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INTEGRATION OF THE TURKISH INSURANCE MARKET WITH THE EUROPEAN SINGLE INSURANCE MARKET

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ABSTRACT

INTEGRATION OF THE TURKISH INSURANCE MARKET WITH THE EUROPEAN SINGLE INSURANCE MARKET

There has been a continuing process of integration in the EU financial markets especially since the establishment of EMU. The aim of this study is to analyze the extent of the integration of the EU/EEA life and non-life insurance markets which occupy an important place in the financial markets and the integration prospect of the Turkish insurance market with the European single insurance market. The results revealed that even though consumers and re/insurers situated in any one of the Member States are completely free to operate throughout the European Economic Area (EEA) under the same conditions with local companies and consumers, insurance market indicators do not converge, insurers do not make use of freedom of services and freedom of establishment and thus insurance markets of the EEA Member States are still far from being integrated markets. Mergers and acquisitions are still the dominant strategy to access a foreign insurance market in the EEA. As far as the Turkish insurance market is concerned, it is argued in this study that Turkey, an acceding country to the EU, harmonized its insurance legislation with the EU insurance acquis to a great extent. Perceptions and expectations of the Turkish insurance market on the current level of harmonization and the integration prospect are investigated by a survey. The sector believes that Turkish insurance legislation is already harmonized with the EU insurance acquis and that the EU membership of Turkey would be beneficial for the Turkish insurance market but would not result in the integration of the market with the insurance markets of the EEA Member States.

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ÖZET

TÜRK SİGORTA PİYASASININ AVRUPA TEK SİGORTA PİYASASIYLA ENTEGRASYONU

Özellikle Ekonomik ve Parasal Birliğin kurulmasından bu yana Avrupa Birliği finansal piyasalarının entegrasyon süreci hızlanarak devam etmektedir. Bu çalışmanın amacı ise, Avrupa Ekonomik Alanında (AEA) finansal piyasaların önemli bir parçası olan hayat ve hayat-dışı sigorta piyasalarının entegrasyon seviyesini ve Türk sigorta piyasasının Avrupa tek sigorta piyasasıyla entegrasyon olasılığını araştırmaktır. Çalışmanın sonuçları, tüm AEA üyesi ülkelerdeki tüketicilerin ve sigorta/reasürans şirketlerinin eşit şartlarda faaliyet göstermesine karşın, sigorta piyasası göstergelerinin birbiriyle yakınsamadığı, sigorta şirketlerinin hizmetlerin serbest sunumu ve yerleşme serbestisinden yararlanmadığı ve sigorta piyasalarının entegre olmaktan henüz oldukça uzak olduğunu göstermiştir. AEA'da yabancı sigorta piyasalarına girmek için kullanılan esas yöntem hala birleşme ve satın almalardır. Bu çalışmada Türk sigorta sektörüne ilişkin olarak ise, AB ile üyelik müzakerelerine devam eden Türkiye'nin sigorta mevzuatını AB sigorta müktesebatıyla büyük ölçüde uyumlu hale getirdiği sonucuna varılmıştır. Türk sigorta sektörünün uyum seviyesi ve entegrasyon olasılığına ilişkin algıları ve beklentileri ise anket yöntemiyle araştırılmıştır. Buna göre, Türk sigorta sektörü, sigorta mevzuatının AB sigorta müktesebatıyla hali hazırda uyumlu hale geldiğini ve Türkiye'nin AB üyeliğinin Türk sigorta piyasasına faydalı olacağını, ancak üyeliğin AB sigorta piyasalarıyla entegrasyona yol açmayacağını düşünmektedir.

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I dedicate this thesis to my beloved father…

TABLE OF CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF ABBREVIATIONS

ANOVA	Analysis of Variance
ASEAN	Association of Southeast Asian Nations
AT	Austria
BE	Belgium
BG	Bulgaria
CACM	Central American Common Market
CEA	Comité Européen des Assurances
CEEC	Central and Eastern European Countries
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CH	Switzerland
COMECON	Council for Mutual Economic Assistance
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EC	European Communities
ECB	European Central Bank
ECJ	European Court of Justice
EE	Estonia
EEA	European Economic Area
EEC	European Economic Communities
EFTA	European Free Trade Area
e.g.	for example
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
EONIA	Euro Over Night Index Average
ES	Spain
ESFS	European System of Financial Supervision
ESRB	European Systemic Risk Board
EU	European Union
EU-27	European Union Member States as of 1.1.2007
EU-25	European Union Member States as of 1.5.2004
EU-15	European Union Member States as of 1.1.1995
EU-10	Member States of the EU that joined in 1.5.2004
FDI	Foreign Direct Investment
FI	Finland
FINNET	Financial Dispute Resolution Network
FOE	Freedom of Establishment
FOS	Freedom of Services
FR	France
FSAP	Financial Services Action Policy
FTA	Free Trade Area
GATS	General Agreement on Trade in Services

GB	United Kingdom
GDP	Gross Domestic Product
GR	Greece
HU	Hungary
IASB	International Accounting Standards Board
IBNR	Incurred But Not Reported
IE	Ireland
i.e.	that is
IFRS	International Financial Reporting Standards
IPT	Insurance Premium Tax
IS	Iceland
ISB	Insurance Supervisory Board
IT	Italy
i.e.	that is
LI	Liechtenstein
LT	Lithuania
LU	Luxembourg
LV	Latvia
M&A	Mergers and Acquisitions
MCR	Minimum Capital Requirement
MT	Malta
MTPL	Motor Third Party Liability
NAFTA	North Atlantic Free Trade Area
NL	Netherlands
NO	Norway
NPAA	National Programme for the Adoption of the Acquis
OECD	Organization of Economic Cooperation and Development
OJ	Official Journal
PL	Poland
PT	Portugal
QIS	Quantitative Impact Study
R&D	Research and Development
RO	Romania
SCR	Solvency Capital Requirement
SE	Sweden
SK	Slovakia
SL	Slovenia
SME	Small and Medium Enterprises
SOLVIT	On-line Problem Solving Network
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer System
TCIP	Turkish Catastrophe Insurance Pool
TSRŞB	Association of the Insurance and Reinsurance Companies of Turkey
UNECA	United Nations Economic Commission for Africa
USA	United States of America
USAID	United States Agency for International Development

1. INTRODUCTION

It is generally agreed that there has been an increase in the level of international financial integration over the last two decades. There has been a continuing process of integration in the European financial markets as well, especially since the establishment of EMU. The theory and empirical findings suggest that the integration of financial markets is likely to contribute to economic growth. In this context, like other financial markets, an integrated insurance market contributes to the economic growth and thus increases the welfare of the citizens. It may also have important implications on the insurers such as improved diversification, increased economies of scale and higher competitive power and on the consumers such as larger choice of products and higher protection. Therefore, the degree of insurance markets integration merits investigation. However, although there has been an increasing interest amongst researchers in the integration of European financial markets, the literature on the integration of the European insurance markets is neither extensive nor exhaustive.

The same argument is valid for the Turkish insurance market as well. Insurance market in Turkey is a young, dynamic and promising market which has been growing steadily in recent years with increasing premium production and foreign investments. It is in a process of harmonization with the EU insurance *acquis* and has a big growth potential. However, among the financial markets, insurance market in Turkey is one of the least studied markets by scholars.

This study sheds additional light on the extent of the integration in life and non-life insurance markets and tries to fill the gap in the literature by analyzing the European single insurance market and the Turkish insurance market. First, it aims to quantify the level of integration of the insurance markets of the EEA Member States constituting the European single insurance market and to find out whether the European single insurance market is an integrated market or is a market composed of different individual national insurance markets. Second, it aims to analyze the Turkish insurance market in its harmonization process with the European single insurance market and to find out the

integration potential between the Turkish insurance market and the European single insurance market.

Scarcity of data, especially data on cross-border insurance trade, was the most important challenge of this study. Main data sources used in the study are Insurance Statistics Yearbooks of the OECD, Financial Stability Reports of the CEIOPS and European Insurance in Figures of the CEA. A great effort is made to make the data comparable. The data set is augmented by sigma studies of Swiss Re, Annual Reports of the Turkish Insurance Supervisory Board About Insurance and Private Pension Activities in Turkey and Annual Reports of the Association of the Insurance and Reinsurance Companies of Turkey.

First chapter of this study introduces the basic aim and methodology of the study and gives the sequences of the chapters. Second chapter is devoted to conceptual and theoretical framework of insurance and financial integration. The section on insurance theory discusses the concepts of risk and insurance and suggests definitions. History, principles and types of insurance are also presented. The role of insurance in the economy is analyzed from theoretical and empirical point of views. The section on financial integration theory discusses the concepts of economic and financial integration and offers definitions. Different methods to measure the level of financial integration as well as the benefits and costs of financial integration are demonstrated.

Third chapter analyzes the European single insurance market and level of integration of the insurance markets of the EEA Member States. Following the discussion on the creation of the European single insurance market and its basic principles, the size of the market is introduced to understand its place in the world insurance market. Legislative harmonization in insurance through three generations of directives is examined in order to find out the level of harmonization in the market. Following a summary on the integration of European money, bond, equity and credit markets, the integration level of the European insurance markets is analyzed. The main aim is to conclude whether and to what extent the insurance markets of the EEA Member States are integrated.

The integration is first measured at legislative level by a cross-country comparison of the transposition and implementation of the insurance directives. Given the impossibility of the use of price-based indicators in the insurance services, the level of integration is measured by quantity-based indicators. In this context, convergence of insurance market indicators, volume of cross-border insurance trade and foreign market entry strategies are analyzed. Furthermore, demand side and supply side barriers for further integration of the European insurance markets are described and possible solutions for overcoming these barriers are offered.

Chapter four is devoted to Turkish insurance market and its level of integration with the European single insurance market. Following the discussion on the history of the accession of Turkish insurance market to the EU, legislation governing the Turkish insurance market and the size of the market are given. A comparative analysis between Turkish insurance legislation and the EU insurance *acquis* is made in order to find out the level of harmonization of the Turkish insurance market with the European single insurance market and existing regulatory and supervisory differences are evaluated. Measurement at legislative level is augmented by quantity-based measurements. In this context, convergence of insurance market indicators and the volume of the EU insurers' operations in Turkey are explored.

The main aim is to conclude whether and to what extent the Turkish insurance market is integrated with the European single insurance market. For the purpose of this study, integration between the insurance markets is defined as the use of FOS and FOE. However, since Turkey is not a member of the EEA and thus, is not part of the single market, integration cannot be measured through FOS and FOE. Therefore, expectations of the managers in the Turkish insurance sector on the level of potential integration of the Turkish insurance market with the European single insurance market as well as their perceptions and expectations on the arguments and claims presented in this study are investigated by a survey. Descriptive and inferential analyses are conducted in order to identify and interpret the results.

Finally, chapter five is the conclusion which summarizes the basic findings of the study.

2. CONCEPTUAL FRAMEWORK

2.1. INSURANCE THEORY

2.1.1. The Concept of Risk

For the study of insurance, risk is the essential element. If there were no risks in the daily life of the individuals and firms, insurance would cease to exist.

