

University of West Hungary
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The Role of Insurance in Corporate Financing

- thesis -

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1. The objectives, hypotheses

Financial innovations lead to new solutions for the banking, insurance and capital market sector. Their interrelated systems are now vital for market economy participants. As a result of their close co-operation and competitiveness, mixed products are developed, created and marketed for the enterprises which perfectly adapted to their needs also. However, the *risk management* factor still remains a central concern, not only in their operations, but contends to the pre- and/or post-financing, customer services, and indeed the entire economy as well.

The thesis presents – by way a descriptive analysis and critical examination – the complex system of the *financing insurance products*, describing the related regulatory organization and operational issues relating to the theoretical and practical problems in the light of *economics and jurisprudence*. In addition, a commonly used theoretical sample set up is done in order to substantiate an *abstract financing insurance model*.

The research topic is *current*, not only domestically but also internationally. The recent economic crisis (2008 – ?) caused, that the recession-, and – in a broader sense – risk management become an important expression in the globalized financial world. Therefore, financial security and its classical solutions imply insurance appreciation. Unfortunately, there are only few summaries and systematic writings on corporate financing insurance in the *specialized literature*, the publications and studies describing unique and specific products.

2. The contents and methods of the research

The thesis analyzes and evaluates the most widely used products, the changes and trends of the corporate financing insurance market. To this end, it takes into account the present and future *economic changes*, the statements, conclusions and relations of economics, and the *legislation* into force and in preparatory phase.

These resources require that the research methods need to be applied in both *economical and legal relationships*. The close and intricate connections between banking and the insurance sectors should have due consideration as well.

The *theoretical fundamentals* are the basis of scientific investigation, contributing to an understanding of the topic and the outcome results. Therefore, it is essential to clarify the concepts of risk management, insurance and financing. In order to show the sector's current situation and recent developments it is necessary to present the market participants. The *concepts* are informative, the reason for their explanation is to summarize the most common terms and elements. The text however, does not claim to be complete, synthesis, because every definition can be formally dangerous and can be misinterpreted: *omnis definitio periculosa est*. The economical examination of the domestic insurance sector in the 21st century is based on *quantitative methodologies*. This is done by applying the analysis of generally accepted institution (Hungarian Financial Supervisory Authority, PSZÁF) and professional association (Association of Hungarian Insurance

Companies MABISZ) which give an accurate overall view of the insurance institutions.

In order to present full-scale the *structure* of the domestic and foreign insurance products the thesis not only confines itself to the dry and well-known rules of the transactions, but also describes and evaluates the contract terms and conditions (clauses and solutions) which are widely applied in the practice. The main *examined topics* are i) the basic elements of the transactions, ii) the role in the economy, iii) the risk management, iv) the financial structure, v) the liability in question, and vi) other related and various important issues. As a result, a general, abstract, theoretical, dogmatic approach to financing insurance is accomplished.

Besides the processing of the current Hungarian and international *literature*, the often quoted reference authors of this specific civil period are: Árpád BAUER, István GRÓH, Jenő FEHÉRVÁRY, Bálint KOLOSVÁRY, Ödön KUNCZ, János SMOLKA, Péter Pál SZENDE, Béni GROSSCHMID, Károly SZLADITS etc., thereby, illustrating the quality of the domestic insurance sector during the inter-war civil era.

3. New research results

The *Hungarian insurance sector* keeps pace with international trends. However, the restrained and cautious attitude of the potential clients causes regression in time and diminution in volume. The sense and worth of security is still not widespread yet, especially amongst the SMEs with poor capital, who consider the premium a pointless, unnecessary expenditure if the insured event does not happen. Nevertheless, the recent economic crisis probably can or may bring a favourable breakthrough in the market as a result.

The domestic financing insurance products are *various*. Besides the significant credit insurance, nowadays separate insurance schemes link to *asset- and debt-based financing* such as leasing and factoring, are widely available and customized. The *security- and credit-coverage insurances* are not simple collateral- or property-insurances; rather, they are stimulating financial guarantees and instruments of both domestic and international trade. The sector's diversity is not only enhanced by industrial shutdowns, the employment insurance, legal protection insurance, but also the potential corporate unit-linked insurance as well. As a result of the financial and legal innovations the basic financing transactions, the insurances, the terms and conditions form a single intricate contractual system.

The *risk management* due to objective and subjective frameworks is complex. Investigating these two elements even before the contractual agreement is signed by the parties, show real

figures. The basic criteria of insurers during the client-evaluation are objectivity and are strictly determined by the clients' assets which establish the risk group. Elements of risk sharing are directly proportional to the corresponding values in place.

