Insurance in Turkey: opportunities and challenges

Following the political difficulties and economic breakdown of 2001, Turkey has enjoyed a spectacular period of economic growth. The fundamental attractions of this dynamic economy include: a young, growing population; the prospect of economic convergence; a strong entrepreneurial culture; liquid and reasonably transparent markets; and a pivotal regional position. Alongside general economic development, financial services are growing fast. While insurance has taken a backseat relative to banking, it is catching up fast, developing products and distribution lines to an immature market...

While insurance has taken a backseat relative to banking, it is catching up fast, developing products and distribution lines to an immature market that offers plenty of scope for further growth.

Changing dynamics of a fast-growing market

Total written premiums in the Turkey insurance industry rose from TL 2,504 million to TL11,774 million[1] in the seven years following the economic dislocation that saw the devaluation of the Turkish lira in 2001 against both the dollar and the euro.This represents an average annual increase of 24.7%. However, there was a slowdown in written premiums in 2008 to just 8% as deregulation in the motor insurance business led to a sharply more competitive marketplace.

And total assets grew at an even faster pace, from TL 4,053 million to TL 24,678 million over the seven years to the end of 2008.

Distribution emerging as a competitive differentiator

The principal channel for the generation of these premiums is via agency networks. This channel has been dominant since the industry was created, and accounts for 70% of insurance sales compared to about a half in Western Europe. But there are signs that the agencies' dominance is starting to be challenged. Bancassurance is becoming more prevalent in Turkey, as is the broker model. There are also a number of new and competing distribution channels such as direct marketing, telemarketing and internet marketing.

These new distribution channels are likely to increase the opportunities vis-a-vis Western markets. This should make Turkey and other emerging markets with similar characteristics even more attractive for companies looking to expand their geographical reach and increase margins. According to Swiss Re's 'World insurance in 2007' report (published in June 2008), premiums grew 2.5% to $3,647 billion in industrialised countries year-on-year, but powered ahead by 11.8% in emerging markets to $414 billion. Growth in Central and Eastern Europe was even higher at 12.9%, while a year-on-year increase of 9.3% was recorded in the Middle East and central Asia region.

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[1] Average $ and € rates in 2008 were 1.29TL/$ and 1.90TL/€, respectively

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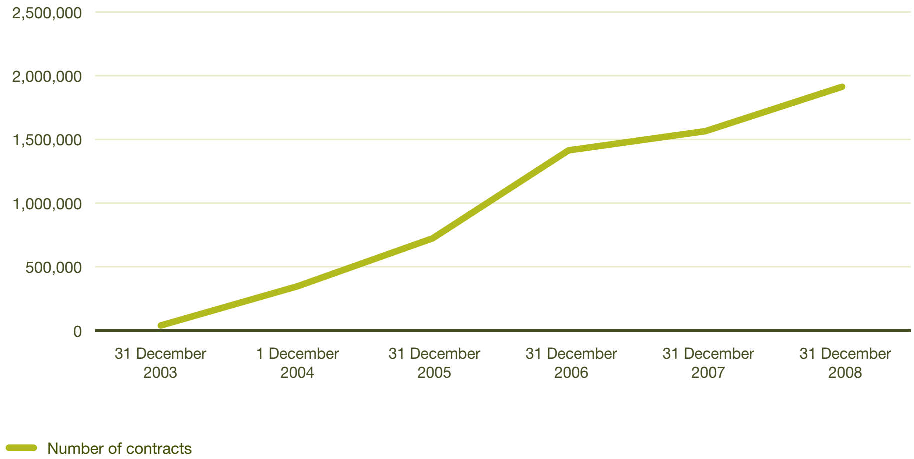
A raft of opportunities

The Turkish insurance industry is so young and penetration as yet so under developed that opportunities are likely to exist in just about every business line, distribution channel and client type.

Underpinning every opportunity is the raw fact that Turkey has more than 70 million citizens, with an average age of 29. The potential to sell life assurance, savings and pension products and employer products is significant, particularly since the ratio of premiums to capita is currently so low (although it has risen from $25 in 2001 to approximately $120 by 2008).