2.1.1.1. Definition of Risk

Risk is defined as the variation in the outcomes that could occur over a specified period (Williams and Heins, 1989, p.8 in Outreville, 1997, p.2). When there is only one possible outcome in case of an occurrence of an event, then there is no risk. If the outcome is well known, then there is no uncertainty, hence no risk. However, if more than one outcome is possible, then there is an uncertainty about the outcome, hence the risk is different than zero. The risk is reduced when the outcomes become more predictable. Therefore, the inability to predict the outcomes of future events is the essence of risk (Mehr and Cammack, 1980, p.18).

For the study of insurance, risk is defined as the uncertainty of a financial loss. The greater the variation of the average expected loss, the greater the risk. In a given event, if a loss is certain to occur, insurance could not be obtained since the companies would not want to insure it.

On the other hand, if a loss is certain not to occur, insurance could still not be obtained since no one would want to buy it. Mehr and Cammack (1980, p.19) give the example that the owners of a house located on a river bank where flood damage occurs three years out of four would be eager to buy flood insurance but the owners of a house on a nearby hill would not buy insurance as flood would never result in financial losses. Therefore, insurance exists because people are uncertain about what will happen to their life or to their property in the future.

The definition of risk for the study of insurance covers also the concept of loss which means an unintentional decline in value arising from a contingency. If someone intentionally buys a gold ring, it does not mean that they have suffered a loss. However, if someone's house is burned due to a fire, it means that they have suffered a loss. In this case, insurance is the most commonly used method by private or legal persons for shifting the financial consequences of a loss.

Risk refers to perils to which private or legal persons are exposed. Peril may be defined as the cause of a loss. While risk is the uncertainty about the loss, peril is the loss-producing agent. The examples of perils from which people are subject to loss may be fire, explosion, storm, premature death, accidents or sickness. Insurance is not a tool to prevent the occurrence of these perils but a tool to protect people from the financial losses caused by the perils.

The cause of the peril which is the cause of the loss is called hazard which refers to the probability of loss. It is the condition that may create or increase the probability of loss arising from a given peril. For instance, the fire breaking in a house is the peril while the faulty electrical equipment is the hazard because it is the cause of the fire and thus the real cause of the loss. The examples of hazards are faulty highways, machines out of repair, dangerous employments or carelessness, all of which increase the probability of occurrence of the peril and thus the probability of loss. The electrical equipment in the example and the construction material of a house are the examples of physical hazards. There are also moral hazards which refer to the individual characteristics of the policyholders that increase the probability of loss. Not being honest in case of loss or being indifferent to losses due to the existence of an insurance coverage are the examples of moral hazard.

2.1.1.2. Classification of Risks

Risks can be classified as, static and dynamic risks, particular and fundamental risks or pure and speculative risks. Insurance is not concerned with all of these classes of risk.

In literature, risks are distinguished depending on the cause of the event as dynamic and static risks[1]. Dynamic risks are not insurable by nature. These risks are the result of the changes in the economic conditions such as price levels, consumer tastes, demand patterns or saving behaviors. On the other hand, static risks involve losses that would occur even if there were no changes in the economy, such as accidents, fires or other natural perils (Outreville, 1997, p.3). Such risks are more predictable and the risk of occurrence of a peril in one year is the same in any other.

Risks can also be classified depending on their sphere of impact as particular and fundamental risks. Particular risks such as traffic accident, personal accident or burglary refer to individual risks which only impact a small number of people while fundamental risks such as war, unemployment or natural catastrophes refer to mass risks which impact a large number of people. Whereas it is theoretically possible to insure both types of risk, it is much more difficult to insure fundamental risks.

Economic risks which are under the scope of insurance may best be divided as pure and speculative risks depending on their nature. In both of these classes there is uncertainty as to the outcome of the event but in case of speculative risks, there is also a possible outcome producing profit which is not the case for pure risks.

Pure risks refer to possibilities that range from loss to no change and thus there is no gain potential. A house's exposure to loss by fire is an example of a pure risk because if there is a fire, there is a loss and if there is no fire there is no change in your situation since the fact that the house was not consumed by fire leaves you no better off (Bennett, 1989, p.61). Mowbray and Blanchard (1961, p.7) consider the possession of any form of property as an example of exposure to pure risk since its destruction is uncertain and it results in loss while its preservation does not of itself yield any increase in value or profit. Pure risks are often insurable as they lend themselves to the law of large numbers and as there is no possibility of gain at the end.

On the other hand, speculative risks refer to possibilities that range from loss to gain. Dorfman (1998, p.8) classify the gains or losses associated with interest rate

[1] see Willett, A. H. (1901). *The Economic Theory of Risk and Insurance*. New York: Kessinger Publishing.

changes, stock market investments and price movements of foreign currencies as speculative risks. Since there is a potential of gain and they do not meet some of the criteria for insurable exposures, most speculative risks are not subject to insurance.

2.1.2. The Concept of Insurance

First of all, insurance should be distinguished from gambling. While in gambling the risk is created by the transaction, in insurance the risk is reduced by the transaction (Mehr and Cammack, 1980, p.30). Therefore, gambling and insurance are opposites as one creates risk and the other reduces it.

Second, insurance is not a charity either. While charity is given without consideration, insurance guarantees the payment of a loss only in return for the payment of a certain amount of premium.

Finally, insurance is not a tool to prevent loss, damage or injury occurring to the subject matter of the insurance itself, i.e. to the life, property or other interest insured (Carter, 1979, p.5). It cannot compensate the suffering of people or the loss of commodities possessing sentimental values. It can only compensate the economic losses measured in monetary terms after the occurrence of the insured risks.

Insurance offers financial protection in the case of unpredictable adverse events which are called risks. If there were no uncertainties about the occurrence of an adverse event, the concept of insurance would cease to exist. However, in a world full of uncertain risks, insurance plays a crucial role for eliminating or reducing the cost of certain types of risk to society. Accordingly, Mehr and Cammack (1980, p.29) define insurance as a financial mechanism for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable.

Insurance is different from other financial services since its main role is to spread financial losses. It is basically a risk transfer method. Historically, economic risks were managed through informal agreements within the community. In our modern world, this idea of cooperation among the members of the society became formalized in the insurance industry. Under a formal insurance arrangement, each insurance policyholder

implicitly pools his or her risk with all other policyholders without necessarily knowing or having direct connection with other policyholders (Anderson and Brown, 2005, p.2).

European Insurance and Reinsurance Federation defines insurance as in exchange for payments (premiums) from the policyholder, the insurance company (also called as insurance undertaking or simply insurer) agrees to pay the policyholder a sum of money, to provide them with a service or to compensate the damage upon the occurrence of a specific potential event (CEA, 2005, p.6).

The term insurance can be defined in financial as well as in legal terms. The legal definition deals with the insurance contracts whereas the financial definition deals with the funding of the uncertain future losses.

2.1.2.1. Financial Definition of Insurance

Insurance is a financial arrangement that redistributes the costs of unexpected financial losses through a pooling mechanism. In insurance, loss is transferred to a multiplicity of people exposed to similar risks and who are willing to enter into the same type of agreement. Insurance is then pooling a large number of people with homogenous risk exposures and the redistribution of losses among the members of the pool.

The pool participant is called policyholder. The party agreeing to make the claim payments is the insurer. Insurance is a transfer mechanism from the insured's point of view and a pooling mechanism from the insurer's point of view (Outreville, 1997, p.131).

Through its pooling mechanism, insurance converts uncertainty to certainty. Through insurance, individuals are able to transfer their irregular and uncertain large losses for a certain premium payment. They exchange an unknown loss for a known cost. On the other hand, the insurer must be able to attract enough policyholders for the risk to be well spread. Then, lots of uncertain individual risks transferred to the insurer will become fixed and predictable according to the law of large numbers. Therefore, it is this pooling mechanism which transforms the random nature of risk into a known cost for both individuals and insurers (Soo, 1996, p.1).

Mehr and Cammack (1980, p.30) explain that insurance allows individuals to replace a large and uncertain loss with a definite and affordable cost under an arrangement whereby the fortunate many who escape loss will help compensate the unfortunate few who suffer loss. The loss is in fact paid for by the policyholder making the claim and by all the other policyholders who have not suffered in the same way. Logically, while some people will pay for their insurance and never have a claim, others will be compensated for their losses in return for a premium which constitutes a limited proportion of these losses (Acar, 2008, p.40).

Insurers consider the probability of different types of risk happening and they calculate the premiums needed to create a fund large enough to make loss payments from this fund. Those premiums, therefore, form the primary resource available to insurers for meeting claims (Diacon et al., 2005, p.4).

To sum up, insurance involves the transfer of potential loss exposures to an insurance pool and the redistribution of losses among the members of the pool by collecting a premium payment from every participant (Dorfman, p.3). In exchange for the premium payment, the insurer promises to cover the losses of the pool members on the occurrence of the insured event.

2.1.2.2. Legal Definition of Insurance

Insurance can be defined as a contractual arrangement between two parties by which one party undertakes to indemnify any financial loss suffered by the other party, in consideration of a sum of money, on the happening of a specified uncertain future event such as fire, accident or death.

The insurance contract is called as policy. The party of the insurance contract agreeing to pay for the losses is called as insurer. The party who receives this payment is called as insured. The payment that the insurer receives from the insured is called as premium.

The insurance contract must express an agreement offered by one party and accepted by the other. The offer may come from the insurer as well as from the insured as

long as both parties have the capacity to contract. Put another way, both parties of the contract should be legally capable of contracting. For instance, in Turkey, persons under 18 years are not capable of contracting. Furthermore, the contract must not be illegal. For instance, for properties acquired from unlawful acts such as a stolen car, signing an insurance contract is not possible.

Since the conditions of the insurance contracts are part of the bargain, they are called as aleatory contracts. Such contracts may be a benefit for one party but create a major loss for the other. In making an insurance contract, the insured knows that she is paying a sum far less than the insurer is to pay her under certain conditions that will probably not occur (Mowbray and Blanchard, 1961, p.53). Since there is uncertainty of loss, more benefits may be paid out than the premiums received on the occurrence of the event or even if the premiums are received, claim payments are not made if the event does not occur.

An insurance contract creates rights and corresponding obligations for both the insurer and insured. The insured has the duty to inform the insurer about the subject matter of the insurance both before and after the signature of the contract (Özbolat, 2010, p.89). Likewise, the insurer should inform the insured about the insurance coverage and the rules of the contract. Furthermore, the insured has the duty to pay the premiums and thus the right to receive a payment from the insurer if a loss occurs. The insurer has then a corresponding right to collect premiums and the duty to pay for losses.

As insurance by its nature is an intangible good involving payment in advance for an unknown service in the future, trust is a critical element. That is why many countries have insurance supervision regulations that reflect solvency concerns and information asymmetry between suppliers and policyholders, and have explicit reference to insurance contracts in their civil codes (Lester, 2009, p.2).

2.1.3. Criteria of Insurable Risks

Not all risks are insurable. With the risk classification in mind, the ideally insurable risk is a pure, static and particular risk (Outreville, 1997, p.132). It can be cited several indispensable criteria to be satisfied in order to insure a risk. In principle, a risk is

insurable if the loss is uncertain and out of the policyholder's control, the loss exposure is definite and quantifiable, and the pool covering similar loss exposures is large and diversified enough.

