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Financial Health of a Commercial Insurance Company and its Coherences

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Abstract

Purpose of the article: The main purpose of the article is to define the term "financial health of a commercial insurance company" and identify the factors that influence management and its economic results of a commercial insurance company. The above mentioned term will be faced with other similar terms such as financial stability, financial strength, solvency, liquidity or profitability (always with emphasis on the insurance sector). Related to this purpose, this hypothesis is formulated: "Financial health of a commercial insurance company can be identified in the long perspective with the term financial stability and as its synonym the concept of solvency can be stated."
Methodology/methods: The methods of description, analysis, deduction and induction will be used in the article. The research part is based on a qualitative basis. It combines three methods of qualitative research: interviews with experts, a structured interview with open questions, a questionnaire with open questions. Its subject is a managed conversation with leading experts in the field of insurance and related branches, who answered questions related to the topic. Evaluation of interviews was done by method of interview analysis, respectively thematic analysis and subsequent synthesis based on respondents' answers. The synthesis is used as a method to gain new knowledge. The conclusions are the basis for discussion for the theory completion in the case of the term mentioned above and for statements to other contexts that are defined in the objectives of the article. Synthetic approach is applied in the formulation of conclusions of the research. Significant findings for the theory are obtained by abstraction, as derived from observations of the issues, *i.e.* financial health of a commercial insurance company. The evaluation also includes a summary of significant matters and it reflects the opinion of the author devised throughout literature and based on interviews.
Scientific aim: Article aims to define on the theoretical level the term financial health of a commercial insurance company and identify the factors that influence management and its economic results of a commercial insurance company. Definition of „financial health of a commercial insurance company" is the main research aim of the article.
Findings: Among the findings the formulation of the term of financial health of a commercial insurance company can be included, as specified in the article text. In terms of factors influencing the management of commercial insurance these ones can be stated: (a) good governance realized by a competent management and optimal internal settings of an insurance company, (b) capital strength, (c) the ability to identify and evaluate risk in accordance with a healthy competitive environment, (d) underwriting of risks, (e) an application of a correct trade policy, (f) correct determination of technical provisions, (g) adequate reinsurance program and the selection of a stable and (financial) healthy reinsurers, (h) the ability to properly manage the entrusted money and assess developments in the financial markets.
Conclusions: This article aimed to clear a terminological ambiguity in a sphere of financial health of a commercial insurance company and similar terms such as financial stability, financial strength, solvency, liquidity or profitability. The above formulated hypothesis had a negative result, which supports the argument that the term financial health of a commercial insurance company can be defined as a completely autonomous term with its pragmatic object matter.

Keywords: insurance industry, commercial insurance company, solvency, financial stability, financial health of a commercial insurance company

JEL Classification: G22, M21

Introduction

Activities of a commercial insurance company and their results undoubtedly have an essential impact on its financial health. Although frequently used, the term financial health is not more closely defined in the insurance economic theory. There is no fixed definition in the company economics either. The insurance industry more often uses terms such as stability or solvency; however, these terms do not coincide with the term financial health. The first of the terms is broader, the other one only covers the area of financial health partially. However, this premise corresponds to the intuitive understanding of the term financial health, as there is no complex definition.

The main aims of this article are to identify and define the factors that influence management and its economic results of a commercial insurance company. Based on these, the definition of the term "financial health of a commercial insurance company" will be formulated and this term will be confronted with similar terms (financial stability, financial strength, solvency, liquidity or profitability), always with an emphasis on the insurance sector.

With respect to this purpose, the following hypothesis is formulated: "Financial health of a commercial insurance company can be identified in the long--term perspective with the term financial stability and the term solvency can be used as its synonym".

The necessary bases that will also be presented are the context of a commercial insurance company economy and its economic management, including information about the underwriting risk, which is closely related to the management and its economic results.

The article uses the methods of description, analysis, induction, and deduction. The research part has a qualitative basis. It combines three methods of qualitative research, namely an interview with experts (Hendl, 2008), a structured interview with open questions (Hendl, 2008), and a questionnaire with open questions (Hendl, 2008). Its subject is managed interviews with leading experts in the field of insurance and related branches, who answered questions related to the topic. The interviews are evaluated by the method of interview analysis (Strauss, Corbinová, 1999) and a thematic analysis (Hendl, 2008), as well as a subsequent synthesis based on respondents' answers. The synthesis is used as a method to gain new knowledge. The research involves seven respondents (experts).

