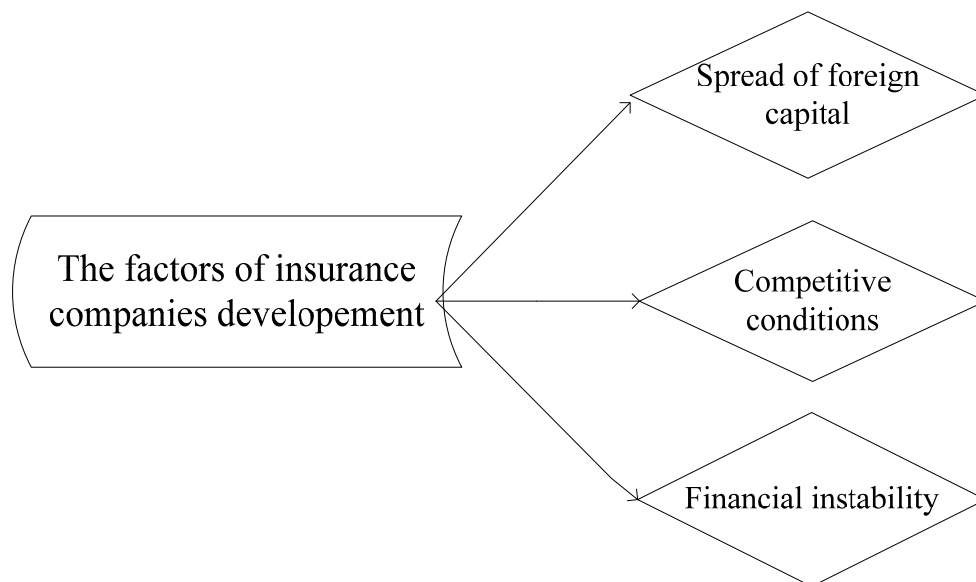
The data of global report on the insurance market in 2008-2009, published by the European Association for Financial Management and Marketing (EFMA) indicate the following trends in the insurance market of developed countries:

- oversaturation of markets by insurance services, which limits the development opportunities;
- unstable, volatile position of insurers in connection with the problems in the financial sector;
- the income of the largest insurers in Europe during the crisis reduced on average by 6.7%.
- on average, consumers in developed insurance market own 5.2 insurance contracts: 1.5 in life insurance and 3.7 in other areas.

The recession in financial market affected the global insurance market. This is confirmed by outstripping fall of DowJonesInsurance ETF index in comparison with the general index DowJones. General index DowJones in 2008 decreased by 36% and the index DowJonesInsurance ETF has lost more than 60% [4].

So, the insurance business both in Ukraine and in the world is exposed to thorough impact of economic factors and market volatility, ending the ever increasing competitive environment.

The driving factors for insurance companies nowadays represented in Pic. 1.



Pic. 1 Driving factors for insurance companies at the present stage

Ukrainian insurance market in 2007-2008 has shown remarkable growth, which was accompanied by increasing the number of insurers and insurance agreements. However, the financial crisis worsened the development indicators and they fell to the level of 2007. Market recovery began at the end of 2010 [9].

So, global as well as Ukrainian insurance market is developing complicated and unstable. The main reasons for this situation are:

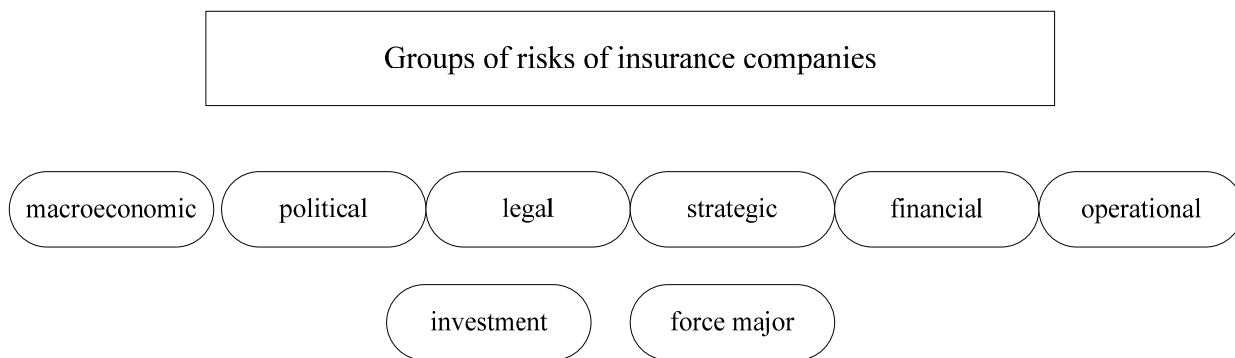
- destabilisation of the situation in global financial markets;
- a significant decline in the real economy;
- crisis in the banking system;
- low solvency of insurance consumers.

American scientists called the current economic situation in the world markets "the world VUCA" - VUCA - abbreviation of volatility, uncertainty, complexity and ambiguity.

Activities of insurance organizations related to all areas of the financial system of the state, and therefore is constantly influenced by social and economic factors. Factors of influence on insurance activities include a large number of risks. The insurer, protecting its customers from certain risks, is constantly under their influence, because the range of risk situations significantly expanded in the market conditions.

Russian scientist N. Kirillova considers that "the total risk of insurer expressed by probability of changes in asset quality and reducing their costs. That leads to a decline in its financial stability or the demise of the insurance market" [5].

The risks of insurance organizations are different in nature and origin. They can be united in the following groups:



Pic. 2. Groups of risks of insurance organizations

In the area of financial management of the insurance company is necessary to study the financial risks faced by insurers in their activity.

There is no definitely interpretation of the term of financial risks in the scientific literature. Consequently there is no clear system and their classification. A number of scientists find that the financial risks belong to economic risks[6], while others consider financial risks as a separate type of enterprises risks [7].