First, the future occurrence of the insured event should be uncertain and losses should be out of the policyholder's control. Since the risk is defined for insurance purposes as the uncertainty of a financial loss, the occurrence of the peril and its results should be accidental and unexpected. For instance, insuring a house is impossible when the roof is already on fire. Moreover, the policyholder should not be able to cause the loss to receive a payment from the insurer. Non accidental or expected losses are not insurable. However, it is only possible to insure against perils that are certain to occur if there is uncertainty on the timing of the occurrence or the amount of the possible loss (Dorfman, 1998, p.24). For instance, it is scientifically predicted that an earthquake will happen in Istanbul but its timing and the amount of loss are not certain and therefore the earthquake risk is insurable. Another example may be given from life insurance business. The risk of loss from death is not insurable since everyone is certain to die. However, losses arising from untimely death are insurable since the hour of death is uncertain.

Second, even if the loss is uncertain, it should be a pure loss. It means that if the event does not occur, the insured gains nothing and if the event occurs, the insured is faced with a loss. Therefore, while pure risks are insurable, risks containing speculative elements that may cause profit such as gambling are not considered insurable.

Third, the loss should be definite and quantifiable. Outreville (1997, p.132) emphasizes that the loss exposure should be definite in cause, time, place and amount. It means that the cause of the loss should be well known and the occurrence of the loss should be objectively verified by a reasonable person with sufficient information. Moreover, the loss should be calculable in terms of money. For instance, the loss of a loved pet can cause a family much grief, but such discomfort is not easily measured (Dorfman, 1998, p.25). If the loss is not quantifiable, it should at least be determined empirically with a projection of the past experience into the future. For instance, insuring the risk of a new disease is not always possible since no reliable data or experience is available. Catastrophic risks are also difficult to insure since the frequency and severity

of the possible loss is not easily calculable. Mehr and Cammack (1980, p.34) point out that if no statistics on the chance of loss are available, the degree of accuracy in loss prediction will be low even in the case of a large number of exposures. Estimating the chance of loss is also indispensable in order to determine the level of premium which is one of the most crucial elements for the surviving of the insurer. Therefore, unquantifiable risks are not insurable.

Fourth, a large number of similar exposures are needed to insure a risk. Large number of exposures means that the number of insured in the pool with similar exposures should be large enough to make losses predictable. To predict probable loss, it is essential that a large number of similar, though not necessarily identical, units be exposed to the same peril (Mehr and Cammack, 1980, p.32). By combining the risks of various clients in a pool, insurers can spread the risks over a large group of clients and become able to pay the amount of loss (De Haan et al., 2009, p.260).

The principle stating that the greater the number of exposures is, the more likely the actual result will approximate the expected result is called the law of large numbers which was named by Poisson in the 19th century (Mehr and Cammack, 1980, p.31). According to this law, as the number of cases increases, the gap between the estimated future losses and actual future losses becomes less and less.

The law of large numbers makes insurance feasible by making possible to predict collective losses with sufficiently large number of cases. By applying the law of large numbers, insurers can predict accurately the amount of losses they will experience in a given period (Dorfman, 1998, p.9). In other words, large number of exposure in insurance pool facilitates loss forecasting of the insurer.

Insurers enable individuals and firms to protect themselves against infrequent but extreme losses at a cost which is small compared to the loss. If losses can be predicted accurately, this will reduce the risk. Moreover, combination of individual risks will result in the reduction of total risk. Therefore, the cost can be handled with relatively small premiums. A large insurer with a large insurance pool is able to provide insurance cover at a lower rate than a smaller company could.

Large number of exposures is not always sufficient by itself and diversification of the portfolio may be necessary. The diversification means that the insurer writes several types of insurance that cannot happen simultaneously (such as traffic insurance and fire insurance or personal accident insurance and hull insurance). If it underwrites insurance policies in different parts of the country or even in different countries, then the insurers will benefit from geographical diversification.

To sum up, all of these four criteria, if fully satisfied, mean that the risk is insurable. The fact that a potential loss does not fully satisfy the criteria does not necessarily mean that insurance will not be issued, but some special care or additional risk sharing with other insurers may be necessary (Anderson and Brown, 2005, p.6).

On the other hand, European Insurance and Reinsurance Federation (CEA, 2005, p.6) warns that although all these criteria are met, the risk is insurable if it corresponds with the financial strength of the insurer or insurance sector. For instance, risks that may cause extraordinary damages such as nuclear risks may be too heavy for the insurance sector to bear. Also, the risk absorbing capacity of the insurer does matter. Capital constrains insurers' ability to insure risks. An insurer with a big amount of written premium and with a big reinsurance capacity may easily insure big risks that small insurers may not be able to insure. Furthermore, a risk may be insurable in one country where the insurance sector has sufficiently developed but not insurable in the other country with still small and developing insurance sector.

2.1.4. Asymmetric Information Problem in Insurance

Asymmetric information in financial markets means that one party has inaccurate and insufficient knowledge about the other party. It causes the need for increasing information available to the other party in order to maintain reliable, efficient and stable financial markets (Deligöz, 2006, p.4). Due to information asymmetries, the regulation and supervision in financial markets are necessary for protecting the consumers.

Asymmetric information leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets, including insurance markets. (Mishkin, 2006, p. 186)

2.1.4.1. Adverse Selection

In insurance sector, when one party of the insurance contract has more relevant information than the other party, the party with superior information can take advantage of the situation. Taking advantage of the possession of asymmetric information is called adverse selection.

All policyholders do not have the same risk exposure and they are not homogeneous. Unlikely to low-risk individuals, high-risk individuals will tend to buy insurance policies. However, insurers cannot determine the risk situation of all of its customers and thus every insured is charged the same premium rate (Loubergé, 2000, p.13). Adverse selection occurs when customers with high expected losses buy more insurance than those with low expected losses, when charged the same premium. People with a chance of loss above the average would certainly apply for an insurance policy and if they succeed in purchasing insurance at the average premium rates, the insurer is a victim of adverse selection. In this case, the premium is based on the average risk of the population as a whole while the actual insurance pool consists of an adverse selection of the population with high risk exposures. Adverse selection results in the insured not paying a rate that fairly reflects the insurer's loss exposure (Dorfman, 1998, p.32).

Adverse selection is particularly important in life and health insurance. For instance, if people know that their health is deteriorating, they try to purchase health insurance to cover their future medical expenses and if the insurer underwrites health insurance policies for these people without being aware of their situation on the same premium rate with other policyholders, then adverse selection occurs.

As a solution, insurers try to select the insured carefully and charge each of them with a rate reflecting their expected loss. Rothschild and Stiglitz (1976) offer a solution for the insurer to overcome the adverse selection problem. By offering a contract that is

just on the margin of being preferred by the high-risk individual, the insurer can force the buyers to self-select the contract that is intended for them (Hedblom, 2008, p.10).

The solutions to adverse selection problem include the contractual requirement of utmost good faith, the imposition of a degree of insurance on policyholders (restricting the opportunity for policyholders to over or underinsure) and designing incentive schemes for insured to reveal their own risks (Diacon et al., 2005, p.22).

2.1.4.2. Moral Hazard

Moral hazard refers to the individual characteristics of the insured that increase the probability and size of loss. Moral hazard occurs when the party (the insured) with more information about its actions has a tendency to behave inappropriately from the perspective of the party (the insurer) with less information. Since insurers cannot have perfect information about the behaviors of their policyholders, they will suffer from moral hazard problems.

When an individual is, consciously or unconsciously, less careful about preventing the losses due to purchase of an insurance coverage, then the moral hazard problem occurs. The chance of the occurrence of the moral hazard is even higher if the contract outcome is partly under the influence of the insured and the insurer is unable to observe without costs to which extent the reported losses are attributable to the insured's behavior (Loubergé, 2000, pp.12-13).

Since the probability and size of a loss is almost always related to the individuals' actions, being indifferent to losses because of the elimination of the uncertainty concerning the financial consequence of a risk make the probability and size of the losses increase. Individuals who do not act honestly in case of losses also lead to the moral hazard problem.

The policyholder of a motor insurance who tends to be less careful about locking the automobile, or who tries to have claim payment without occurrence of a loss are the examples of moral hazard. Increasing the amount of a loss by making a false claim (property insurance), by over utilizing the services (health insurance) or by charging

excessive costs to repair the damage (motor insurance) generate for the insurer a higher cost than expected and thus must be taken into account in the premium rate (Outreville, 1997, p.134).

Moral hazard is distinguished from adverse selection because moral hazard refers to hidden action while adverse selection refers to hidden information. Furthermore, contrary to adverse selection, moral hazard occurs after the transaction takes place. Depending on the timing of the insured's action, moral hazard may occur before or after the realization of the loss. Ex-ante moral hazard occurs before the realization of the insured event. In this case, the insured behaves in a more risky manner, resulting in higher claim payments by the insurer. For instance, a motor insurance policyholder who does not drive carefully increases the risk of accident and thus leads to higher claim payments by the insurer. On the other hand, ex-post moral hazard occurs after the realization of the insured event. In this case, the insured does not behave in a more risky manner, but they do ask for higher claim payments that would not be born without the existence of the insurance. For instance, a motor insurance policyholder who has an accident and who is getting a service from the most expensive repair shop leads to higher claim payments by the insurer.

While ex-ante moral hazard arises when the incentives to reduce the occurrence of a loss are reduced, ex-post moral hazard arises when the incentives to control the size of the loss are undermined because of the insurance (Diacon et al., 2005, p.22). Since it is often recognized that insurance reduces the loss prevention incentives of the insured, insurers try to prevent moral hazard.

In order to minimize moral hazard, insurers should carefully select their insured who would not intend to behave inappropriately. Contractual provisions and level of premiums are at the core of the moral hazard prevention efforts. Insurance contacts may include provisions causing the insured to regret the loss despite the insurance coverage such as the provisions requiring the insureds to pay a percentage of each loss (Dorfman, 1998, p.6).

The level of premium sufficiently reflecting the risk level of the insured may also be an incentive to reduce the losses. Wagner (2005) proposes the insurers to monitor the behavior of the insured in order to adapt the premium immediately once the insured relaxes his safety measures. Another solution is to update the premium after the occurrence of the insured event which causes insured losses. Policyholders would intend to take the necessary precautions to prevent any future probable insured losses as well as the size of the losses just after the occurrence of the insured event if they know that their level of premium will increase with the claim payments made by the insurer.

In order to reduce the moral hazard problem, regulations may also be put into force, such as enforcing restrictions on contract terms or building financial transaction monitoring processes.

2.1.5. Principles of Insurance

Insurance is a contract whereby one party, the insurer, promised to compensate the losses of the other party, the insured, upon the payment of premium to cover the subject matter of insurance. There are some vital principles determining the relationship between the parties of the insurance contracts. These are the principle of insurable interest, utmost good faith, indemnity, subrogation, contribution and proximate cause.

2.1.5.1. Insurable Interest

The aim of an insurance contract is not to prevent the occurrence of the risk but to compensate the financial losses after the occurrence of the risk. For instance, the liability of a doctor cannot disappear with the purchase of liability insurance which may only cover the monetary losses of the doctor.

Insurable interest means that the insured has a financial or monetary interest in the subject matter of the insurance. In other words, the occurrence of the insured event should cause loss to the insured. Therefore, the insured must have insurable interest at the date of the conclusion of the insurance policy and also at the date of loss giving rise to a claim payment. The insurable interest cannot be illegal. For instance, a stolen automobile cannot be insured.