The selected experts were representatives of a commercial insurance company, an insurance association, an insurance regulatory authority, an insurance industry supervision, an auditing organization, a rating agency, and a consulting organization. Thus a wide range of institutions that get in contact with a commercial insurance company has been covered. The area of insurance mathematics, which the author considers essential, was covered by including one of the respondents that has the relevant education and uses the principles of insurance mathematics in the practice. The respondents' identity has been concealed at their request; however, it is revealed in the author's dissertation thesis, which includes the presented research (see Nečas, 2012).

1. The context of a commercial insurance company economy and its economic management

A commercial insurance company is an entity that provides insurance protection for a fee. If an insurance relationship occurs, there is a potential obligation to pay out the insurance settlement in the case of an insured event. Each insurance company has to be ready for such a situation; therefore it needs to create technical provisions, as stipulated in the relevant law. The entire system of commercial insurance is based on them. Technical provisions are the insurance company's liabilities and they express a potential obligation towards the insured, or the aggrieved. A commercial insurance company is obligated to create technical provisions to the extent that corresponds to the company's liabilities and so that the provisions enable the company to realize a potential insurance settlement.

Technical provisions are created for both life- and non-life insurance and their Czech Republic list is available in the Act on Insurance Industry (Czech Republic, 2009). Auditing organizations carefully monitor the structure and creation of technical provisions, *i.e.* they monitor their amounts and, among others, try to eliminate a possible impact on the management and its economic results of an insurance company. Such a situation is really possible as the accounting includes the creation of technical provisions in the insurance company's costs, which decreases the economic result.

Here, we have to mention two basic differences between a commercial insurance company and a company outside the insurance industry: (a) the aforementioned technical provisions form a substantial part of a commercial insurance company's liabilities, therefore, a commercial insurance company may seem to be overindebted (when the principles

applicable to production companies are used). However, such a view would be much simplified and incorrect, not only for the reasons stated in the previous text; and (b) there is an "inverted production cycle" working in the insurance industry. An insurance company must first set the insurance rates, which are the basis of the premiums as its most significant revenue, while the insurance company does not know the extent of the costs (insurance settlement). With an incorrect estimate, the costs may exceed the revenues and the insurance company sustains a loss (within a specific product).

Although risks are not the primary subject of this article, at least one of the most significant has to be identified so that the description of the context of a commercial insurance company economy and its economic management is full. This is the underwriting risk.

In order to characterize and classify the underwriting risk, we present one existing risk classification. It is the classification based on the balance (balance sheet): (a) risks within assets (especially investment risks); (b) risks within liabilities (especially underwriting risks); (c) risks within the relationship between assets and liabilities (asset-liability risks) (Daňhel *et al.*, 2005, p. 80).

In order to deal with the underwriting risk, a commercial insurance company performs risk management, *i.e.*: (a) it identifies it (investigates which changes can affect the risk rate of particular insurance products), (b) it quantifies it (explores how the risk rate changes affect the amount of insurance settlements in particular insurance products, decides on possible insuring of particular risks), (c) looks for a way to deal with this risk – considers minimizing the impact of the underwriting risk on the insurance company's economy (Ducháčková, 2005, p. 81).

The existence of the underwriting risk is related to the fact that the extent of insurance settlement cannot be determined beforehand; it can only be estimated. The actual underwriting risk consists in the potential danger that the premiums and the insurance settlement will not be balanced (Vávrová, Doložílková, Stuchlík, 2001, p. 9).

This idea is further discussed in Ducháčková (2005, p. 80–81), who says that the risk can come true in three ways. First, by coincidence, the claims record can deviate from the mean value; second, the conditions under which the premiums were determined can change. Last, the claims record can be wrongly estimated, or the premiums of insurance products can be wrongly determined by the insurance company. Additionally, there is the risk of bad timing, which occurs when the insurance settlement has to be paid earlier than expected.

