

# Role of Insurance Companies in Financial Market

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## Abstract

The financial market in the broadest sense is an organized place where supply and demand for financial assets meet each other, where we have a price formation of those activities. Financial job market means all institutions and processes by which buyers and sellers of financial instruments connect regardless of the nature of the financial instrument. It allows the free circulation of cash and capital and their routing where these funds can best be utilized.

Modern insurance is no longer of importance only to individuals who are joining in community protected from possible adverse consequences. It is of great significance for a number of subjects, but also for the community.

Due to the fact that insurance forms huge capital which is a part of national savings for unpredictable cases, the importance of insurance for the economy of each country is enormous.

The subject of this paper is a theoretical study of the influence of insurance companies on the financial market. By analyzing insurance companies, the aim is to determine how and in what way they affect business of financial market.

**KEY WORDS:** financial market, offer, demand, insurance, insurance companies, capital

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## Introduction

Insurance represents joining of all who are exposed to danger with aim to mutually bear the burden if someone suffers some kind of damage. Hence the early idea that people who are threatened by some danger should organize into a community; the community made of contribution of each of them, which would provide sufficient funds to those who were hit by some kind of accident.

The importance of insurance for the insured one is that it helps him secure himself from various risks. Apart from that, he or she can provide existency to the family in case of loss (death, permanent inability to work...) or some travel expenses or similar costs. Modern insurance influences the increase of "freedom and independence of a man". Freedom is primarily reflected in the possibility that a man is secure from the consequences of their activities if causing damage to another one.

Based on theoretical concepts through the analysis of the insurance companies this paper work will come up with an answer to the question in which way they affect the financial market and how they contribute to its development.

Research in the scientific sense is based on the already well-known theoretical views and concepts on the subject of research and, in its largest part, on focus on empirical research. The scientific objective of this research is to achieve scientific knowledge about the importance of insurance companies and their impact on financial markets.

Social justification arises from the fact that the insurance sector is faced with many problems but also challenges, which is why it is necessary to intensify research efforts that may contribute to a better perception of the current state and prospects of development of the insurance sector and, consequently, Financial Markets as well.

The paper outlines the general hypotheses that: insurance companies have a very significant impact on the financial market of each country.

As a special hypothesis we can highlight:

- capital market growth driven by the development of insurance.
- insurance companies are one of greatest employers in the world, and thus affect the employment rate, especially in developed countries.
- Huge capital is formed via insurance which affect positively financial flows and financial market.

## Market of capital

Together with the market of goods and services and labor markets, financial market is an integral part of the overall market environment. What makes this market different from all the others is that it generally does not have the direct contact between transactors. The market is characterized by high price volatility, where the value of assets determines its future sale price. The future is, by the rule, uncertain, and thus the formed price on the market is uncertain or risky. Highly standardized assets that are traded on financial market and trading system which is mainly done by computers, enable relatively easy performance of a huge number of transactions of great total value. The rapid flow of information present

nowadays on financial markets can very quickly change the image of the market, elevating it to unknown heights or turning off in a very short time.

Financial market allows those who need funds to obtain them and enables those who have excessive funds to earn more by investing. Development, wideness and stability of financial market are of great importance for successful functioning of economy and at the same time they are important indicator of national market development in regards to environment.

Basic role of financial market and, subsequently, the market of capital is performance of efficient allocation of finances through financial institutions, instruments and wide range of financial services, from those decreased to increased ones and to enable easy transaction performances (Brzaković, 2007, pp.18)

The higher the volume stated deficit and surplus, the greater the need for efficient financial markets which will channel excess funds to end users in a simple manner and at the lowest possible cost. Efficient financial markets are undoubtedly important to ensure adequate provision of capital and economic growth in the economy. One of the primary functions of the capital market is to increase the profitability and efficiency of operations, because the capital market provides clear and quick overview of realized rates of return in relation to invested assets and leads to a kind of 'cleansing' of the economic system of inefficient economic entities.

At the same time, the capital market is also a place which assesses management quality issuers. Financial markets mobilize domestic financial savings and provides guidance in the economically and financially most successful entities. The capital market allows successful companies to take over companies that perform poorly due to rehabilitation of those companies. It also provides access to financial markets to finance a wider audience (proprietary democracy) that have good projects and who are not able to finance through banks (Brzaković, 2007, pp.19).