Insurable interest may be a life, a property or a liability. In property insurance an exposure to a financial loss is required and the insurable interest must be present at the time of this loss, whereas in life insurance an insurable interest can be any reasonable expectation of financial loss arising from the death of the person whose life is insured (Mehr and Cammack, 1980, p.92). In liability insurance, insurable interest arises from an event that could impose an obligation to pay damages to other persons.

Possession of a house, an automobile or a machine may give the holder an insurable interest in that property. However, insurable interest does not mean that the insured should own the subject matter of the insurance. It is sufficient that the insured has an interest in the subject matter of the insurance (Çipil, 2008, p.57).

2.1.5.2. Utmost Good Faith

Since insurance business is based on trust between the contracting parties, insurance contracts are contracts of utmost good faith where the greatest degree of good faith is needed in the negotiations preceding the issuance of the contract (Mehr and Cammack, 1980, p.129).

The insured should accurately and fully disclose the necessary information about the risk to be covered. The prudent insurer will then decide whether to accept the risk and if so on what terms. On the other hand, the insurer should also highlight the terms, conditions and exceptions of the insurance policy to the insured. The disclosure takes place not only at the time of the inception of the policy, but also at renewal and at any midterm point. If the insurer determines that the insured disclosed incorrect or incomplete information, it has the right to cancel the policy.

Utmost good faith is also indispensable in case of the occurrence of the insured loss. In this case, the insured should take all the precautionary measures to reduce the size of the loss and the insurer should sufficiently compensate the losses of the insured as soon as possible under the terms of the contract (Özbolat, 2010, p.106).

2.1.5.3. Indemnity

Indemnity means compensation for loss. Property and liability insurance contracts are contracts of indemnity as they provide compensation only for the amount of loss whereas life insurance contracts are not contracts of indemnity but contracts to pay the amount written on the policy upon the death of the insured.

Indemnity payment is possible to the extent that the insured event is occurred and a quantifiable financial loss is materialized.

The object of the indemnity payment is to leave the insured in the same financial position as before the loss. That is to say, if a 10 year-old car is totally demolished, the insurer will only pay what the car was worth at the time of loss. Therefore, whereas the contract can be arranged in such a way that it gives a level of compensation under the size of loss, the opposite is not possible since it would mean unjust enrichment for the insured.

Indemnity payment is generally made in the form of cash payments. However, especially in motor insurances, making the damaged vehicle repaired by the insurer is also considered as indemnity payment. Replacement may be another way of indemnification. In this case, damaged property is replaced by a new one of the same standard, taking always into account the actual cash value of that property. For instance, a broken glass may be replaced by the insurer under the glass insurance policy coverage.

2.1.5.4. Subrogation

Subrogation means the right of one person to stand in the place of another person and use all the rights of that person. Subrogation principle gives the insurer the right to require the insured to assign all rights of recovery against a third party who caused the loss, but only for the amount of the payment by the insurer to the insured (Mehr and Cammack, 1980, p.131).

The right of the insurer to subrogation of the insured’s claim against those responsible for the loss prevents the insured recovering more than the indemnity she receives under his insurance policy and thus it guarantees that the principle of indemnity

does not fail. Therefore, it only applies to indemnity contracts but not to life or personal accident policies.

For instance, when an accident involves two or more vehicles, the insurers covering the policyholders who were not at fault can recover their outlays from the insurers of the policyholders who are responsible for the accident. Another example may be given from fire insurance. In case of a fire spreading to a house after a neighbor carelessly burns leaves, that person's insurer will pay the loss caused by the fire to the insured and will proceed against the tort-feasor, the neighbor in this example, for reimbursement. In this case, the insured who gets the claim payment from the insurer cannot ask the neighbor to pay for the loss. Otherwise, the insured would receive double compensation. On the other hand, the insurer may only recover the exact amount she paid to the insured. Therefore, the insurer cannot make profit from her subrogation right.

2.1.5.5. Contribution

Policyholders may have more than one insurance policy from multiple insurers for the same subject matter covering the same peril. In such a case, if the loss occurred, all the insurers liable for the loss should share the claim payment. This means that if at the time of loss it is found that there is more than one policy covering the same loss, the insurers must contribute to the claim payment in accordance with their proportion. Since indemnity principle forbids the insured from recovering more than the actual amount of loss, she cannot recover the total loss from each of the insurers.

On the other hand, the insured has the right to make a claim against one insurer. If a particular insurer pays the full loss, the contribution principle states that it has the right to collect proportionate coverage from the other interested insurers.

2.1.5.6. Proximate Cause

An insurer is only liable to pay a claim under an insurance policy if the loss that gives rise to the claim is caused by an insured event. Unless the loss is proximately caused by an insured event, the claim payment is not made. Therefore, this principle is vital in the decision of making the claim payment.

The proximate cause of loss is the most dominant and efficient cause in the chain of causation. Mowbray and Blanchard (1961, p.55) explain that the active efficient cause that sets in motion a train of events which brings about a result without the intervention of any force started and working actively from a new and independent source is the proximate cause.

For instance, consider that a thief breaks the door of the house but cannot steal anything. Insurance policy with theft cover will pay for the damage of the door since the proximate cause of the damage is the theft which is the insured event under the policy. However, in some other examples, a chain of causation would result a loss. In such cases, it is more difficult to determine the proximate cause of the loss. Çipil (2008, p.60) gives one of the most classical examples showing a chain of causation in insurance: a storm breaks down the building's roof, then the roof damages the electrical cables, then the damaged electrical cables give rise to a fire which finally damages the household furniture. In this example, the proximate cause of the damaged furniture is the storm which is the dominant and efficient cause of the chain.

2.1.6. History of Insurance

2.1.6.1. History of Insurance in the World

Insurance can be seen since the beginning of humanity in the form of people helping each other. Therefore, history of insurance goes back to the Ancient World. In ancient times, on the occurrence of an adverse event, people were helping each other. For instance, if a house of a person burns after a fire, members of the community help him build a new one. In this way, all the members of the community guarantee to receive help when they suffer a loss.

Insurance was developed when primitive societies found themselves unable to support trade and business activities because of the significantly increased size and frequency of losses involved (Diacon et al., 2005, p.4). Early methods of risk transfer were originated in the Egyptian civilization in 3000 BC and followed by Babylonian civilization. In around 2250 BC the Code of Hammurabi set out the rules on the circumstances under which compensation could be received in case of certain accidental

events during trade. For instance, if a merchant receives a loan for his shipment, in exchange for an additional sum paid by the merchant itself, the creditor agrees to cancel the debt when the shipment is stolen or lost.

Early forms of insurance examples are also seen in Greek civilization which aims to protect its merchants against the losses during trade in the Aegean Sea. For instance, Greek merchants whose goods were being shipped together were proportionally reimbursing the losses of any one of these merchants whose goods were thrown overboard in order to save the ship.

Moreover, in around 600 AD, Greek and Roman civilizations established guilds for family care and funeral expenses upon the death of its members. These are considered as the origins of modern life and health insurance. Similar guilds were established in England where people were donating a voluntary amount of money that could be used in case of emergencies. These simple forms of insurance continued until the emergence of modern monetary economy with its financial instruments in late 17th century.

Modern forms of insurance were born in the Mediterranean peninsula in 14th century. It is generally accepted that modern insurance was developed during the Renaissance period to compensate the losses of the merchants in Mediterranean States where marine trade was widespread. These marine insurance contracts were generally exchanged on a reciprocal basis between port-based merchants and mariners who knew and trusted each other and were able to share their exposure to similar perils (Diacon et al., 2005, p.5). The first example of insurance contract in history was a marine insurance contract written in 1347 to cover the cargo of the ship called Santaclara going from Genoa to Mallorca (Oksay, 2005, p.146). The contract displays for the first time the characteristics of a modern insurance policy which covers a future probable loss in lieu of payment of a premium.

Insurance became far more sophisticated in post-Renaissance Europe and industrialization has let the development of specialized varieties of insurance. With the internationalization of trade, England emerged as the new European trading centre. In 17th century, London's growing importance as a center for trade increased the demand for

marine insurance. In the late 1680s, Edward Lloyd opened a coffee house that became a popular place for ship owners, merchants and captains. The coffee became a reliable source of the latest shipping news and thus it became the meeting place of the parties wishing to insure their cargoes and ships, and those willing to offer insurance for them.

Land insurance can be traced back to the Great Fire of London in 1666. The devastating effects of the fire converted the development of insurance from a matter of convenience into one of urgency (Dickson, 1960, p.4). In 1681 first fire insurance company was established in England. However, until the end of 19th century, premiums were not determined by statistics as in the modern sense, but were often determined as a result of haggling.[2]

The modern insurance as we know it today goes beyond mutual risk sharing, necessitates a large pool of risks and depends on accurate risk classification, loss data and trust (Diacon et al., 2005, p.6). Today the insurance sector is a major global industry covering a huge range of risks from natural disasters and environmental hazard, through life and disability and standard property risks (fire, explosion, burglary, and so forth) to various types of liability (Lester, 2009, p.4).

2.1.6.2. History of Insurance in Turkey

History of modern insurance in Turkey goes back to 19th century with first insurance transactions starting in 1860s during the Ottoman period. There were some regulations in Commercial Code of 1860 and in Maritime Code of 1864 related to marine insurance. However, insurance was mainly developed with the Great Fire of Pera in 1870. Just as in the case with the Great Fire of London in 1666, the interest of citizens and city governors in fire insurance had increased in view of the damages caused by the fire. As a result, in 1870s, insurers such as English insurers Sun and Northern, and French insurer La Fonciere were established in Istanbul (Güvel and Güvel, 2010, p.31). Similar to the insurance development in the world, modern insurance in Turkey was born with marine insurance and was developed with fire insurance although its starting date was late and its level of development was limited compared to the World (Çipil, 2008, p.41).

[2] See http://www.insurance.za.org/insurance/history-of-insurance.htm

Since Renaissance or Industrial Revolution leading to the increase in industrial production, international trade and capital accumulation in Europe did not take place in the Ottoman Empire, an institutionalized insurance sector in the Empire emerged very late compared to Europe. Insurance business was totally in the hand of foreigners and insurance policies were mostly demanded by non-Muslim population of the Empire. Traditions and Islamic beliefs were also the natural obstacles for further development of the financial sector in the Empire. However, Oksay (2004, p.145) attributes the lack of financial development in the Empire and the provision of financial activities by foreign companies mainly to the capitulations which give trade privileges to foreigners.

The first insurance company established in the Ottoman Empire, "Osmanlı Umum Sigorta Şirketi", dates back to 1892 and it was established with foreign capital.

The lack of regulation and supervision of the sector became a concern for the insurers due to unfair competitive practices among them and against the policyholders. Therefore, they decided to be organized under a professional organization in 1900 and thus they established the "Syndicate of Fire Insurance Companies Operating in Istanbul" which was turned by 81 foreign companies into "The Society of Insurance Companies Operating in Turkey" in 1916 (TSRŞB Annual Report 2009, p.6). Finally, the first insurance regulations requiring the production of policies in several foreign languages and envisaging rules to protect policyholders came into force in 1908 and 1914 (Malatyalı, 2008, p.41). However, unfair practices as well as the dominance of the foreign companies continued until the establishment of the Turkish Republic in 1923.