Insurance companies can deal with the underwriting risk in several ways: (a) by using more advanced actuarial mathematics models as well as some underwriting instruments for the calculation of the premiums (*e.g.* using some forms of insurance – first-loss insurance, franchise etc.), (b) by distributing the risks, *i.e.* the insurance company tries to cover the risk in the widest possible area, (c) by diversifying the risks – the effort not to specialize in one type of a risk but cover the widest possible structure of risks, (d) by creating fluctuation reserves – the commercial insurance company creates reserves for the cases when the claims fluctuate, (e) by transferring the risk to another institution – the commercial insurance company tries to reduce the values of risks taken over to the values it is able to sustain (Ducháčková, 2005, p. 82).

OECD (2003, p. 12–13) adds an extensive commentary on the underwriting risk, out of which the essential ideas will be presented in the following text. The underwriting risk is based on the fact that the premiums are determined beforehand, *i.e.* before the actual costs of the insurance services are known. In spite of rational estimates of the claims and overhead costs, these can be exceeded. "And because a very long time may elapse between payment of the premium by the policyholder and performance of the service promised by the insurer, the latter may in fact be insolvent without experiencing any cash flow problem, new premiums being used to pay out earlier claims. To avoid this, premiums have to be sufficient to cover the insurer's expenditures – claims and management-related costs – allowing for the contribution of financial income" (OECD, 2003, p. 12). "In assessing a product's profitability it is also necessary to factor in the cost of reinsurance and the establishment of an equalisation provision to smooth out the company's results over time. The weight of these additional costs is in inverse ratio to the size of the contract portfolio (pursuant to the law of large numbers)" (OECD, 2003, p. 13).

2. Economic management of a commercial insurance company

The economy of commercial insurance companies is based on the principle of gaining positive economic result, which is the difference between revenues and costs. It follows that the basic principles of economic relationships are valid for all insurance entities, not only for commercial insurance. The deviations are caused by the differing systems of economic management of commercial and non-commercial

insurance companies. Using computer technology, insurance company's management explores the phenomena that occur during its economic activities, monitors the level of individual indicators comprehensively expressing the company's performance, and also determines the economic management instruments inside the company. Therefore, we can identify a number of activities, practices and instruments that affect and also create the insurance company economy. According to Chovan (2006, p. 185), they include: the insurance and economic activity, management of assets, accounting, planning, co-insurance and reinsurance, creation of technical provisions, financial analyses, internal audit, solvency of an insurance company.

Financial management can be defined as the system of monitoring the creation of financial resources, their development and movement and the development of financial flows within a commercial insurance company. Financial management is a part of the economic management of an insurance company. Economy of an insurance company, or its economic management, is similar to that of other entrepreneurial entities in many ways so generally valid microeconomic ideas are applicable in most cases. However, there are deviations from the general rules, or special features, which do not appear elsewhere and which are related to the specific business of an insurance company. Economic management of an insurance company is delimited by a specific area that can be seen as a triangle. Its peaks are the insurance company's shareholders, its clients, and the supervisory authority. Naturally, this delimitation is a simplification to an extent, as it abstracts from other features of economic environment, *e.g.* the tax system, public and private law, etc (Kolektiv autorů ČAP, 1996, p. 86–87).

Management of an insurance company is based on direct management (various internal standards and orders, internal habits), indirect management (organizational structure reflected in the organizational system), and the formation of a system that corrects the behaviour of its particular parts by economic instruments. The main aims of such economic management are pertaining and further increasing the assets. In order to achieve the aims, the economic management uses a number of instruments. Some of them are based on the need to respond adequately to external influences (competitive environment, legislative conditions, etc.), others on the needs following from the internal structure of the company. There is a very close relation between the insurance company's system and economic management instruments. All economic management instruments form a complex system, which involves the necessary information mechanisms, feedbacks, and outlining of the economic environment inside the company. This environment mainly depends on the level of the company decentralization and we can state that the higher level of centralization, the greater significance of directive normative methods; and the higher decentralization level, the greater significance of economic management instruments and the structure of economic links between specific organizational units (Kolektiv autorů ČAP, 1996, p. 87).

According to the Czech Insurance Association, the basic tools of economic management are: (a) planning and balancing – includes both analysis, which serves for the description of the grounds and establishment of goals, and strategic planning process, including the process of assessing to what extent these plans are met, (b) principles of financing – the principles of the financial policy of the company as a whole in relation to the external environment, and the constitution of the internal policy including internal financial relations with the main aim being the management of cash flows and solvency, (c) economy of work – from the perspective of economic management it mainly concerns the remuneration, and (d) financial and managerial (cost) accounting – among others, includes establishing the ways for measuring, calculations, budgeting, methods for the creation of technical provisions, accounting schedule, etc (Kolektiv autorů ČAP, 1996, p. 88).