Development of capital market stimulates competition, leads to specialization and division of labor between the stockbrokers which, then, leads to a reduction of costs of financial intermediation. Capital market ensures the solvency of the financial system, and the prerequisite for this is that there is a developed secondary market capital to ensure liquidity of investments, ie. the possibility that investors, if they wish, can turn re-investments into cash.

Development capital market allows easier entry of foreign capital (foreign investment), which is particularly important for countries that have a deficit of necessary financial resources. The capital market provides long-term ownership financing through the application of the sale of shares, thus increasing the issuers' own permanent capital.

Financing Corporation through the capital market, regardless of the percentage share of such funding in the total volume of financing, has many advantages: it allows obtaining additional external funding for the development and financing of companies growth, the creation of optimal financial structure and achievement of optimal ratio between debt and equity sources and raising funds at favorable financial conditions; it increases the efficiency of management and improves the image of the corporation (Brzaković, 2007, pp.20)

On the other hand, " opening " of companies includes some of the negatives, such as the creation of additional costs due to the obligation of more frequent and more comprehensive presentation to the public of data (report) on business; corporate risk exposure to hostile takeover; exposure of corporations to pressure of broad number of investors.

## Insurance companies

These institutions on the contractual basis collect funds at regular intervals. These financial intermediaries that are characterized by a high level of security can anticipate to pay its obligations in the coming years, so unlike depository institutions may not be affected by the current loss. They are not the main concern of achieving liquidity assets, and therefore tend to have long-term investments in corporate bonds, shares and mortgages. (Marović et al., 2009, pp.77)

The insurance industry has a very important role in the financial systems of countries around the world. The world market for insurance year after year records an increasing growth, largely thanks to the opening of the insurance market in developing countries. Insurance markets in developing countries until recently were closed to foreign companies, and therefore, due to the lack of competition and adequate knowledge management, insurance companies were inadequately developed.

The insurance industry today, despite the great importance it has in the developed parts of the world, gets the increasing influence on the markets of developing countries. In developed countries, there is almost no one who does not have one or more insurance policies: life insurance, health insurance, disability insurance, auto liability, auto insurance, fire insurance, etc.

The insurance industry applies for one of the largest employers in the world, taking into account that in developed countries the employment rate in this sector began to decline slightly, while in developing countries, due to large growth potential of their insurance markets, there is an upward trend. The reason for declining growth rates in developed countries is attributed to the development of technologies which enabled insurance companies to handle incoming claims for compensation for damages in simple way, which reduced demand for administrative workers. The process of deregulation that swept through financial markets worldwide has caused a huge competition between the deposit and non-deposit financial institutions, so that commercial banks and brokerage houses have begun to encroach on the parts of the market, which until recently were traditionally reserved for insurance companies.

Insurance companies are considered as financial intermediaries for several reasons. The first reason is that they receive funds from their clients for further investment. Many people use insurance companies as institutions in which they invest most of their savings. Another reason why these institutions can be found as financial intermediaries is that these institutions place invested assets of its clients in a series of investments that will make them some money. So, they take resources from one sector and invest them in another sector.

Insurance companies deal with the risk-taking on behalf of their clients in exchange for compensation in the form of premiums. Insurance companies generate profits by charging insurance premiums that are designed to be sufficient to pay expected claims for damages and to obtain certain profits. (Marović et al.,2009, pp.79)

## Assets of insurance companies

Insurance organizations as legal entities have their property. Assets of insurance organizations constitute the right of ownership on immovable and movable assets, cash, securities and other property rights (Vuković,2004, pp.40).

Insurance companies acquire funds from multiple sources. Initial funds consist of assets which founders provide while founding (initial capital), then the money come from collected premiums received for the risks in insurance as well as assets remained as profit at the end of the fiscal year.

The joint stock company sorts the means it deals with into certain funds. According to the Law on Insurance, the funds of insurance companies are (Zakon o osiguranju, 2014, pp.49)

1. Means of technical reserves
2. Means of gurantee reserves
3. Other insurance means

Initial funds are the resources that the founders provide while establishing an insurance company. Unlike companies engaged in other jobs with the insurance companies, this means these funds must be constant. These are the so called "horizontal tools". They serve as a condition for a particular security of insured person who conclude a contract on the initial period of operations of the new company for insurance. These funds can be used only in exceptional cases and only if there are no other means. It is believed that an organization which uses these funds doesn't fulfill the conditions for business so the liquidation process of such company may begin.