During the first years of the Republic of Turkey, the establishment of domestic insurers and the regulation and supervision of the insurance sector were the first priority issues in the sector. Insurance policies had to be written only in Turkish by 1924. The first domestic insurer, Anadolu Sigorta, was established in 1925 as a state-owned insurer. The first insurance law regulating and supervising the domestic and foreign insurers entered into force in 1927. The first private insurance company, Doğan Sigorta, was established in 1942.

After the proclamation of the Republic, insurers came together under the umbrella of a professional organization called The Club of Insurers which then took the name of Central Office of Insurers. In 1954, it finally took the name of “Association of the Insurance and Reinsurance Companies of Turkey”. The Association is today a specialist institution with the characteristics of a unique non-governmental institution established by law and all insurance and reinsurance companies operating in Turkey should be members of the Association.

The insurance law enacted in 1959 was a milestone for the sector. More comprehensive and sophisticated rules for the insurance sector were introduced. However, between 1968 and 1984 establishment of new insurance companies was forbidden. After 1984, liberalization in the sector, establishment of new insurers and transition to free tariff system paved the way for the development of the sector both in terms of quantity and quality.

Today, insurance and reinsurance sector in Turkey is regulated and supervised by the Undersecretariat of Treasury under the Insurance Law no 5684 enacted in June 2007 largely in conformity with the EU *acquis*. However, the level of premium production per capita and the share of insurance in Turkish economy are still far behind the EU average.

2.1.7. Types of Insurance

2.1.7.1. Social Insurance

Insurance can be mainly categorized as social insurance and private insurance. Social insurance aims to redistribute the income to achieve some social objective and it includes all kinds of insurance schemes required by law for the general population and supervised by the government. Social insurance such as pension plans, disability benefits, unemployment benefits and sickness insurance is part of the social security system of the state and although there is involvement of private insurers in some examples, it is generally administered by governments (Acar, 2008, p.40).

2.1.7.2. Private Insurance

Private insurance which is purchased from the insurance companies is the insurance based on a contract between the insurer and the insured. The risks covered by private insurers may be life or health of a human, fire, accident, theft, third party liability, financial losses or natural catastrophes such as flood, storm or earthquakes. The present thesis deals with this particular type of insurance and the word insurance refers to private insurance in each case.

There are some important differences between these two types of insurance. First, social interest is the dominant factor in social insurance while personal interest of private or corporate individuals is the dominant factor in private insurance (Özbolat, 2010, p.49). Second, social insurance providers are non-profit state institutions administered and supervised by the government while private insurers are profit making companies established by private individuals. Third, social insurance is financed by the employer, employee and state while private insurance is financed by the premiums paid by the policyholder. However, in some private insurance examples such as natural catastrophe insurance where the size of loss is too big to be covered by private companies, private-public partnerships can be established. Fourth, in social insurance, premiums, that are called contributions, are set according to the profession and level of income of the contributor while in private insurance premiums are set according to the risk level of the insured (Güvel and Güvel, 2010, p.25). Fifth, while social insurance programs are compulsory for most people with different levels of contribution prescribed by law, private insurance is normally voluntary. It means that in private insurance, people are free to decide to buy insurance products. Social adequacy is usually stressed in social insurance and thus it tends to be universal in application while the risk selection is important in private insurance. However, in some cases regulations may envisage a minimum amount of compulsory private insurance to protect third parties injured because of the insured's conduct. Motor insurance, known also as traffic insurance, is one of the most classical example of compulsory insurances.

While private insurance can be classified as compulsory and non-compulsory insurances or indemnity and non-indemnity insurances, the categorization involves in

general the distinction between life and non-life insurance. Life insurance protects against premature death, disability or retirement whereas all the other types of insurance can be grouped under the name of non-life insurance which protects against risks such as accidents, fire or liability.

Life and non-life insurances differ significantly. First, the subject matter in life insurance is the life of a human while in non-life insurance it can be anything other than the life of a human. Second, occurrence of the risk (risk of death) is certain in life insurance and only its timing is uncertain while the occurrence of the risk is unexpected and uncertain in non-life insurance (Özbolat, 2010, p.247). Third, as the economic value of a human life cannot be measured precisely before death, life insurance cannot be a contract of indemnity while non-life insurances are contracts of indemnity where the claim payment is limited to the actual value of the subject matter at the time of loss (Dorfman, 1998, p.202). Fourth, life insurances may include risk cover and investment component at the same time while non-life insurances may only include risk cover as they are indemnity contracts. Fifth, life insurance policies may be long term while non-life insurances are in principle short-term covering a period of time up to 1 year. Finally, subrogation principle cannot be applied in life insurance while in non-life insurer, the insurer has the right of recovery against a third party who caused the loss (Özbolat, 2010, p.247).

Since the aims and operating principle of life and non-life insurances are different, they are regulated in different laws or at least by different provisions in many countries.

2.1.7.2.1. Life Insurance

Life insurance, also called as life assurance, provides a payment of a sum of money at the end of the insurance period or upon the death or survival of the insured in a specified date. In return, the policyholder agrees to pay a stipulated amount at regular intervals or in lump sums.

If an individual buys a life insurance policy on her own life, she is both the policyholder who pays the premiums and the insured who benefits from the policy.

However, in some cases the policyholder can designate a beneficiary who receives a payment upon the death of the policyholder.

The basic types of life insurance are temporary life insurance (term insurance), permanent life insurance (whole life, universal life and endowment) and annuities. While temporary life insurances are for specified periods of time, permanent life insurances offer coverage which continues for the duration of the insured's life.

Term insurance is the classical type of temporary life insurances. The insurance coverage is for a specified period of time and if the policyholder dies (or survives) within the policy term, the beneficiary receives the sum of money determined on the policy. Otherwise, the insurer keeps all the premium payments at the end of the term. There is no saving component in term insurances. Decreasing term insurance, such as mortgage protection insurance, provides a death benefit that decreases at a predetermined rate over the life of the policy while increasing term insurance provides an increasing death benefit (Çipil, 2008, p.74). Another type of term insurance is convertible term insurance that gives right to the insured to change the type of the policy such as to switch to permanent life insurances.

On the other hand, the classical type of permanent life insurances is whole-life insurance. It covers the death risk not only for a specified period of time but irrespective of when it happens. It guarantees only a death benefit for the beneficiary upon the death of the policyholder who pays regular premiums until his death. If, contrary to whole life insurance, the premiums and death benefit are flexible, it is called universal life insurance. The schedule of payments is not set and the growth of cash value is not fixed in this type of life insurance.

Life insurance policies combining risk cover with financial savings are called endowments policies. In traditional endowment policies a part of the premium paid is directed to investment. In an endowment policy, if the policyholder dies, the beneficiary receives the sum assured. But, if the policyholder remains alive on the maturity of the policy, she receives a lump sum payment covering also the saving benefits (Çipil, 2008, p.75). Furthermore, endowment policies can also be surrendered before the maturity and

then the policyholder receives the surrender value. Therefore, while in the previous types of life insurance the policyholder has no chance to receive the sum assured, in endowment policies the policyholder has the chance of receiving lump sum payment at the maturity of the policy or at any time before the maturity.

If the policyholder prefers to receive the payments at regular intervals in the form of pension, then it is called annuities. In an annuity, the insurer agrees to pay the insured a stipulated sum of money periodically after the maturity of the policy.

Life insurance policies with saving component are very important for the long term savings of the household sector and they play a crucial role in the growth of the economy. Premium payments of the policyholders for their life insurance policies are a significant source of investment funds for productive means. Soo (1996, p.2) explains that since the supply of funds for investment is greater than it would be without life insurance, capital is available at a lower cost which will then stimulate more investment and thus bring more production to the economy.

2.1.7.2.2. Non-Life Insurance

Non-life insurance defines all types of insurance other than life insurance. It is also called as “general insurance”, “elementary insurance”, “property-causality insurance” or “property-liability insurance”. The subject matter of non-life insurance can be anything other than the life of a human. Fire, theft and accident are the examples of non-life insurance. The health of a human is also covered by non-life policies.

There are two main lines of non-life insurance. Property insurance is insurance against loss of or damage to property. It is a first party insurance because the insured event causes an immediate and direct loss on the property of the policyholder. The claim payment is made by the insurer to redress the losses and put the policyholder to the same financial situation as before the loss. There are different kinds of property insurance such as fire insurance (generally for stationary property), marine insurance (generally for mobile property such as ships, planes, trains, trucks and their cargoes), accident insurance (generally for motor vehicles), engineering insurances (such as construction all risk

insurance or machinery breakdown insurance), agriculture insurance or insurances against the losses caused by natural catastrophes such as earthquakes, storms or floods.

The second line is the liability insurance which is the insurance against the losses caused by the policyholder to third parties. Liability insurance is a third party insurance because it ultimately aims to protect the interests of third parties injured by the insured's conduct. It covers the expenses of the insured who causes bodily injuries (such as disability, death or deterioration of health) to third parties as well as the financial losses in the properties of third parties (Güvel and Güvel, 2010, p.148). Most of the liability insurances are compulsory in most of the countries. Motor third party liability insurance (traffic insurance) is the classical example of compulsory liability insurances. For instance, traffic insurance as well as third party liability insurance for road passenger transportation, for dangerous materials and hazardous waste, for LPG, sea pollution third party liability insurance for coastal plants and some professional liability insurances are compulsory in Turkey.

Non-life insurance can also be categorized as business insurance and household insurance. Business insurance is the type of insurance that covers large commercial and industrial risks. Household insurance, on the other hand, covers the risks exposed by individual consumers in their everyday life except the risks on their own life. These are called mass risks. It means that they are smaller compared to business risks but much more common.

The risk dynamics of non-life insurance are diverse compared to life insurance. While mass risks (such as car accidents) are fairly predictable and can easily be pooled by an insurer, large risks (such as natural catastrophes) are low-probability but high-impact events and cannot easily be pooled by one insurer (De Haan et al., 2009, p.261). Therefore, large risks are in most of the cases divided among different insurance (coinsurance) and/or transferred to reinsurance companies or to capital markets via alternative risk transfer methods. Public-private partnerships are also developed to cover the losses from these risks.

Similar to life insurance, non-life insurance promotes economic development. Non-life insurance allows individuals and firms to swap uncertain losses with certain costs. Soo (1996) explains that non-life insurance contributes to the growth of the economy by making individuals more comfortable to save knowing that their accumulated wealth is protected against uncertain risks. Acar (2008, p.40) concludes that since reduction in uncertainty will make potential investors less hesitant to invest, higher investments will encourage accumulation of new capital which will then lead to higher economic production.

2.1.8. Reinsurance

Although the law of large numbers makes the insurance feasible, the probability that an event will occur cannot be accurately known. Furthermore, the size of the loss occurred may be far more than the expected loss. It may be difficult for a single insurer to cover especially low frequency events affecting large number of insureds at once, such as catastrophic events. Therefore, insurers need to transfer their risks to keep their financial strength sufficient enough to fulfill their liabilities towards the policyholders.

When one insurer agrees, for a charge, to reimburse another insurer against all or part of the loss, it is called reinsurance. The insurer purchasing reinsurance is known as the ceding company and the company that accepts part or all of the insurance risk from the ceding company is the reinsurance company that is also called reinsurer (De Haan et al., 2009, p.266). Outreville (1997, p. 263) simply defines reinsurance as the transfer of liability from a ceding insurer to the reinsurer. While insurance contracts are signed between private or corporate individuals and insurers, reinsurance contracts are signed between insurers and reinsurers.