Financial management is closely related to strategic planning and balancing. The basic task when creating a strategy is to describe the initial situation and establish the goal, which is usually formulated using aggregate indicators describing *e.g.* the expected position of the insurance company at the market and the level of profitability. To attain the goals established it is necessary to analyse the insurance market as a whole including the impact of legislative changes, outline measures to eliminate the underwriting risk, analyse the current economic situation of the insurance company, analyse the positions and methods of competitors, analyse the existing products of the insurance company and its competitors, develop the company's own products including tools for their promotion and distribution, and outline methods and tools to achieve the goals established (Kolektiv autorů ČAP, 1996, p. 88).

Economic balancing is an important part of planning. Its main aim is to estimate the feasibility of the established goals as regards balancing of resources and needs and the effect of the balancing results on the goals.

The main tasks of balancing are: establish the need for financial resources and estimate if the need can be fulfilled from revenues, establish how many employees are needed, calculate the necessary investments, estimate further financial needs to attain the established goals, estimate the expected economic results (Kolektiv autorů ČAP, 1996, p. 89).

Economic analyses are an inseparable part of the economic management. They are closely related to the planning process. They facilitate the preparation of initial postulates plans will be based on and prepare data for the correction of long-term plans in short-term plans and operative plans, by comparing the really achieved results to the planned ones. Economic analyses of insurance companies employ statistical methods, including regression and correlation analysis. The analyses use tools of actuarial mathematics, statistical methods or methods of product analyses (*e.g.* value analysis).

Economic analyses involve: (a) analyses of external environment – these are mainly explorations of the development and relations of various indicators describing the risk, its frequency, and geographic, demographic and economic distribution, analyses of tax and credit conditions, or analyses of competitors; (b) internal analyses – focus on the financial analysis, which has similar parts as in other businesses, including a similar structure of indicators, the quantities investigated are similar to those explored in analyses of external situation; (c) marketing analysis of the company's own products (Kolektiv autorů ČAP, 1996, p. 90).

Another part of the financial management is controlling. Its main aims are to ensure goals are attained and carefully planned, to determine partial goals and practices as well as methods to achieve them. A basic idea of controlling is gaining knowledge for the future or advance thinking. This concerns consistent monitoring of the development and searching for new measures that would lead to the removal of the existing deviations. It is not to find what was wrong and who is to blame but to find what has to be done to remove the deviation. Controlling orients to the future of the company, solution of critical spots in the company's activity, regular assessment of activities and goal meeting, decision making and implementation of the decisions in the practice, application of efficient methods, permanent development, perfection of procedures, methods and rules, as well as consistency and exactingness. Controlling has to be understood as a modern way to manage a company. It provides essential information for decision making and thus represents an instrument to increase competitiveness. In essence, it helps analyse and assess the insurance company's situation and helps find critical factors that prevent implementation of strategic plans (Chovan, 2006, p. 186).

Controlling mainly involves the following activities: goal establishment, prognoses, planning, comparing plans with the reality, deviation analyses, measures to remove the deviations, establishing new goals (Hofmeister, Stiedler, 1992).

3. Economy of a commercial insurance company and its financial stability

As has been stated, a commercial insurance company strives for harmony between revenues and expenses. The harmony can be achieved using economic management instruments that respect the basic rules of formation and usage of the insurance company's resources. From a general perspective, it is obvious that the economic management of an insurance company aims to reach a positive economic result the insurance company can achieve in the long term, and to keep the insurance company in a condition allowing it to be pronounced "financially healthy".

The term financial health is often used in literature for a satisfactory financial situation of a company. A company that is at the moment and prospectively able to fulfil the sense of its existence is considered financially healthy. In the conditions of market economy, this means that such a company is able to permanently appreciate capital to an extent that meets the investors' requirements in respect of the risk the given type of business is connected with. In addition to profitability, liquidity, *i.e.* the ability to settle liabilities in time, another important feature is financial health (Valach *et al.*, 1997, p. 75).