Technical reserves are the assets that consist of: Reserves for unearned premiums, reserves for unexpired risks, reserves for bonuses and discounts, damages reserves, mathematical reserves for insurances where insured ones accept participation in investment risk and reserves for risk equalizations. (Zakon o osiguranju, 2014, pp.50)

Funds of mathematical reserves are special funds that are formed in insurance companies dealing with insurance of persons. These funds have purpose and so, as a rule, they are on separate account or accounts. They can not be used for any purpose other than to pay the amount of insurance based on life insurance. Compulsory execution is not applicable to them, and they have special treatment in case of bankruptcy of the company engaged in life insurance.

The guarantee reserve are special funds and used for permanent fulfillment of obligations of insurance organizations. The insurance company shall, for permanent fulfillment of obligations and filing of business risks, forme a guarantee reserve, in the manner prescribed by law. The guaranty reserve shall consist of a primary capital and supplementary capital, reduced of deductions (Zakon o osiguranju,2014,pp.52).

## Financial Performance of Insurance Organizations

Insurance organizations in legal matters act with full responsibility. This means that they are responsible for its obligations to third parties with all its assets. It should be noted that shareholders who have established a joint stock company are not liable for obligations of the company. They can only bear the risk in the amount of funds invested in founding. Financial transactions are understood under the term organizational business (revenue and sale of assets, loss coverage and distribution and taxes).

**Income and expenses** - insurance organizations (JSC) receive income from its business operations. Income sources are different. Revenues of insurance companies are made of insurance premiums, and active reinsurance businesses, and perhaps others functional incomes, income from investment activities, financial income, income on the basis of the valuation of assets and other income (Zakon o osiguranju, 2014, pp.59).

Expenditures include costs of an insurance organization in the course of the business year. Expenses include costs for paid damages and the sum insured whether they are direct or for those received in reinsurance or co-insurance, then come the risk premiums submitted in reinsurance expenses for prevention, as well as expenditures for business of insurance organizations (material costs, salaries of employees and all those expenses that have any legal entity), as well as extraordinary expenses and capital losses. Expenses are considered expenses of determining claims incurred, expenses for recourse claims (court fees and costs), costs of expertise in contentious cases and other costs incurred in connection with the evaluation and settlement of claims (Zakon o osiguranju, 2014 pp.59).

Allocations for reserved damages are, at the same time, revenues in the coming year.

**Loss coverage** - Organization for insurance during the annual business can show a loss. Insurance Act lays down rules to cover the loss and sequence of resources that can be used for this purpose. If an insurance organization experience business loss during the year, the coverage is made out of the following sequence: from retained earnings, or surplus, out of the free reserves, the assets of the fund prevention, from the initial fund safety. If it is a mutual insurance company, the loss is covered before using funds from the initial security fund by paying additional contributions of the insured or the proportional reduction of damages to all members, insured ones or a combination of these two methods (Zakon o osiguranju, 2014, pp.61)

The Act further stipulates that the insurance organization is responsible to cover the loss in the business year, and to compensate ("return") means to the initial security fund in the amount that was used to cover the loss. In addition, insurance company obliged to inform the competent authority of finance about the occurred loss. The reason for this notice is that the competent Ministry of Finance determines the official who will, at the expense of the organization controlling the implementation of measures, repair or cover the loss.

**Distribution of profit** - Joint-stock insurance company is established in order to profit. Gains of the insurance company are part of the income that remains when covering total expenditure in the accounting period (during the business year). Tax is the first thing to be paid from the profit. The rest of the profit is a part of the deployment, and according to the Law, it is allocated in the following schedule (Zakon o osiguranju, 2014, pp.60)

- to cover the loss from the previous year (if any)
- Dividends and other remuneration to shareholders in proportion to the funds they have invested

- mutual insurance company,
- for the refund of excess contributions of members (policyholders), in proportion to the amount of their contributions,
- the safety reserves, allocations to other funds (fund prevention, means of collective consumption) and in the mutual insurance company for the return of the founding roles with appropriate interest,
- to gain employment in accordance with the collective agreement.