Reinsurance reduces volatility and uncertainty which then allows insurers to offer larger limits of protection to the policyholders than their size would allow. It plays a significant role in absorbing the volatility in underwriting results and peak exposures to natural catastrophes in addition to the provision of capacity to the insurance market (Das et al., 2003, p.16). It also enables the insurers to improve their financial power by spreading the risks and thus to improve the efficiency of the insurance sector as a whole.

There are the two major categories of reinsurance namely facultative reinsurance and treaty reinsurance which is divided into proportional and non-proportional reinsurance.

2.1.8.1. Facultative Reinsurance

In facultative reinsurance, the reinsurer is reinsuring one specific risk and each risk is ceded by the insurer to the reinsurer. Facultative reinsurance is negotiated separately for each insurance contract that is reinsured. The choice to accept or reject a risk is of the reinsurer.

It is particularly useful in reinsuring the individual risks that the insurer is unwilling or unable to retain, such as large risks. It can also be used for unusual risks, such as satellites or public free pop music live shows (Outreville, 1997, p.266). As each risk is individually reinsured, the price of the contract accurately reflects the risk level. However, since underwriting, administrative and personnel costs are high due to handling of each risk separately, this type of reinsurance is expensive and time consuming for the insurer.

2.1.8.2. Treaty Reinsurance

In treaty reinsurance, the insurer should cede the risks determined in the contract and the reinsurer should accept all cessions under the terms of the contract. Therefore, contrary to facultative reinsurance, the parties have no right of choice because they agree with the terms and conditions of reinsurance in advance. This type of reinsurance is less expensive and quick to operate.

Kumcu (2009) explains that in literature, treaty reinsurance is divided into two main categories depending on the transfer methods between the insurer and the reinsurer, namely proportional reinsurance and non-proportional reinsurance.

2.1.8.2.1. Proportional Reinsurance

In proportional reinsurance, the insurer cedes a proportion of the premiums and risks to the reinsurer taking a share of each policy under the terms of the contract. The

remainder of the premiums and risks, which is called as the retention amount, is retained by the ceding insurer (De Haan et al., 2009, p.266). The reinsurer pays to the ceding insurer a reinsurance commission to compensate the acquisition and administrative costs of the insurer (Outreville, 1997, p.271).

Proportional reinsurance can be categorized as quota share reinsurance and surplus share reinsurance.

In quota share reinsurance, the insurer cedes to the reinsurer a predetermined portion of each policy it writes. The reinsurer shares the ceded percentage of the premiums written and pays the same percentage for each loss. For instance, 50% quota share reinsurance means that the insurer share half of its written premiums and incurred losses with the reinsurer. Quota share contracts are profitable, simple to administer and there is no adverse selection for the reinsurer. They are mostly used by the insurers operating in a new line of business or in a new foreign market since these insurers would have difficulties to set the premiums due to uncertainties in predicting the losses (Çipil, 2008, p.106).

In surplus share reinsurance, the retention is defined as a monetary amount rather than the fixed percentage principle of quota share reinsurance. The ceding company's retention is called as a retained line. The portion of the risk exceeding the insurer's retained line is reinsured. The number of lines determines the maximum policy limit. For instance, assuming that the retention of the insurer is 10.000 euro, when it writes a policy with a premium level of 20.000 euro, it would cede half of the premiums and losses to the reinsurer. Surplus share reinsurance is mostly used for large commercial and industrial risks. It gives the ceding company the opportunity to determine the retention rate according to the risk level of each line of business. However, Kumcu (2009, p.41) reports that it is complicated and costly because it requires to determine the retention rate for each risk and then to calculate the ceding portion accordingly.

2.1.8.2.2. Non-Proportional Reinsurance

Contrary to proportional reinsurance, non-proportional reinsurance is not risk based but loss based. The reinsurance covers the insurer's losses exceeding a certain

amount of retention. Premiums paid by the ceding company to the reinsurer are not directly proportional to the premiums written by the ceding company because the reinsurer does not assume a direct proportionate risk.

Non-proportional reinsurance can be categorized as excess of loss reinsurance and stop loss reinsurance.

In excess of loss reinsurance, the ceding company and the reinsurer do not share the premiums. Instead, losses of an event exceeding the retention limit of the insurer are paid by the reinsurer up to a certain maximum limit. Kumcu (2009, p.42) gives an example of an insurer which decides to retain the losses up to 2 million euro and purchases an excess of loss reinsurance of 8 million euro. In this case, she explains that losses up to 2 million euro will be covered by the insurer and the excess will be covered by the reinsurer up to 8 million euro. It means that 2 million euro of the total loss of 10 million euro will be covered by the insurer and the remaining 8 million euro will be covered by the reinsurer. The insurer pays a premium to the reinsurer for such a contract and the reinsurer does not pay a commission to the insurer. This type of insurance is mostly used for large catastrophic losses.

In stop loss reinsurance, the reinsurer begins to pay when the ceding insurer's losses for some determined period of time exceed the retention of the insurer. The retention may be determined in terms of monetary value or a proportion of the premium income of the ceding insurer. This type of reinsurance does not cover individual claims due to one event but covers an aggregate amount of claims over a period. Therefore, it protects the cedent against the possibility that the aggregate value of small losses in a particular line of business exceeds its total premium income in this line. Outreville (1997, p.273) describes it as the most effective form of stabilizing the underwriting results of a ceding company since it puts a limit on the ceding company losses.

2.1.9. Role of the Insurance in the Economy

Whereas insurance plays an important and indispensable role in socio-economic life, there is no simple way to measure its economic value since it is an intangible product whose primary role is the control of risk. The monetary value of the premium production

and claim payments has often been used as alternative measures of what the insurance industry produces. Although these are useful indicators of the size of the industry, they fail to reflect the role of insurance in providing investment and risk management, and in contributing to economic growth.

The insurance sector forms a major component of the economy by virtue of the amount of premiums it collects, the increasing contribution it makes to GDP and the scale of its investments (Hussels et al., 2003, p.4). Therefore, a combination of quantitative and qualitative approaches such as the consideration of insurance and economic growth, an assessment of the value of insurance in terms of the output and value added should be examined in order to understand the role of insurance in the economy (Diacon et al., 2005, p.3).

2.1.9.1. Theoretical Point of View

From the theoretical point of view, insurance helps the economic development of a country and fosters economic growth through allowing effective risk management, fostering a more efficient allocation of capital, promoting financial stability, enhancing the efficiency of the financial system, complementing social security programs and providing employment.

In addition, Skipper (1997, p.38) documents that subject to reasonable prudential, market conduct and competition regulation, opening insurance markets to appropriate foreign insurers can lead to greater economic growth and can enhance overall social welfare.

Furthermore, Haiss and Sümegi (2006, p.1) claim that the impact of the insurers on the economic growth will rather grow than decline due to issues such as ageing societies, widening income disparity and globalization.

2.1.9.1.1. Improvement of Effective Risk Management

Harichandra and Thangavelu (2004, p.9) conclude that the key role of the insurers in the economy is the enhancement of risk management through effective risk pricing and pooling. Insurers apply higher prices for riskier exposures and give loans to

individuals which have creditworthiness. As foreign insurers often are part of multinational insurance groups, their risk pooling activities might be particularly helpful for better pricing. Assessment of the risk level and loss potential of the individuals and firms and their appropriate pricing has three benefits for the economy.

First, by gathering and analyzing information about the risk level of the individuals and firms, insurers allocate financial capital and insurance risk bearing capacity to the most attractive firms and projects. Moreover, Skipper (1996, p.19) argues that foreign insurers can often bring innovative and more efficient means of gathering and evaluating information, hence helping capital allocation.

Second, business owners, potential investors, creditors and other stakeholders can use the risk pricing signals of the insurers to make better informed decisions (Skipper, 1997, p.14). These benefits enhance economic efficiency and thus provide growth in the economy.

Third, since insurers are well aware of the risk exposure of their policyholders, they help them reduce their losses. Insurers have the incentive to engage in risk mitigating and loss prevention activities because their claim payments will be reduced when the policyholders take precautionary measures before and after losses. In addition, reduction of the risks exposed by firms through risk mitigating and pooling procedures allows these firms to take additional risks which promote innovation within an economy (CEA, 2006b, p.12).

2.1.9.1.2. Promotion of Financial Stability

At micro level, insurance brings benefits to individuals and firms by helping them minimize the financial impact of the unexpected and adverse future events and organize their lives and businesses with greater certainty (HM Treasury, 2006, p.7).

Insurance provides security to individuals by protecting their wealth from financial losses generated by adverse events. It also provides security to firms to operate with less volatility and risk of failure. This role of insurance will benefit all stakeholders because it avoids the inherent costs associated with bankruptcy and financial distress and

provide them instant liquidity in case of losses (Diacon et al., 2005, p.18). It thus promotes financial and social stability in the society.

Since insurance restores the individuals to their financial position prior to the loss, they do not need to retain as much wealth in liquid savings to protect them against the results of unexpected adverse event. Thus, they can keep spending and purchasing consumer goods which promote economic growth. Similarly, since insurance prevents firms from suffering financial losses or even fail, they do not need to set aside large liquid capital. Thus, they make investments for their firms and R&D activities and increase the level of production which finally leads to economic growth.

2.1.9.1.3. Enhancement of Financial Efficiency

At macro level, insurers enhance the efficiency of the financial system by mobilizing savings to investments. Skipper (1997, p.11) documents the fact that by amassing large funds composed of relatively small premiums received from policyholders and by channeling them towards productive investments, insurers are playing an important role to mobilize savings and to create economies of scale in investments which would otherwise be time consuming and costly. Insurers efficiently invest these amassed funds to meet the financing needs of big and feasible projects, thereby encouraging financial efficiency which will finally create economic growth.

Insurers are also one of the major institutional investors into stock, bond and real estate markets. In particular, life insurers and pension companies are crucial for providing long term savings which are ideal sources of finance for both governments and businesses.

The greater the number of the insurers within a market, the higher should be the national saving rate. From this point of view, locally incorporated foreign insurers can bring additional capacity to the domestic market and hence greater economic development.

2.1.9.1.4. Reinforcement of Social Security Programs

Insurance does not replace but complements the government social security programs. In particular, life and health insurance policies as well as private pension plans relieve pressure on the social welfare system of the country. Since insurance reduces government spending, it can reduce the burden on tax payers and can make for a more efficient allocation of societal resources. CEA (2006b, p.20) notes that through products designed to complement social security programs, the insurance sector contributes significantly to guaranteeing a stable and lifelong level of revenue and to limiting the impact of demographic change on states budgets.

2.1.9.2. Empirical Point of View

While the insurance sector contributes to economic development and growth from a theoretical point of view, empirical evidence is mixed. Outreville (1990) who was one of the first researchers who tested empirically the role of the insurance sector in the economy and found a positive relationship between the non-life insurance sector (in terms of non-life premiums per capita) and the economic growth (in terms of GDP per capita) by investigating the economic significance of non-life insurance sector in developing countries. While the relationship between insurance and economic growth was proven, the direction of causation between them was unclear.

Then, researchers have tested the causal relationship between insurance and economic growth. In fact, the question of whether the financial services sector preceded or followed economic growth has for a long time been debated in the economic history literature. However, compared to empirical research in financial sector in general and specifically in banking and stock markets, insurance sector has been hardly investigated and the existing studies are relatively new.