Kalouda (2011, p. 164) defines financial health of a company in a similar way and considers it one of synthetic criteria of special significance, specifically "a logical intersection of profitability and liquidity attained by the company".

However, there is no exact application of the term financial health to the insurance sector. It is used, but without a definition. It is also often used as a synonym with financial strength or financial stability. This statement has been confirmed in *e.g.* Chen and Wong (2004), who admitted the interchangeability of terms solvency, financial stability, financial strength, and financial health, considering them measures of financial strength of insurance companies that do not mean failure or potential failure. As regards Czech authors, the term financial stability was defined in Pojistná teorie (Daňhel *et al.*, 2005, p. 74–76).

3.1 Financial stability

Insurance companies perform their activities with the aim to maximize the market value for their owners, *i.e.* shareholders. The relationships in an insurance company can be described using a simple diagram that reflects the mutual transfer of risk and revenue between shareholders, the company, and its clients.

Shareholders provide capital, carrying thus the risk. They expect compensations in the form of a corresponding revenue and their requirement is therefore maximization of the market value of their investment. Clients transfer risks to the insurance company and expect that the obligations stipulated in the insurance policy will be met in the future. In return, the insurance company demands corresponding premiums and decides which risks to take (Daňhel *et al.*, 2005, p. 74).

At the first sight, it might seem that shareholders' and clients' interests are contradictory. However, closer analysis confirms this is not the case. Shareholders demand returns on investments as high as possible and clean from risks. Clients want maximum possible guarantee that the insurance company will be able to meet all its obligations following from insurance policies in the future. The extent of the insurance company's ability to meet its obligations can be generally termed capital endowment. On the other hand, the higher rate of capital endowment, the more difficult it is for a shareholder to gain the required revenue. Finally, we can merge the requirements of both groups using the financial stability as a connecting element. It is based on the following implication chain emphasizing that financial stability is the key prerequisite for the insurance company's long-term ability to meet shareholders' and clients' requirements:

financial stability => good rating => safety for clients => market share growth => profit growth => revenues for shareholders => financial stability => good rating => safety for clients (Daňhel *et al.*, 2005, p. 74).

If we want *e.g.* to evaluate the stability of the company using the parameter defined by the volume of paid-in equity/capital in relation to the total equity/capital, we will not find a standard value of this parameter to use it for comparison in a healthy company (Sedláček, 2001, p. 1). It is therefore questionable whether we can identify financial stability with financial health.

3.2 Ability to meet obligations

By concluding an insurance policy, each insurance company accepts the obligations that follow from it and are valid during the policy duration. This is based on the nature of and legal regulations on the insurance industry and it means an insurance company has to be able to meet the obligations.

As regards meeting the obligations from insurance policies, an insurance company faces the following problems: (a) instant liquidity, which satisfies the needs to meet instant obligations of the insurance company caused by events occurring during the common accounting year with a known extent, (b) creation of technical provisions sufficient to meet the obligations that have come into force during the accounting period but will only be dealt with in the following accounting periods for several reasons, (c) creation of other resources to meet the insurance obligations, which the insurance company needs to span a potential deficiency of technical provisions to be used in future extraordinary events.

According to Czech Art. 3, Act No. 277/2009 Coll., on insurance industry, solvency means "the insurance or reinsurance company's ability to guarantee a permanent fulfilment of obligations following from insurance or reinsurance activity from their own resources". Further, the Act defines fulfilment of obligations as "an insurance or reinsurance company's provable ability to meet the obligations created in relation to the insurance or reinsurance activity including obligations due in the following accounting periods" (Czech Republic, 2009).

"Due to the randomness of insured events, an insurance company needs to have sufficient funds so that it can meet its obligations following from all its insurance policies concluded at any moment." (Majtánová *et al.*, 2006, p. 206).

The insolvency risk is related to a longer inability to meet the obligations of an insurance company. It occurs if the insurance company's assets are insufficient as regards the coverage for insured events (Ducháčková, 2005, p. 83).

Simpson and Damoah (2009, p. 31) accentuated an important idea that an insolvent insurer brings the insured persons in great difficulty if an insured event really occurs. Therefore, it is important that the financial situations of insurance companies are regularly assessed and monitored by the supervisory authority as well as the actual insurance company's management.