Due to the concept of the rule of law and market economy the *economics* approach is also reflected in the *jurisprudence*. The state, public intervention and regulation define minimum mandatory, cogent requirements. The client-evaluation and products contain risk management elements in accordance with the principle of freedom of contract, and as individual norms are legally binding on behalf of both parties. The examination and the application of these principals are extremely interesting and strong in value, because they are generally speaking, commonly used in the financial sector; and actually far more “ binding ” than the legislative provisions for the clients.

As a result of research and consultations, the dissertation identifies *scientific novelties*, in other words innovations, and original statements.

- i. The bank and the insurer *convert* and sell – as a result of the *risk management* – the pre-financing *risk* and a portion of the profit during the post-financing. The use of alternative risk sharing is transferred to the capital market and commonly applied by insurers.
- ii. Since, insuring objective and subjective risks relating to financing principals and as a rule, affecting in an *indirect way* the *insurance* industry (financial division), the need to implement more specific legal regulatory norms are essential and

command a – *prudent operation* (liquidity and solvency) outlook. Of course some of the financial sectors assist one another with an invisible hand. The banks' out standings, secured by insurance coverage, need to be calculated in compliance with the *solvency index* of financial institutions and justifies a different and more suitable approach.

- iii. The solution of *valuation* should be a central element of the risk management in the products and/or legislation, which arises from the changes in the value of currency, collaterals, exported goods and services etc. It is also important to note, that the applied indexation is not limited solely to the inflation rate, and does not mechanically follow the consumer price index or some other economic indicators.
- iv. The *corporate unit-linked insurance* can offer a spirited and enlightened solution especially to the SME sector in particular, because it can provide simultaneous, all risk security and/or investment opportunities. A *credit-coverage clause* converts this, so if the insured bears debt from credit or loan against a financial institution or an individual, or needs other types of financing, the insurance can be used as collateral (e.g. suretyship). Another financing opportunity is the *redeeming*, which takes place when the client gets into a situation where he is in a significant lack of resources or has financial problems.
- v. The demand for corporate insurance is positively affected by the repeated and widespread application of the *occurrence technique*, which means in essence, that the bonds after a certain number of years cover the insurance event(s) (damages)

occurred during the insurance period; for example, in the cases of financial losses or during the limitation period within the recourse (legal expenses insurance) where the insured event occurred during the insured period, but its adverse effect is only discovered later after the insurance coverage has expired. It is conceivable that at a large-scale, a long-term investment or financing, regarding a post insurance situations or events, that during a possible subsequent revision a former injury may constitutes an insured event.

- vi. The corporate *decision-making mechanisms* should be made aware of the fact that financing insurances reduce the required capital coverage regarding investments, meaning that with the same financial capacity, projects of a much larger-scale in effect, are possible. A further advantage is that the premium may include other services, such as, external professional monitoring.
- vii. In the case of high cost research, development and innovation projects (R+D +I) financing insurances can prove to be effective tools for the preservation of the *venture capital*.
- viii. In order to the more proportional and responsible operation of the financial sector in our country and generally speaking, in the European Union, it would be worthwhile introducing a *financial ombudsman* institution at large.
- ix. The general introduction (let it be by legislation) and development of all products, the *Total Cost Indicator* (TKM) could improve the demand for insurance in a corporate financing

strategy, with as a result a better comparability and measurability on the marketplace.

- x. Under the provisions of the new Fundamental Law the *credit- and loan-borrowing system of local governments* will enhance more stringent and controlled devices. As a result, the volume of transactions is bound to *decrease* and therefore, the *financing insurances will decline* in this given area.

4. Conclusions and recommendations

The conclusions and observations contain general statements, and formulate concrete proposals for the insurance sector, enterprises and even the legislation, extending to even law-enforcement.

General statements

- i. The *common elements in financing and insurance* are: that both banking and insurance sectors also generate profits with risk management by providing pre- and/or post-financing services, typically capital allocation and financial liability. The banking and insurance sectors show a very closely knit relationship, whereby, the boundaries are increasingly interwoven with disappearing diversities.
- ii. The research on the subject matter shows several – regrettably – widespread *terminological confusions*, diversions, disruptions in the literature:
 - the term, *financing insurance* (such the credit-, leasing-, factoring-insurance) is misleading, because in fact the in-

- surance event is not the non-financing, but the non-repayment, typically in the case of damages from (breach of) contracts, delayed or faulty performance.
- the *enterprise* (corporation) is a regulated organizational unit, in contrast the *entrepreneurship* which provides a way of thinking and processing to create and develop economic activity by blending risk-taking, creativity and/or innovation;
 - the *credit* means money-creation (credit line maintenance), the *loan* signifies money-redistribution (lending money), but since the practice often mixes them up together, this is why *credit insurance* applies to both expressions;
 - the *credit-insurance* not only relates to commercial lending, and the export credit-insurance a specific subtype of it;
 - the *leasing-insurance* provides liability on the non-payment of the leasing fee, the insurance on the leased instrument is an all risk, namely CASCO injury insurance;
 - the *insurer's surety and guarantee* provides financial coverage; the *surety- and guarantee insurances* are misleading, because they insure the surety's and guarantor's person their non-payment is the insured event; the *insurance*

suretyship / guarantee are collaterals linked to an insurance product.