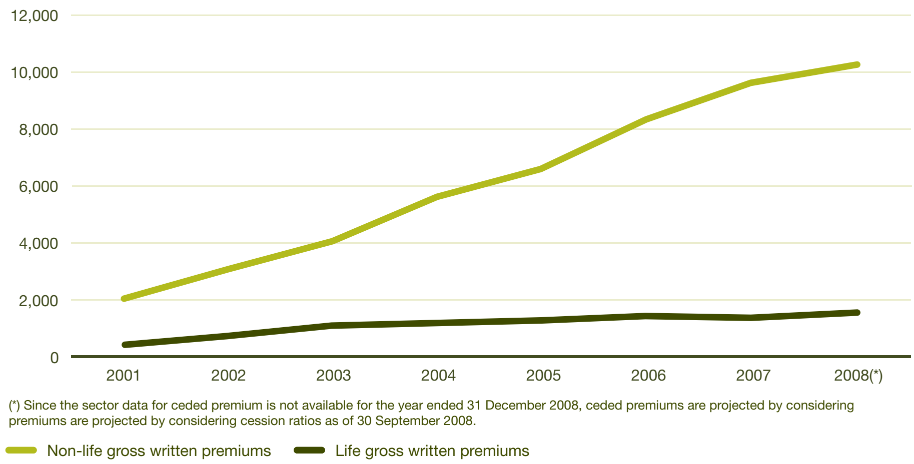
Pension products, introduced in 2003, are starting to take off from a low level (see Figure 1). There were just TL 6.3 billion ($5 billion) of assets accumulated in pension funds in the whole of Turkey in February 2009, less than a single large Western institution holds on its own balance sheet. Pension rights are conferred to people aged 56 or older with at least 10 years' saving history, so annuity products will not be applied until 2013. But preparation for the widescale rollout of annuities is already beginning.

Figure 1: Number of pension contracts between FY03 – FY08



Source: Pension Monitoring Centre in Turkey

Figure 2: Life and Non-Life premium growth compared



(*) Since the sector data for ceded premium is not available for the year ended 31 December 2008, ceded premiums are projected by considering premiums are projected by considering cession ratios as of 30 September 2008.

Source: Association of Insurance and Reinsurance Companies of Turkey

Expansion of compulsory products

Compulsory insurance products, introduced in the motor sector in the shape of third-party insurance, are now being extended to other economic spheres and represent a future opportunity. Since Turkey is situated in an earthquake zone, earthquake protection has become obligatory for workplaces and households. Companies that work with or produce dangerous materials must have liability cover, as should some professionals such as lawyers and doctors. But compared with eurozone countries, penetration of compulsory insurance is still weak and governmental effort is required to increase the penetration of existing compulsory insurance products in the coming months and years.

Then there is the life insurance market, which will undoubtedly take off at some point, catching up with the proliferation of life products in developed markets. Consider this: in 2008, just TL 1.58 billion of premiums were written in the life sector, compared to TL 10.2 billion in the non-life sector (see Figure 2).

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Critical illness and death cover taken out as a package with bank loans is currently the most prevalent life product. But life-savings products are likely to increase following the enactment of new regulation on March 1, 2009 which allowed annuities and other saving products to be launched.

Agencies still the greatest source of new business

New distribution channels may, in the future, change the whole shape of insurance in Turkey. But for now, agents control about 70% of business and brokerage models have yet to make significant headway. The catalyst for greater broker-led business is likely to be the advent of more complex products. Businesses, for instance, are likely to transact increasingly with brokers for block insurance cover. Meanwhile, the bancassurance model, widespread in continental Europe, has gained some traction in Turkey, especially in life insurance.The result is that the agency channel has declined from 80% to 70% in the last five years, the change mainly taking place in non-life business lines. At the same time, the bancassurance channel has increased from 42% to 55% in life in the last three years (see Figure 3). The recently launched telemarketing and internet channels have yet to take off, and the dilemma for market participants is whether, by creating alternative channels, they risk losing the trust of the all-important agency networks.

Foreign entrants: a well-informed approach is key

The striking gains in prosperity of recent years owe a great deal to Turkey's success in attracting foreign capital. Foreign direct investment reached a high of $20.2 billion in 2007, although this fell to around $15 billion in 2008 as the credit crisis started to bite, according to the central bank.

Foreign financial services firms have been particularly enthusiastic entrants into the market. In the banking sector, Citigroup, Unicredit, BNP Paribas and Fortis - all have significant stakes in, or control of, Turkish banks. Foreign insurers were late arrivals, but many have gained significant positions - Axa now has the largest share (12.1%) of total non-life premiums while Allianz is the third-largest insurer in Turkey with an 8.9% share of non-life premiums. Other major groups entering the market in the last two years include ZFS, Aegon, Groupama, Mapfre, Eureko, ACE and Munich Re.