One of prerequisites of solvency is liquidity. This term has more meanings (*e.g.* a bank's ability to cover deposit withdrawals). Generally, liquidity is the ability of a company to pay its financial obligations or liabilities in time. Another possible explanation

for this term is the ability of a property element to change into cash fast and without large losses in value (Růčková, 2007, p. 48).

In Europe, sufficiency of free equity/capital (company's own resources) usable to cover unexpected fluctuations in insurance was assessed (for a long time) using the solvency test. The test finds out whether the insurance company has a sufficient volume of capital for an objective future need to meet its obligations. The experience from the insurance practice shows that neither a negative solvency test must necessarily mean an immediate insolvency. The test may show that the insurance company does not have sufficient capital to meet unexpected obligations from the existing insurance policies but it has created adequate technical provisions to deal with common obligations. The new rules that have been long prepared and are functioning since 2016 will change and expand the aforementioned parameters (project Solvency II, which is, however, not a subject of this article).

4. Questions asked within the research

Within the research whose principle, aims and methods have been described in the abstract and introduction, the respondents were asked the following questions related to the aforementioned issues:

Question 1: Try to formulate the factors that affect the management and its economic results of a commercial insurance company and determine whether the insurance company is "financially healthy" or not.

Question 2: Do you consider financial health, profitability, liquidity, solvency, financial stability and financial strength (in all cases concerning insurance companies) to be synonyms? If the answer is yes, it is not necessary to answer the following questions.

Question 3: Do you identify financial health of an insurance company with its profitability?

Question 4: Do you identify financial health of an insurance company with its liquidity?

Question 5: Do you identify financial health of an insurance company with its solvency?

Question 6: Do you identify financial health of an insurance company with its financial stability?

Question 7: Do you identify financial health of an insurance company with its financial strength?

5. Summary of the research part and conclusions

The synthesis of the respondents' opinions allowed us to identify the following factors affecting the management and its economic results of a commercial insurance company: (a) good and competent management and the optimum internal structure setting; (b) capital strength which determines how vulnerable the insurance company is and should be a lead for the determination of the business strategy; (c) the ability to identify and measure the risk in harmony with a healthy competitive environment – the ability to determine adequate premiums in dependence on the insurance portfolio (portfolio should be homogeneous) and opportunities provided by the competitive environment. Adequate premiums will enable the insurance company to meet its obligations in the future; (d) underwriting of risks – implementation of appropriate underwriting mechanisms in order to select risks (and thus clients) respecting the insurance company's capital options; (e) application of an adequate business policy which enables the insurance company to sell well-measured risk with a sufficient margin; (f) an appropriate determination of technical provisions – sufficient technical provisions are important for the insurance company to be able to meet its obligations; underestimated technical provisions mean that the insurance company is not prepared for all its potential obligations; (g) sufficient reinsurance program and selection of a stable and financially healthy reinsurer; (h) the ability to manage the credited money well and predict the development of financial markets – this factor is mainly significant for life insurance companies; the effort at financial position with the minimum risk and maximum revenue.

The above mentioned list corresponds to still another concept of the factors that appeared in the interviews – their identification with the parameters of financial analysis indicators. This understanding of the factors further specifies the above mentioned list as the individual indicators use, among others, premium written and earned (expressing the business aspect of insurance), both in gross and net forms (*i.e.* without and with respect to the reinsurance effect), technical provisions (again in gross and net forms), equity or liquid assets, etc. All these components of the indicators are closely related to the factors listed.

Similar can be said about the last possible mentioned concept of the factors that one of the respondents defined in relation to a rating agency methodology. Without doubt, this concept has its substantiation. However, the author of this article aims at an independent list of factors so this attitude will not be commented upon any further.

The main aim of this article is the definition of the term financial health of a commercial insurance company. The understanding of this term has been extensively subjective so far, due to the non-existence of any relevant definition in the literature. One of the respondents considers financial health to be an opinion, not an autonomous indicator. Before the actual definition, we have to clarify the links to the terms compared.

The second block of the questions (questions 2–7) endeavoured to examine the terminological context and understanding of financial health of a commercial insurance company by comparing it to the terms selected by the author (based on the criterion of the supposed greatest affinity to the term financial health). The terms for comparison came from two groups. The first group contains the terms that have their official definition (liquidity, solvency, profitability); the other group contains terms financial strength and financial stability, whose definitions are similarly abstract as in the case of the term financial health. These terms are often used interchangeably with the term financial health.