- iii. The previous point implies that both *economics and law education* should play a more important role to the *risk management* sectors with theoretical and practical training. One of the central elements to be concerned with is the globalized economic system. The combined knowledge and practice of the methods and the regulations can result in an effective, conscious risk management in the financial and corporate sector. Notably, Ödön Kuncz's thoughts regarding the civil sector are still appropriate and remain timeless: “ ... *the economists cannot praise enough attention to the legal aspects, and the lawyers did not want to take note the economic structure of insurance. And finally both ignore the internal organization of insurance, technical, business management conditions.* ”

Insurers

- i. Due to the structure of the domestic corporate sector – that is, the high proportion of weak SMEs (99.8 %) – this segment should be involved to the insurance market by introducing less expensive and complex products.
- ii. To increase the corporate client base an effective solution would be to exploit the latent and/or domestic market gaps with the introduction of new products such as corporate unit-linked, all risk, insurance risk, and venture capital insurances.
- iii. Amongst the general contractual conditions it would be worth establishing the need for actively involving (*financial*) experts,

in order to avoid (legal) disputes, established procedures and to avoid future misunderstandings.

- iv. In the insurance products should be *regulated in details and comprehensively* those cases when the insurance contract should be repealed, terminated or cancelled, extinguished the enforceability of claims.
- v. In order to establish a more widespread application of the Total Cost Indicator (TKM), a stronger and more effective MA-BISZ action is needed to encourage membership, since only 18 insurers are members of the TKM Charter up to this date.

Enterprises

- i. In enterprises, especially in the CEO's (chief executive officers) need to *increase and stimulate the demand and value of being insured*. so that at the failure of the insurance the premium should not considered an unnecessary expenditure. Therefore risk management describing and promoting presentations (business academies), information forums, and trainings should be organized, particularly for the SME sector. This can be supplemented by the related informative direct marketing activity.
- ii. It would be wise for corporate and financial insurance companies to encourage programs, to introduce favourable promotional introductory priced products developed for the SME sector. These activities may be accomplished by applying for and receiving state grants, tax credits, or through a state-owned, profit-orientated foundation, specialized in insurance, like in the case of MEHIB.

Legislation, law-enforcement

- i. The Financial Supervisory Authority and the National Consumer Protection Authority shall examine more complexly the client rating procedures and unfairness and/or discriminatory of the general contractual conditions and applied contract terms, particularly with regard to the exclusions and exemptions. The excessive amount of the franchise causes striking imbalance of values, resulting in omissions, void, and invalidity.
- ii. Small and medium-size enterprises should be a part of the *definition of a consumer*, or at least should benefit of a more favourable and secure position.
- iii. The codification of the new Civil Code should also imply institutionalizing the *financial guarantee*, i. e. the legislation should not only be directed towards banks, but it should also regulate other institutions relating to finances, such as insurers, who could participate proactively in the coverage of security markets by suretyship and guarantees in the form of insurance.
- iv. In the process of updating private law, the legislature should standardize a *general duration (prescription) period* covering the claims arising from insurance contracts (policies). It is difficult in the practice that many solutions (1, 2, 3, 5 years) are located in similar products in accordance (!) with the provisions of the Civil Code.
- v. The insurance industry's most comprehensive public rule is the Insurance Act (Bit.), allowing the possibility of *unit-linked* elements to be created *in the non-life insurance sector*, and consequently, the Civil Code should be amended accordingly.

- vi. The use of unit-linked insurance policies as *financing collaterals* is a common practice. Indeed, it would be worthwhile to amend the legislation in this direction. At present, only financial institutions are allowed to provide crediting, lending, leasing, financing operation services. The insurers are forced to establish financial institutions themselves or use external financial institution(s) in order to accomplish the above mentioned activities. However, it should be noted, that its own securities (insurance policies) used as collateral are not always favourable. This is furthermore prohibited in the EU-compliance law Hpt; but since these are investments paid by the parties, this situation represents a real financial weight. (The banks also lend their depositors money, but take into consideration their clients banking credit rating.)
- vii. The introduction of the uniform *Total Cost Indicator* (TKM) increases market place comparability and competition between the players and their products, particularly those product which are unit-linked.
- viii. It is worth taking into account – during the development of the *prudent regulation* of financial services providers – that the insurance of maturity and repayment risk means in an indirect way the insurance of liquidity and solvency (regulated in Hpt.). This must be enforced on Hungarian and European level during the Basel III. process, in the calculation method of the capital adequacy ratio (currently 8%).