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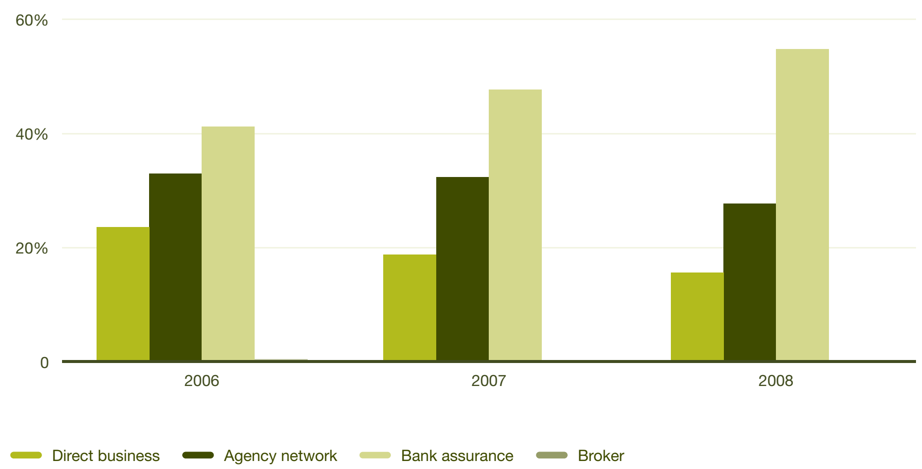
Groups seek to increase market share via consolidation

Consolidation of the market is now likely. With 54 domestic and foreign insurers operating in Turkey, groups with a suboptimal share of the market will want to boost their presence or else sell their holdings or otherwise withdraw from the market. There were six major purchases by foreign groups alone in 2008. A further way to enhance market positioning is by increasing control of joint ventures. Both Axa and Allianz have decided to follow this path in recent times. Last year, for instance, Axa paid $525 million for the 50% it did not own of its joint venture with Oyak Holding.

M&A is far from the only issue for foreign firms in Turkey. They face a host of challenges if they are to successfully penetrate and sustain earnings in this market. For example, competition has intensified following the introduction of free tariffs in July 2008, which gave insurers the right to determine prices for third-party motor liability insurance.

Figure 3: Life gross written premium per distribution channel between FY06 – FY08



Source: Association of Insurance and Reinsurance Companies of Turkey

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It will be increasingly difficult for companies to gain additional market share if they offer only existing products or rely on saturated distribution channels. At the same time, free tariffs create an opportunity to segment within insurance types, pricing products according to defined criteria. When setting up in Turkey, there is also a raft of administrative procedures to complete, and obtaining an insurance licence will take approximately three to six months. A number of investigatory procedures by the regulator and other agencies have to be navigated.

Adequate capital is also a key issue. New Turkish regulations stipulate stringent minimum capital requirements for each business line, as well as other solvency requirements. These are mostly in line with European practice and are closely policed by the regulator.

EU accession preparation driving new regulation

The regulatory environment is, to say the least, dynamic. The much-anticipated accession of Turkey to the EU has engendered a frenetic pace of regulatory change to ensure the country adopts the correct standards in a timely fashion.

Recent changes include a transition to IFRS accounting standards and the publication of new reserving regulations. Furthermore, internal control and internal audit requirements have been introduced. New entrants to the market need to take care, however: while regulations are similar to EU rules, they are not always an exact mirror image. Calculations are sometimes more mechanistic and this requires a subtly different approach.

If, following a merger or takeover, the group HQ is now in the US, Europe or even in Asia, the local office needs to be able to prepare accounts to the standards and template of the parent company.

Meanwhile, human resources can be more complicated than commonly conceived. New entrants will need to source an experienced management team that will be able to adapt to the regulatory environment and handle the transition process in the case of a takeover. If, following a merger or takeover, the group HQ is now in the US, Europe or even in Asia, the local office needs to be able to prepare accounts to the standards and template of the parent company. For the same reasons, internal controls and actuarial rules also need to be examined carefully.

Standing out from the crowd

We have explored some of the promising product and distribution opportunities that are starting to present themselves in the Turkish insurance sector, but how else can entrants to the market differentiate themselves?