**Business principles** - Insurance organizations and other legal entities are obliged to act in their own business or operate in accordance with certain principles. These are the principles of economy, and the implementation of the profession in the insurance business in accordance with the law and good business practices and business ethics, as well as the principle of fair competition. For insurance organizations, the principle of reciprocity and solidarity is particularly stressed as well as operations in order to ensure continued fulfillment of its obligations.

The obligation of insurance organizations to provide lasting performance of its obligations is legally regulated in the sense that the obligation of the guarantee reserve exists. In addition, insurance is required to take into account whether you can cover all the risks assumed in insurance. If that's not possible, it is obliged to provide them via reinsurance or coinsurance. If the organization is not able to cover all risks with its own funds, a part can be transferred to reinsurers abroad, but only if it is not possible to achieve it within the country.

## Supervision of operations of insurance companies

Specifics of insurance operations require special supervision over the work of insurance organizations. In most countries, this monitoring is very emphasized through the control carried out by national authorities. National Bank of Serbia monitors every insurance business by the Law on Insurance in Serbia.

National Bank of Serbia monitors performances of insurance branch, i.e. monitors business of insurance companies and reinsurance companies (subjects of monitoring) (Zakon o osiguranju, 2014, pp. 76)

Reasons for increased control of the insurance organization are explained by the following arguments:

- It is necessary to preserve the interests of the insured ones
- It is useful for the insurers as well (competition elimination and rentability providing)
- Governmental interest.

Supervision over the operations of insurance organizations determines in the first place if the general acts, business policy and business insurance organizations are in accordance with the law and the regulations made thereunder.

The control is in the first place legality obedience, ensuring the solvency and liquidity of insurance organizations, preservation of equality of parties, the ban on gambling and betting elements, ensuring fair competition between insurance organizations and so on.

In order to achieve the objectives of the control - monitoring is present in all stages of the existence of insurance organizations and even before that (a requirement for obtaining

the license is the fulfillment of certain conditions stipulated by law). Therefore, the supervision over the operations of insurance organizations can be viewed through three stages:

1. Phase of establishment - the fulfillment of the conditions for the establishment and initial operation of insurance organizations.
2. In the course of operations - control of tariffs of insurance, signed agreements, the obligation to maintain certain funds, the obligation to report on the operations and so on.
3. During the termination of insurance organizations-rehabilitation, withdrawal of license, etc.

Measures for supervision of insurance organizations constitute the whole which consists of:

- special control over the operations of insurance organizations that are engaged in the business of automobile insurance
- mathematical counting (obligations of organizations engaged in the business of life insurance to ensure the actuary, the actuary participation in the evaluation of the annual calculation results and so on.)
- Revision (obligations of insurance organizations to conclude an agreement on the revision of accounting statements.).

## Conclusion

The importance of insurance for the insured one is in preventing him/her from various risks. Huge capital is formed by insurance and it represents a part of national savings for unpredictable cases and the importance of insurance for every country's economy is enormous. Assets of insurance organizations constitute the right of ownership on immovable and movable assets, cash, securities and other property rights.

The funds that the founders provided during the establishment of the insurance company make initial stock. Safety reserves consist of assets formed from premiums in the year when the premium is greater than the damage occurred. The funds that are formed in insurance companies dealing with insurance of business men are the life assurance reserves. Guarantee reserve - these are special funds that are used for continuous performance of the obligations of insurance organizations.

Insurance organizations (JSC) gain revenue from its business operations. Income sources are different. Revenues firstly come from collected premiums received for insurance, reinsurance and coinsurance, then revenues from recourse for the paid damage from the responsible persons, and also extraordinary income and capital gains. If an insurance organization, during the year, registers an operating loss, coverage is made out of the following sequence: from retained earnings, or surplus, out of the free reserves, the assets of the fund prevention, from the initial safety fund.

Gains of the insurance company are part of the income that remains when covering total expenditure in the accounting period. Organization for insurance is required to take into account whether it can cover all the risks assumed in the insurance; if not possible, is obliged to provide them via reinsurance or coinsurance.

Supervision over the operations of insurance organizations is determined in the first place if the general acts, business policy and business insurance organizations in accordance with the law and the regulations made thereunder. Insurance companies are required to provide the National Bank of Serbia with data about legality or illegality of the business. Thus, the insurance organizations are obliged to provide the National Bank of Serbia with:

- Annual and business report
- the copy of revision report with the authority's comment on it
- Comment of the supervisory board, amendments to the business policy.

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