As regards the relation to the terms solvency, liquidity and profitability, virtually all the respondents consider them a subcategory or a prerequisite of the financial health, or a necessary but not sufficient condition for an insurance company to be considered financially healthy.

This is very true for profitability. Only one respondent does not consider profitability a basic criterion for the financial health of an insurance company, because in his opinion, profit can be affected by *e.g.* reducing technical provisions. Another respondent proposes to link profitability to the volume of capital and risks and talk about profit adequate to the held capital (*i.e.*, disrespect the absolute value of the profit). The author of this article agrees with this opinion.

A similar situation occurs as regards the term liquidity, which is understood as a component, a subcategory or a partial indicator of financial health, only indicating whether the insurance company has sufficient liquid capital and this condition is compared with an expected or empirically observed degree.

In the case of the term solvency, the situation is similar, except that this term is referred to as an element, basis, component or an important prerequisite of financial health. Therefore, this term is the closest to the term financial health; however, it cannot be considered a synonym, which rejects the hypothesis stated in the introduction to this article.

The situation is more complex with terms financial stability and financial strength and their potential identification with the term financial health. First, the term financial stability. In the respondents' opinions, this term is the closest to the term financial health; some of them consider them synonyms. This assertion is supported by one of the respondents who sees the term financial stability as the synthesis of solvency, liquidity, and perhaps even the profitability, which puts it very close to financial health. Another respondent identified the financial stability with solvency, which he considered to be the closest to the term financial health. Another respondent stated that financial stability indicates the ability to meet the legal requirements, *i.e.* solvency requirements and requirements to meet obligations, in the long term. This concept is very similar to the previous one. The proximity of the two terms, but not their equality, is confirmed by another respondent, who understands the financial stability as a state in which the indicators relevant for the evaluation of an insurance company's management and its economic results are stable. This respondent sees the financial stability as a subset in monitoring the financial health of an insurance company. In the author's opinion, the most accurate definition, which also corresponds with the hypothesis, is that financial stability is the ability to operate on the principles of financial health in the long term thanks to good management, or the ability of an insurance company to survive even fluctuations and respond to external as well as potential internal influences. However, this opinion in this form appeared only once, so the hypothesis mentioned in the introduction has not been confirmed.

The situation is different with the term financial strength. The opinion that financial health and financial strength are identical appeared in the minority, or more specifically, was complemented with a condition in one case (see below). A closer analysis of the respondents' views shows that the word "financial" in the term financial strength is clearly more important than in the term financial stability. Financial strength implies a situation when the insurance company has enough financial resources, or capital, and its business scope is able to generate stable and reliable revenues. However, this situation does not necessarily mean that it is financially healthy, since there can be hidden risks. The link to the capital was confirmed from another perspective by a respondent who accentuated the undertaking of risks as the primary activity of an insurance company. This respondent understood the financial strength as an insurance company's ability to accept a risk. Financial strength thus determines the insurance company's capacity, *i.e.* how big risks in terms of volume and danger it can afford to accept. The capital aspect is

also confirmed by the opinion that a large insurance company with a strong shareholder able to replenish capital in the case of problems is financially strong. From the author's perspective, the most interesting opinion is again the one that considers the two terms synonymous in principle, but the respondent who gave this opinion ponders whether two insurance companies with the same financial health can have different levels of financial strength, due to the fact that one of them has a greater volume of resources. Therefore, if two insurance companies show the same signs of financial health with a different degree of capitalization, it might imply that one of them does not use the capital quite optimally.

It is now appropriate to define the term financial health of a commercial insurance company on the basis of the above stated assumptions and contexts.

In the author's opinion, the financial health of a commercial insurance company is the state when an insurance company is able to meet all of its obligations permanently (the solvency aspect), generate a stable profit in relation to its capital (the profitability aspect), make insurance settlements within the statutory time limits without unnecessary delays (the liquidity aspect), and the analyses carried out in the insurance company do not prove any evident trends of deteriorating parameters or parameters evaluating the quality of investments, the adequacy of technical provisions, insurance premiums or setting up of internal processes. At the same time, an insurance company can be considered financially healthy only if it is able to absorb external effects and changes in market conditions, without disturbing any of its above mentioned abilities in the present or prospectively, and has prerequisites for an adequate sustainable growth and long-term operation.