For one, there is ample scope for improvement in performance measurement. Investment in banking technology and bank systems has simply not been matched in insurance. This may be because banking requirements are more complex, but complexity is now a facet of the insurance market and stronger internal controls are required. Investment by new shareholders in domestic companies is likely to reap rapid benefits.

Do's for foreign entrants

- Know your customer base in order to create a pricing strategy based on segmentation. The alternative is to compete on price and accept compressed margins.
- Build up fully functioning relations with agencies, which generate about 70% of the written premiums in the dominant non-life segment. Agencies can defect if not properly rewarded and motivated. They require support for products and systems.
- Create a strong capital structure that has a large enough cushion to satisfy regulators.
- Consider the implications on profitability of the reinsurance structure. This market is heavily reinsured, but there are signs that optimisation plans are being implemented at some companies.
- Ensure customer satisfaction. This sounds obvious, but after-sales servicing, speed of payment in the event of a claim and assistance in the event of motor accident are all key competitive differentiators in an increasingly crowded non-life market.

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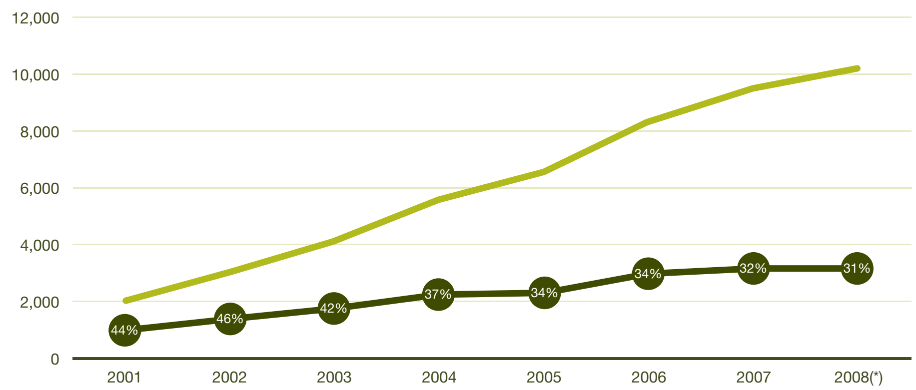
Figure 4: Non-life insurance gross written premiums versus ceded premiums between FY01 – FY08 (TL million)



(*) Since the sector data for ceded premium is not available for the year ended 31 December 2008, ceded premiums are projected by considering premiums are projected by considering cession ratios as of 30 September 2008.

Gross written premiums — Ceded premium to reinsurers

Source: Association of Insurance and Reinsurance Companies of Turkey

Beware reliance on pricing models

We have mentioned non-life actuarial pricing (particularly in the motor segment), noting that segmentation can help to avoid the race to the bottom of the price spectrum. However, it should be said that pricing models are not helpful if they dissuade a firm from entering the market at all. It is possible that large, diversified insurers will wish to enter the maturing motor insurance market as a loss leader in order to break into the local market.

They are then in a position to sell add-on products that other providers cannot offer as a package or are unable to offer at all.

We have also alluded to the reinsurance structure, but it is worth exploring this further, since the correct capital structure can have a sizeable impact on the overall profitability of the enterprise. In this respect, we note that 45% of non-life written premiums were transferred to reinsurers in 2001. That figure is now 30% and falling (see Figure 4). With the appropriate capital structure, insurers can optimise their portfolios and drive risk-adjusted profits higher.

Turkey not immune from the global downturn

Finally, the slowdown in global markets will, of course, have an effect on the future growth trajectory for Turkey's insurance market. In 2009, we expect growth of perhaps 2% - 3% compared to the double-digit growth of recent years. Sluggish growth may even continue into 2010, but there is little doubt that when markets recover, emerging markets in general and Turkey in particular will provide ample opportunities for domestic and foreign insurers alike.

Conclusion

The Turkish insurance sector requires substantial strategic effort on the part of companies wishing to tap its potential. New entrants that have conducted in-depth research are well-prepared, suitably advised and sufficiently resourced have the greatest chance to avoid the pitfalls and succeed in breaking into this exciting market.

Once established in the market, insurers will want to quickly achieve scale and brand recognition as well as creating new products and distribution channels. Growth in the market to date suggests there is only a limited time to achieve this multi-pronged approach before the bar for success is raised considerably higher.