VIEWPOINT

REASSURING DEVELOPMENTS

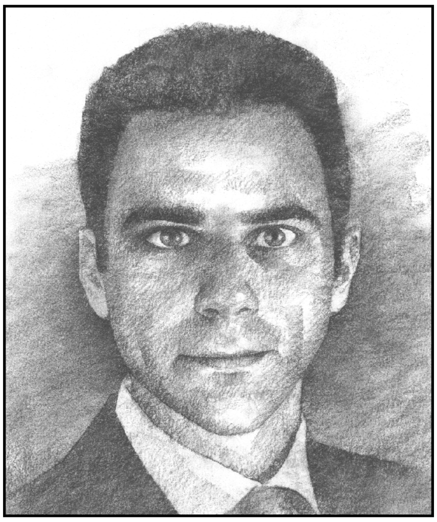
Phillip Rosenblatt, Managing Partner of Rosenblatt & Co., on the insurance sector's evolution.

Today, the participants in Turkey's insurance market, including both the insurers and their potential customers, will have the opportunity to influence changes that can serve to bring the insurance sector into its rightful place at the centre of Turkey's financial services sector. To do so, the groundswell for substantial reform in this sector needs to be focused on the changes that will support the long-term health of the sector.

This health depends on the adoption of the right, modern framework insurance law to replace the current patchwork of legislation. Long-awaited legislative reforms are now being considered, and may well be adopted during the next year. The discussions about changes have received interest from both the current industry players and the regulators, who may have particular views about how the legislation will affect the status quo. An equal amount of attention should be given to how to balance the need to address Turkey's current needs and the needs that Turkey will have as this market matures.

MOVING CLOSER TO THE EU: One of the under-appreciated trends in Turkey has been the breathtaking pace at which European law is being adapted and adopted by the Turkish legislature. This is consistent with the current government's clear strategic decision to comply with the criteria set out by the EU as a precondition for Turkey's membership. While the implementation sometimes lags, little appreciation has been expressed for the extent of the changes made to date and the pace at which this process continues.

With these changes in mind, we can expect Turkey to seek to close the wide gap between itself and EU member states. For the insurance market, this means that EU legislation will be the frame of reference for legislative reform. For Turkey, this means that as it makes the changes to the regulation of insurance, it must follow, as well as learn lessons from, the experiences of EU insurance markets.



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EUROPEAN TRENDS AND THE TURKISH MARKET: The past two years have not been the best for the European insurance industry. Since September 11, 2001, some of the largest and best-known international insurers have had their once sterling credit ratings tarnished. Much of the focus in the press has been on the large casualty insurance payments due for the terrorist attacks in New York. While some insurers have undoubtedly been affected by this, the attention paid to this catastrophe has obscured from view some of the important reasons for the difficulties facing insurers, including the change in financial returns available to insurers and the effects of higher risk investment decisions.

In fact, casualty insurance can be thought of as two separate and somewhat unrelated businesses. The first, and most familiar to the layman, is the underwriting business in which risks are weighed and their probability priced (and, of course, partially transferred to reinsurers). The second is the investment business, in which insurers calculate the expected returns on the premiums they retain.

During buoyant economic times, when the financial products are providing high levels of returns, insurance companies can, and in some cases consistently did, lose money on their underwriting business, while more than making up for this with the healthy profits they made on their investments.

With some European regulators being more flexible than their American counterparts in permitting a broader range of investments casualty insurers can make with their premium income, some companies were tempted by the higher returns of the stock markets. With the sudden drop in returns, not only did these companies face losses on their investments, but also losses on their insurance policies, which they under-priced on the assumption that they could count on substantial offsetting income from their investments.

For Turkey, this has important lessons. The market for insurance is sure to grow as the government successfully implements the economic reforms required to bring down interest rates and moderate the endemic cycle of financial gyrations that have long characterised the Turkish economy. However, permitting insurance companies to pursue business on the basis that they will lose money on underwriting – and supporting this with hoped-for returns from risky investments in the Turkish financial markets – would serve to put prudent insurers at an economic disadvantage. It also puts at risk the growth of the insurance market and the benefits a solid insurance market offers to the economy as a whole.

A FLEXIBLE FRAMEWORK WITH RISK-BASED REGULATION: In addition to regulating minimum standards of prudence in investments by insurers, it is important that in adopting a legislative framework for Turkey there be a push towards greater transparency, so that insurers, their shareholders and regulators can correctly measure and evaluate the risks the insurers undertake, as well as their financial positions. This information will also be of increasing interest to the policy holders, who may be at risk if the insurers are unable to meet their financial obligations on a timely basis.

While the principle of disclosure is simple, implementation is much more complex. To be effective, there must be a consistent and well thought out set of accounting rules that are required to be applied by all insurers. Turkey, in this case, should not invent its own. It should use international standards, like those used by European markets or markets of equal sophistication. There are many difficult and complex issues to be considered when determining when income and expense should be recognised and how to account for the rapidly changing values of an insurance company's investment portfolio. Turkey would be best served by using an existing model that works well, taking into account, where appropriate, the volatility that the Turkish exchange rates have shown. The added benefit would be that the ratios widely used in the insurance business to evaluate insurance companies will have more relevance as they are more easily comparable to those of other markets.

THE ROLE OF THE REGULATOR: Of all private enterprise, insurance is somewhat unusual. In most sectors, the issue of whether a company offering competitive services errs on the side of overly competitive pricing is strictly a concern for its shareholders — and a potential boon for its customers. In the case of insurance, the regulators, and indeed the public, should be concerned that the insurers not erode their profitability. An insurer that erodes its profitability can also destroy the raison d'etre of its service and thereby harm both their customers and the market for its competitors. Where the government is expected to bail out insurers (or their policy holders) it brings with it the same issues of moral hazard — the government risks creating perverse incentives that support the least responsible companies at the expense of the more responsible competitors and the general public.

Currently, the Treasury has the role of regulating insurers. Whether this will continue or one of the new trends in Turkey, the independent regulator, will be used for this role is of less importance than the need for the regulator to perform this role in an appropriate manner. This means a move away from the tradition of bureaucratic controls, such as detailed regulation of processes and standard terms of insurance products and, as experience of independent auditors and actuaries increase and corporate governance potential is enhanced, more of a focus on the areas of greatest risk to the financial health of insurers.

The regulator would also be well advised, having learned by example from the banking industry, to quickly implement a more rigorous accounting along the lines suggested above and to move quickly if this shows any reason for concern. Insurance regulators are no doubt well aware of the risks and tremendous cost to the public brought about by failure of such controls in the banking system, a problem that is still being addressed in light of recent issues with İmar Bank. They have an excellent incentive to ensure that any problems that arise in the insurance sector are promptly corrected and do not, in the future, tarnish their reputation.

As interest rates decline and Turkey is able to restructure its economy to reduce the level of risk, the insurance market as a whole will become more relevant and critical. Areas of business decision-making that were previously fraught with risk will be less so. The transference of such risks by means of insurance will take a much more central role than previously. However, the role of underwriters in casualty insurance will increase as the expected financial returns begin to reflect the more mature economic environments that Turkey is focused on emulating. To do so effectively, a non-intrusive, transparent and risk-based regulatory framework can make all the difference.

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