Beyond the questions within the questionnaire, respondents were asked about the factors that are important to restore the financial health of an insurance company, *i.e.* what an insurance company has to do to remedy a negative development of its economy. The responses show that the essential factor is the ability to identify its own problems and risks, assess their remedy and their controllability, consider various solutions and select the one that is the most appropriate for the insurance company. To find the reasons and causes, the insurance company must have very good information, *i.e.*, have well working controlling and financial accounting. Also the actuarial report can provide a very good service as the actuary's perspective compasses a longer period. In addition, it is necessary to continuously evaluate the sales of new products and the behaviour of the insurance portfolio. If the problem is only detected after it impacts the company's economy, it can be difficult and even expensive to rectify the situation and save the insurance company. The worst possible situation occurs if a supervisory authority must step in. The consequences of such development are then carried by all stakeholders, *i.e.*, shareholders, management, etc. If the problem is identified earlier, *i.e.* in time, and the insurance company is managed responsibly, it will develop an effort to improve the process with the aim to prevent its material impact and find an adequate solution for the insurance company. The choice of instruments for the improvement of the situation will undoubtedly depend on the stage of the problems the insurance company is in. Also for this reason, it is not possible to provide a "universal guide" for the solution of these problems, but it is possible to list the individual factors in a compact way.

An insurance company should: (a) assess whether the situation is only a fluctuation that can be solved by a one-time loan; (b) increase insurance rates of new policies – this option is appropriate in the case of a loss ratio increase with an obvious impact on the ability to generate profit; (c) adjust the investment portfolio – this option is recommendable if the lossy activity is not the insurance itself, but investing of the funds that are temporarily free; (d) increase insurance rates of all policies — however, in this case, the insurance company must take account of the expected loss of a part of the insurance portfolio; (e) make efforts to reduce costs – only a one-time saving can be expected; (f) obtain additional capital necessary to rescue the insurance company – however, it should be noted that this is not proactive; (g) obtain additional capital necessary to implement changes to transform the insurance company and prevent further negative development (*e.g.* purchase of a new information system, a change of a supplier of some services, etc.). Paradoxically, the costs can grow as a result if the remedial measures are meaningful from the perspective of the insurance company's expenses and the return is carefully considered; (h) consider a potential abandoning of the industry, or the impacts of staying in the industry, including the quantification of the impact on its economy. Therefore, this option also includes a possible merger or sale of the insurance company on condition that the insurance company is unable to successfully and sufficiently implement the remedial measures.

Conclusion

The economic performance of a commercial insurance company is an outcome of its economic acti-

vities. It can be evaluated using many methods but their description is beyond the scope of this article. They include *e.g.* solvency calculations, financial analysis, Value at Risk, Risk Assessment or Early Warning System. While each of the above methods has its characterization, the same cannot be said about some of the terms related to management and economy of an insurance company that are used within the scope of these methods and their interpretation. In particular, this concerns the terms financial health, financial strength and financial stability (the latter has a definition available in some renowned literature sources). Other terms used in the context of the economic analysis, such as solvency, liquidity, profitability, have definitions; however, their relationship to financial health is not clear.

This is caused by the fact that the term financial health has not been defined in the theory of insurance economics. There is no fixed definition in the business economics either. The insurance industry more often uses terms such as stability or solvency; however, these terms do not coincide with the term financial health. The first of the terms is broader, the other one only covers the area of financial health partially. However, this premise corresponds to the intuitive understanding of the term financial health, as there is no complex definition in the insurance industry. Therefore, this article put the above stated terms into the context and tried to clarify them. The definition of the first of them, *i.e.*, financial health of a commercial insurance company was a challenge. First, it was necessary to define the factors that affect the management and its economic results of a commercial insurance company and thus have an impact on whether the insurance company can be considered "financially healthy" or not. The hypothesis that financial health of a commercial insurance company can be identified in the long perspective with the term financial stability and the term solvency can be used as its synonym has not been confirmed (see above).

In author's opinion, the conclusions that emerged from the research carried out, should contribute to the discussions on the issue in concern.

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