Patrick (1966) argued that the causation between financial sector and economic growth can be either supply-leading through growth in financial sector or demand-following through growth in the economy. According to supply-leading view, economic growth is generated through the supply of financial services while according to demand-following view, the growth of financial services is the result of the growth of the

economy. Demand-following view implies that the demand for financial services generates growth of financial institutions and their assets (Das et al., 2003, p.8). On the other hand, supply-leading view implies that the creation of financial institutions and their services occurs in advance of demand for them and stimulates the demand for these services (Kar and Pentecost, 2000, p.5).

Applying the theory of Patrick (1966) to the insurance sector, the supply-leading view considers the development of the insurance sector as the precondition for economic growth, while the demand-following view considers the increase in demand for insurance as the result of the growth in the economy.

Ward and Zurbruegg (2000) tried to answer whether the development of insurance was supply-leading or demand-following, an issue which had not been considered by Outreville (1990). They examined the potential causal relationship between economic growth and insurance sector for nine OECD countries and showed that the insurance sector causes economic growth only for some countries of their example due to cultural, regulatory and legal differences across countries. Their study is supported by Harichandra and Thangavelu (2004) who also showed the existence of a long term supply-leading causality effect from insurance to economic growth by examining the relationship between premium income and GDP growth.

However, Kugler and Ofoghi (2005) criticized Ward and Zurbruegg (2000) who found no causality between insurance and economic growth in the UK which is one of the largest insurance markets in the world. Since they attributed this result to the problem of aggregation in the estimations, they investigated the relationship between economic growth and different branches of insurance separately. They found that an increase in the market size of most of the non-life insurance branches in the UK has a positive and statistically significant effect on economic growth.

Since the function and operating principles of life and non-life insurance differ significantly, their relationship with economic growth is investigated separately in most of the studies, but every time with mixed results. While Arena (2006) found robust evidence of a causal relationship from both life and non-life insurance development to

economic growth, Webb et al. (2002) and Haiss and Sümegi (2006) who empirically tested this relationship in European countries found that life insurance sector is important for GDP growth whereas non-life insurance is not significant.

The contribution of the insurance sector to economic growth is also investigated in developing and developed countries separately. While there is a relationship between insurance sector and economic growth both in developing and developed countries, the direction of causality between the two is different in developing and developed countries because they have different levels of financial development. The insurance sector in developed countries offers several specialized products and insurance coverage is important in terms of value and the number of insured. Therefore, Haiss and Sümegi (2006, p.24) see the potential of growth contribution of the insurance sector much higher in high income countries compared to developing countries.

In its S curve hypothesis, Enz (2000) states that insurance consumption is slower at lower levels of development and accelerates as the insurance market and the economy expand. But, after a certain level of development where consumers become so wealthy that they can afford to retain risks and start saving, the insurance consumption decreases, so as its contribution to economic growth.

Arena (2006) found evidence that the contribution of life insurance to economic growth is driven by high-income countries only whereas non-life insurance contributes to economic growth in both high-income and developing countries, but it has a larger effect in high income countries than in developing ones.

The empirical study of Köse et al. (2009) on Turkey having a developing insurance market where the share of insurance premium production to GDP is very small, indicated that there is a relationship between insurance premium production and GDP, but contrary to the findings of the studies on developed countries, they only found one way causality from the growth of the economy to the growth of the insurance sector. Therefore, the study supports demand-following theory which considers the increase in the demand for insurance as the result of economic growth.

2.2. FINANCIAL INTEGRATION THEORY

2.2.1. The Concept of Economic Integration

In order to increase their level of economic development, countries in several parts of the world with different rules and regulations may prefer to cooperate. In order that market players, buyers and sellers, operate freely in all markets, countries may eliminate some of their rules and liberalize their markets and re-regulate them with the rules similar to other markets. This process of economic cooperation between two or more countries thanks to rapidly falling costs of transport and communications is known as international economic integration. Oksay (2006, p.29) argues that the result of this process at macro level is the integration of the countries, known as regionalism, to increase their competitive power and the result at micro level is the integration of companies by way of mergers and acquisitions.

2.2.1.1. Definition of Economic Integration

The term economic integration does not have a clear cut meaning for all economists and definitions in literature differ. It is an evolving and continuing process rather than a limited and finite one. Molle (2006, p.3) points out that in the 1950s and 1960s, the discussion on economic integration was mostly concentrated on international economic relations, in the 1970s and 1980s it spread to the economics of the sectors of economic activity and by 1990s, the establishment of a single market and monetary integration were central to the discussion of economic integration, especially in the European Union which is the most advanced example of economic integration.

Traditional theory of international economic integration was first developed on the theory of customs union suggested by Viner (1950) who explained the redirection of trade flows (trade creation and trade diversion) after the establishment of a customs union between two states.

One of the first definitions of economic integration was given by Tinbergen (1954, p.122) who defined it by the terms negative integration and positive integration. He defined negative integration as the removal of discriminations and restrictions on free

movement of economic transactions and positive integration as the replacement of existing instruments and institutions with the new ones in order to enable the market to function effectively and to successfully implement the policy objectives of the integrated area (Robson, 1998 p.2). He also emphasized that although both forms of integration were necessary for a full integration, it was easier to begin the process with negative integration such as removal of trade restrictions, and then to continue with positive integration covering issues of national sovereignty such as the introduction of new institutions and common policies.

Balassa (1961, p.1) defined economic integration as a process and as a state of affairs. As a process, which is a dynamic concept, integration means the removal of discrimination between different national states, while as a state of affairs, which is a static concept, it means the absence of various forms of discrimination between national states.

In line with Tinbergen (1954) and Balassa (1961), El-Agraa (2007, p.1) referred economic integration to the removal of all trade barriers between at least two countries and to the establishment of certain elements of cooperation and coordination between them. However, Jovanovic (2006, p.19) criticized this definition by stating that it only partly covers free trade areas and customs unions but not the more advanced type of economic integrations.

Molle (2006, p.4) defined economic integration as the gradual elimination of economic frontiers between two or more countries. In the dynamic sense, economic integration is a process where economic frontiers between member states are gradually eliminated and national economic entities gradually merge into a larger whole and in the static sense, it is the situation in which national components of a larger economic zone function together as one entity. However, the idea of gradual establishment of economic integration is criticized by Jovanovic (2006, p.18) who states that the integration may not always be gradual as in the case of European Free Trade Area (EFTA) countries which applied the *acquis communautaire* of the EU immediately after they established the European Economic Area (EEA) in 1994 with the EU Member States.

On the other hand, Machlup (1977) claimed that complete economic integration requires the equality of prices of similar goods and services in every country of the integrated area. Therefore, economic integration means that all means of production in the integrated area which are both perfectly mobile and substitutable for one another have the same prices. Transportation costs as well as the production and consumption patterns in different countries of the integrated area are not taken into consideration in this definition.

Jovanovic (2006, p.20) states that today, international economic integration mostly refers to an increase in the level of welfare since, it is seen as one of the tools for economic development in the developing countries whereas it is seen to be a way of using the most profitable technologies and fostering free and fair competition in the developed countries.

2.2.1.2. Levels of Economic Integration

There are several factors facilitating economic integration between countries. The first one is geographical proximity. Language, historical and cultural similarities as well as transportation costs may be the underlying factors behind the integration of neighbor countries. The EU composed of European countries, NAFTA composed of North American countries and ASEAN composed of Southeast Asian countries are the examples of the integration of neighbor countries.

The economic systems which are alike between countries facilitate the formation of economic integrations. During the cold war, COMECON was an example of such integration between socialist countries whereas EEC was an example of integration between capitalist ones. When the level of development between countries is similar, the establishment of an economic integration can also be relatively easier. EFTA may be considered as an economic integration between developed countries while CACM is an example of the integration between developing countries from Central America.

Behind all these regional economic integrations there may be several common geographical, historical, cultural and more importantly economic motivations but the

level of economic integration differ both between the integrated areas and within the specific integrated area through time.

Balassa (1961) identified five main stages of integration namely free trade area, customs union, common market, economic union and total economic union, from a simple non-tariff trade system to a system with all relevant economic policies conducted at the supranational level. The process of integration should not necessarily be gradual from one type to another. The establishment of any of these types depends on the agreement among the participating countries (Jovanovic, 2006, p.23).

2.2.1.2.1. Free Trade Area

In a free trade area (FTA), all tariffs and quantitative restrictions on trade among the member countries are eliminated. But, each member has the right to determine its own external tariff against third countries. Since members maintain their own tariffs and quotas, third countries outside the FTA may redirect their trade to the country with lowest tariff to access the markets of the other member countries of the area. This is why the rule of origin has been implemented in order to prevent the import of goods from third countries into the FTA by the country which has relatively a lower tariff than other members of the area. The European Free Trade Association (EFTA) which was established in 1960 and North American Free Trade Agreement (NAFTA) which was established in 1994 are the examples of FTA.

2.2.1.2.2. Customs Union

In customs union, not only all tariffs and quantitative restrictions on trade among member countries are eliminated but also a common external tariff on imports from third countries is introduced. Members of the customs union have a common commercial policy because they take part in international trade negotiations as a single entity. Customs Union also requires a greater level of institutional coordination and thus it frequently results in the creation of common regulatory bodies and institutions which control trade within the union (Rodriguez-Pose, 2002, p.8). Zolverein established between German states in the first half of 19^{th} century is one of the first examples of customs union (Oksay, 2006, p.107). The EU gradually completed its target of the Rome

Treaty of having a customs union among its Member States in 1968. The current customs union between the EU and Turkey that was envisaged by an Association Agreement in 1963 and that was established with the decision no 1/95 of the Association Council is also an example of this type of economic integration.

2.2.1.2.3. Common Market

In a common market, also known as internal market or single market, there is not only a customs union among member countries, but also free mobility of all factors of production, such as free movement of capital and labor, in addition to free movement of goods and services. Members of the common market create an internal market with free movement of goods, services, capital and persons, and have common external policies on both products and factors against third countries (Molle, 2006, p.11). With the Single European Act inaugurated in 1986, the EU realized its purpose of establishing a common market based on four freedoms of movement in 1993. Central American Common Market (CACM) established in 1958 is the oldest example of integration between developing countries.

2.2.1.2.4. Economic Union

In an economic union, common market among member countries is complemented with a harmonization on economic and social policies such as competition, industrial, regional or transport policies, as well as macro-economic policies. Common policies on trade, production of factors and economic sectors are also pursued against third countries.

Economic union becomes an economic and monetary union (EMU) with the introduction of a single currency circulating in all member countries. Members introduce a central authority to exercise control over the monetary policy of the region. It also requires a high degree of coordination of national macro economic and fiscal (budgetary) policies. Denmark, Sweden and Norway established Scandinavian Monetary Union in 1873 to facilitate trade between them and used krone as the single currency until 1914.

With Maastricht Treaty in 1992, the EU decided to establish an economic and monetary union from 1999 onwards with the establishment of European Central Bank (ECB) and the introduction of euro as a single currency. EMU has been in effect since 2002 and as of 2010, 16 Member States of the EU are members of the eurozone.