The internal financial risks of the insurer are: the risk of decreasing of financial stability, business activity, the risk of insolvency and unprofitableness.

The risk of decreasing of financial stability of the insurance company caused by a rather big proportion involved and borrowed capital. Economic instability, especially decrease in demand for insurance services, lower incomes, increased competition, increased supply in the insurance market, and thus minimizing the size and volume of the insurance premiums can lead to financial crisis or even bankruptcy of the insurance company. Such risks arise by attracting loans to repay insurance payments or financing activities. They are inevitable in the process of achieving a higher return on equity due to the effect of financial leverage.

Decrease in business activity is due to negative dynamics of key performance indicators and efficient use of invested resources in some kind of business. Insolvency occurs when the company is unable to fulfill its financial liabilities to customers and contractors fully and in time. The risk of unprofitableness caused by the lack of competitive benefits of the insurance company, improper organization of marketing activities and financial management. It is connected with the probability of decrease of profitability, complete loss of profits or incurred losses.

In managing of insurance companies internal risks should be given most attention because they can lead to bankruptcy of the insurer.

Risk management for insurance companies is a continuous process, because risk is a "product" with which they are constantly dealing with. Unstable economic situation in the state and in the insurance market in particular needs to improve risk management system of the company.

Without qualitative study of risks taken by the insurance company it may find itself in a situation when amount of payments substantially exceed the expected level. To avoid such situations, important is the proper organization of the process of underwriting – the administering system associated with the evaluation of insurance risks for decision-making about the possibility and conditions of their insurance.

Disadvantages in the operational management of the insurer lead to growth of unprofitable activity.

Traditionally, economic literature highlights the rate of profit, which reflects the value of positive financial results, as the main motive and ultimate goal of any kind of business is the welfare of the owners. The characteristic of such growth is the received profit. The loss is the value that characterizes the decrease of benefits and owners welfare.

In the Methodological Recommendations relating to the use by insurers stress tests determined that the crisis - a situation that may occur in the future due to the effects of external and / or internal factors and stressful situations which result in significant financial losses of the insurer in an amount not less than 10 percent assets on the balance sheet [8].

The economic nature of losses arising in the company and their reasons directly related to the activities of organizations in a market economy. Normal is the indicator of insurance sum unprofitableness at 40-60%. Companies profitability shows the satisfaction of the needs of society and the implementation of effective action of the company. Profit is the financial tool for further expansion of the company. If the company experiencing losses, it may indicate a low demand of its services. Companies that can't adapt their activities to the market receive significant losses.

It is worth noted that there are differences in the level of profitability and loss not only among sectors but also among organizations of the same industry - competitors. This is due to many factors. Every company goes through several phases during its development. One of the important factors influencing the profitability or unprofitability of insurer is its life cycle.

Following the maturity of the insurance company comes aging and the recession stage. The beginning of aging phase is the stabilization position in the market, but with reduced sales volume. These volumes the company supports by reducing the insurance rates that is not the best option support sustainability.

At this stage lower profits and unprofitability of the insurance company is observed, disturbed balance sheet structure, which subsequently may lead to the bankruptcy and deprivation of license.

On a typical lifecycle curve of enterprise financial instability comes at the end of stability phase. According to research on the subject [1] the possibility of financial instability in insurance organization is higher in transitional periods of its development - between the stages of the cycle. That means that in certain unfavorable factors insurer at any stage of the life cycle may become unprofitable and insolvent.

The definition of phases of the life cycle of insurance company and the impact on received income from giving insurance services is one of the determining factors of profitable functioning of the insurance company.

As a result of unprofitableness insurer may face several complicating circumstances which in its turn, can cause difficulties in the implementation of insurance activity, and questioned the very existence of unprofitable organization. Unprofitable activity can be a closed circle: on the one hand the income earned by the organization is not enough to cover all costs, on the other - the presence of damage

generates additional costs in the form of interest on the additional debt and involved capital in the form of penalties from both contractors and regulatory agencies.

However, the presence of significant damage isn't always a sign that the insurer has lost all chances of survival. It should be carefully studied the "quality" of the damage and split it into individual components. It is advisable to determine the amount of financial results by type of insurance and focus on those that are more profitable. It is worth noting that insurance activities are always unprofitable, the company may receive profit particular by investment.

During the financial instability decreases the value of net cash flow of the company, the level of insurance payments, salary paid, reducing the market value of the company.

There are following effects of financial instability in the activities of insurance companies:

- unprofitable activity;
- reorganization;
- bankruptcy;
- liquidation.

### **Conclusions and recommendations:**

To overcome the financial instability in the activity of insurance companies is worth to expand the range of their operations and the use of innovative solutions:

- the development of basic product line by offering customers new insurance objects, increasing the attractiveness of the terms of insurance contracts;
- the development of related, similar to insurance products, types of transactions. Especially it concerns life insurance companies, which are rapidly increasing sales of individual and group annuities with constant and variable income, developing health insurance programs, accident insurance, offer the creation and management pension savings for private and corporate clients [10];
- expansion into other financial businesses, such as the purchase of non-core type of business - commercial and investment banks, finance companies, investment organizations and pension funds. The functional structure of financial groups that are formed in such a way usually includes primary insurance division, banking block, as well as the division which provides asset and resources management of different funds controlled by groups. The world's largest financial conglomerates created on the basis of insurance companies are: Allianz group, which includes the second largest bank in Germany DresdnerBank, ING Group (Netherlands), Fortis (Belgium), Metlife (USA), StateFarm (USA).

Thus, insurance companies that are in a phase of the financial instability should consider all the reasons that led to this situation of the company and choose the most appropriate option for themselves overcome it.

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