5. Publications in the topic of the dissertation

5.1. Foreign Language

1. *The Hungarian Debtor List and Its Problems.* in *Studia Iuridica Caroliensia* 2., KRE-ÁJK 2007.
2. *The Place and Theory of Banking Law – or Arising of a New Branch of Law: Law of Financial Industries –* in *Collega* XI. évfolyam 2007/2. szám
3. *Some Aspects on the Education of the Law of Financial Industries.* in Stoltpin-Volga University Press 2008.
4. *Man's registered debts – Az ember nyilvántartott adóssága.* in *Pénzügyi Szemle* 2008/2. szám
5. *Internship in Hungary.* in JEUNE-FIVOSZ konferencia utókiadvány 2010.
6. *Insurance in Hungary.* in *Studia Iuridica Caroliensia* 6., KRE-ÁJK 2011. (megjelenés alatt)
7. *Financial and legal opportunities on the new Silk Road* in *Jogelméleti Szemle* 2011/1. szám;

5.2. Hungarian Language

5.2.1. Books, book chapters

1. Pulay Gyula –szerk.: A megváltozott munkaképességű személyek támogatási rendszere társadalmi-gazdasági hatékonyságának vizsgálata. Állami Számvevőszék Kutató Intézete 2009. 6. fejezet – *A magánbiztosítás lehetséges szerepe a megváltozott munkaképességű személyek rehabilitációjának elősegítésében.*
2. Pulay Gyula –szerk.: A jogi hatékonyság (megjelenés alatt)
3. Közigazgatási jog. KGRE-ÁJK 2009 Egyetemi jegyzet – Központi közigazgatás

4. *e-közszolgáltatások I. – civil szféra*. Nemzetközi Technológiai Nonprofit Közhasznú Kft. 2010.
5. *e-közszolgáltatások II. – gazdasági és közsféra*. Nemzetközi Technológiai Nonprofit Közhasznú Kft. 2010.

5.2.2. Studies, papers

1. *Az általános forgalmi adó európai és magyar fejlődése*. in Jog, történeti szemle 2006/3. szám
2. *Szakigazgatás I. kivonatos jogszabály gyűjtemény 2006*. a diákok számára internetes jegyzet; 200 o.
3. *A jólét Európában - a CEFASS 2003-as jelentése – recenzió*. in Jogelméleti Szemle 2007/3. szám;
4. *A magyar bankrendszer a 20. században*. in 20. századi magyar gazdaság és társadalom – a Széchenyi István Egyetem Konferencia utókiadványa 2007.
5. *Egyes banki felelősségi kérdések*. in Gazdaság és Társadalom 2007/1. szám
6. *Magyar banktörténet a reformkortól az államosításig*. in Jog, történeti szemle 2007/4. szám
7. *Hozzáadottérték-adó az Európai Unióban*. in Európai Tükör 2008./4. szám;
8. *A hitel-kölcsönszerződés terheinek rendszere*. in Jogelméleti Szemle 2008/2. szám;
9. *Jogi tendenciák a nemzetközi hitelezési gyakorlatban*. in Corvinus Pénzügyi Konferencia utókiadványa 2008.
10. *A pénzügyi finanszírozás helye a jogrendszerben*. in Jogelméleti Szemle 2008/3. szám;
11. *Zinner Tibor: A magyarországi németek kitelepítése – recenzió*. in De iurisprudentia et iure publico 2009/1. szám
12. *A finanszírozási szerződések kötelmi jellege*. in Jogelméleti Szemle 2009/2. szám;

13. *A kataklizmák csapdái – recenzió.* in Jogelméleti Szemle 2009/2. szám
14. *A hitel-kölcsön, a lízing és a factoring ügyletek nemzetközi szabályai.* in Jogtudományi Közlöny 2009/4. szám
15. *Az állami beavatkozás jogi és hatékonysági vetülete.* in Jogelméleti Szemle 2010/3. szám
16. *Gondolatok a jó kormányzásról.* in (megjelenés alatt Jogtudományi Közlöny)
17. *A rehabilitáció és a biztosítási termékek kapcsolata.* in Biztosítási Szemle 2010.
18. *A települési önkormányzati döntéshozatal – különös tekintettel a minősített többség és az akadályoztatás kérdésére –* in Lőrincz Lajos emlékkötet, KGRE 2010.
19. *Gondolatok a fenntartható fejlődésről –* in Tanka Endre emlékkötet, KGRE 2010.
20. *A biztosítás és jogi környezete az elmúlt években* in Jogelméleti Szemle 2010/4. szám