2.2.1.2.5. Total Economic Union

Total economic integration, also called a political union, is the final stage of the integration process and encompasses the integration in economics. It assumes the establishment of a single economic policy and requires unification of budgeting, taxation, social security and foreign policies. In this final stage, independent economic policies of individual states are completely superseded by a supranational federal authority whose decisions are binding for the members.

De Grauwe (2007, p.116) claims that political union affects the optimality of an economic and monetary union because first it makes it possible to centralize national budgets at the union level in order to organize automatic fiscal transfers in case of asymmetric shocks, and second it reduces the risk of asymmetric shocks having a political origin, such as decisions on tax, social security and wage policies. The United States of America and the unification of Germany in 1990 are the examples of political union.

Table 1 summarizes the characteristics of each stage of economic integration. Total economic union is the final stage which covers all of the necessary features that a typical economic integration process requires.

Table 1: Stages of Economic Integration

Stages of Economic Integration	No tariffs no quotas	Common external tariff	Free movement of factors of production	Common economic and social policies	Single currency	Federal authority
Free trade area	Yes	No	No	No	No	No
Customs union	Yes	Yes	No	No	No	No
Common market	Yes	Yes	Yes	No	No	No
Economic union	Yes	Yes	Yes	Yes	No	No
EMU	Yes	Yes	Yes	Yes	Yes	No
Total economic union	Yes	Yes	Yes	Yes	Yes	Yes

Source: own Table

As can be seen from Table 2, the level of economic integration in the EU has evolved since its creation in 1958. It can be considered as an economic and monetary union and has made big steps since 1990s and especially with Lisbon Treaty in 2009 towards political integration but it is still too far away from being a total economic and political union.

Table 2: Stages of Economic Integration in the EU

Level of Integration	Main features	Period
Free trade area	Free trade without tariffs and quotas	1958-1968
Customs union	Free trade area with common external tariff	1968-1993
Common market	Customs union and free movements of factors	1993-1999
EMU	Economic union with single currency	1999-today
Total economic union	Political union with completely unified economic policy	Not yet achieved

Source: own Table

2.2.2. The Concept of Financial Integration

Financial integration is part of the broader process of economic integration between countries. More recently, researchers emphasize the role of real and financial markets and define economic integration in terms of goods and services market integration, capital market integration and foreign exchange market integration (Oxelheim, 1990, p.2). In the EU, after the realization of the common market in 1993, with the introduction of euro and launch of Financial Services Action Policy (FSAP) in 1999 in order to create European single financial market, financial integration has become a hot topic and researchers have begun to define, analyze and measure the integration of different financial markets.

2.2.2.1. Financial Markets

A financial market is a market where individuals buy and sell negotiable instruments representing a financial value, such as securities and commodities. In financial markets, funds are channeled from those with a surplus, who buy securities, to those with a shortage, who issue new securities or sell ones (De Haan et al., 2009, p.65). A financial market can be seen as a set of arrangements that allows trading among its participants.

Financial markets are composed of different markets with different characteristics. Money markets are mainly divided into primary money markets composed of inter-bank markets and secondary money markets composed of cash markets, markets for short term interest rate derivatives and markets for short term securities. Cash markets which provide short term debt financing usually with maturity up to one year are composed of unsecured deposit market without collateral, secured repo market with collateral and foreign exchange swaps. Derivative markets include interest rate swaps, futures and options whereas markets for short term securities include treasury bills, private securities and certificates of deposits issued by banks.

On the other hand, capital markets which consist of bond markets (both government and corporate bonds) and stock markets provide long term financing. These markets use various financial instruments which are documents representing a monetary value.

2.2.2.2. Financial Intermediaries

Financial intermediaries (institutions) are the agents who provide financial services to bring together those economic agents with surplus funds who want to lend with those with a shortage of funds who want to borrow.

Financial intermediaries include banks, brokers, insurers, reinsurers and pension funds. A bank is a financial intermediary that accepts deposits from customers and channels them into lending activities. A broker is a company that trades securities on behalf of its customers. Insurance and pension companies facilitate the redistribution of various risks and provide long term financing. Insurance intermediaries consist of agents and brokers. An insurance broker finds appropriate contracts of insurance on behalf of its customers, whereas an insurance agent acts as a local representative of the insurer.

2.2.2.3. Financial Systems

Financial systems where households, firms and governments obtain funding for their activities and invest their savings are composed of financial markets and financial intermediaries. Therefore, through a financial system, financial intermediaries operating

in different financial markets can channel funds from sectors that have a surplus to sectors that have a shortage. Since the financial system transforms household savings into funds available for investment by firms, having a well functioning financial system that directs funds to their most productive uses is a crucial prerequisite for economic development (De Haan et al., 2009, p.5).

Financial systems may differ between countries. European and Japanese financial systems are bank-based where banks play a leading role, while the financial systems in the US and the UK are market-based where securities markets have a greater role. Kunt and Levine (1999, p.5) found that there is a certain tendency for national financial systems to become more market oriented, as they become richer and that Anglo Saxon countries with Common Law tradition tend to be more market-based. Taking into account the share of banks in the financial sector, the continental European financial system is said to be bank-based. However, Hartmann et al. (2003, p.185) claim that the continental European system is no longer bank-based in the same way as it was in the past because traditional business of credit institutions is in decline compared to other intermediaries, such as investment funds, pension funds and insurance companies.

Both bank-based and market-based financial systems can and should both live together. Economists consider the advantages of bank-based systems as mobilizing savings, identifying good investment decisions and exerting sound corporate control, and the advantages of market-based systems as allocating capital, providing risk management tools and mitigating the problems associated with excessively powerful banks (Levine, 2002, p.398).

2.2.2.4. Definition of Financial Integration

The term financial integration should not be confused with the term economic integration comprising the elimination of restrictions on free movement of all economic transactions. Economic integration is a broader term comprising of both real market and financial market integration.

Financial integration should not be confused with financial globalization either. The two concepts are closely related to each other, but financial globalization refers to

rising global linkages through cross-border financial flows whereas financial integration refers to an individual country's linkages to international financial markets (Prasad et al., 2003, p.7). Financial integration is the process through which a country's financial markets become more closely integrated with those in other countries or with those in the rest of the world (UNECA, 2008, p.120).

Furthermore, financial integration refers only to the integration of financial markets and not to the financial systems. Baele et al. (2004) argue that it has nothing to do with the convergence of bank-based or market-based financial systems of different countries.

There is no unanimous definition of financial integration in literature. In a general sense, it is defined as making formerly regionally separate financial markets work as a single integrated market. The most commonly used definition of financial integration is offered by Baele et al. (2004, p.6). They argued that the market for a given set of financial services is fully integrated if all potential market participants with the same relevant characteristics (1) face a single set of rules when they decide to deal with those financial services, (2) have equal access to those set of financial services and (3) are treated equally when they are active in the market.

This definition has two implications. First, financial integration is not about removing financial market frictions but is concerned with the symmetric or asymmetric effects of existing frictions on different areas (Baele et al., 2004, p.6). If the existing frictions affect different markets symmetrically, it can be considered that the markets are integrated. Second, the two markets are said to be integrated if there are no barriers that discriminate economic agents in their access to and investment of funds within that area on the basis of their location (Hartmann et al., 2003, p.190). So, in case of the access to foreign markets, if there is no discrimination among comparable financial intermediaries based on their location, it can be considered that the markets are integrated.

In financial economics, financial markets are considered to be integrated when only common risk factors are priced (Cappiello, 2006, p.7). Following the definition of Baele et al. (2004), financial markets are said to be integrated when financial instruments

with identical cash flows command the same price, regardless of the domicile of the issuer and of the asset holder (Yin and Huang, 2006, p.1).

For the purpose of this study, the existence of a single set of rules for all insurance market players, equal access to insurance services and equal treatment of insurers when they are active in a foreign market will be used as indicators of legislative harmonization of the insurance markets of the EU Member States. While legislative harmonization is a prerequisite for the establishment of an integrated single market, it cannot be sufficient for full integration. Therefore, financial integration in practice will refer to the sufficient use of freedom of services (FOS) and freedom of establishment (FOE) by financial intermediaries (insurers) and consumers (policyholders) within the European single insurance market.

2.2.3. Types of Financial Integration

A group of countries would decide to integrate their financial markets by eliminating the restrictions on cross-border financial services. The aim of the integration is to attract foreign participation from financial intermediaries within the region and from the rest of the world since the same effort made by each individual country is likely be less effective. Integration of financial markets can be established through formal agreements among countries in several different ways.

2.2.3.1. Direct, Indirect and Total Integration

Oxelheim (1990, p.4) classifies financial integration into three forms, namely direct, indirect and total financial integration. Direct financial integration refers to deviations of financial instruments from the law of one price. It means that investors expect the same return on investments from similar financial instruments in different markets. He explains that if the differential in expected risk-adjusted returns on investment is greater than zero but less than the transaction cost, it means that the markets are not integrated. In indirect financial integration, he explains that the influence on one market is exerted indirectly by other markets and that the return on investment in one country is indirectly linked to the return on investment in other countries.

Oxelheim (1990, p.5) refers total (perfect) financial integration to the integration encompassing both direct and indirect integration. It implies that real foreign exchange rates and interest rates are the same in all markets. He explains that if total integration is global, then the world would consist of one financial market composed of perfectly linked national financial markets under strict purchasing power parity.

2.2.3.2. Vertical and Horizontal Integration

United States Agency for International Development (USAID) classifies financial integration as vertical integration and horizontal integration. Vertical integration refers to integration between domestic and international financial markets while horizontal integration refers to financial markets in which market interest rates array around a basic reference rate which is typically the market rate of a short-term and low-risk financial instrument such as inter-bank rate. Over time, integration with international financial markets will narrow the differences in the cost of funds between markets in different countries and between different instruments (USAID, 1988, p.5).

2.2.3.3. Scale and Scope Integration

Yin and Huang (2006, p.1) refers to scale integration and scope integration. In microeconomics, economies of scale refers to the cost advantages that a business obtains due to increasing or decreasing the scale of a single product whereas economies of scope refers to efficiencies associated with increasing or decreasing the scope of marketing and distribution of different product types. Following these definitions, they give the example of mergers and acquisitions (M&A) of similar financial intermediaries for scale integration and the example of M&A among different financial intermediaries such as banks and insurers for scope integration.

2.2.4. Measurement of Financial Market Integration

Financial market integration can be measured directly or indirectly. Direct measurement refers to the identification of regulatory and supervisory barriers to financial integration. However, Giannetti et al. (2002, p.15) emphasize that even if all regulatory barriers were eliminated in financial markets as far as possible, some

remaining deeper-seated differences in the rules of different countries would still prevent full financial integration.

On the other hand, indirect measurement relates to the observable consequences of existing barriers. In the literature, there are three broad categories of indirect financial market integration measurement, namely price-based, news-based and quantity-based.

2.2.4.1. Price Based Measures

Price-based measures test the validity of the law of one price by looking at the differences in price or returns of financial instruments caused by their geographic origin (Bruno and De Bonis, 2009, p.4). The law of one price means that financial instruments with identical cash flows and similar risk factors should have the same price and return, independent of the location (Baltzer, Cappiello, De Santis and Monganelli, 2008, p.7). Therefore, in order to analyze the integration level of financial markets, price or yield comparisons can be made only if the assets have identical cash flows and risk characteristics.

In literature, two measures of convergence based on the law of one price have been mostly used. One of them is sigma convergence which identifies the degree of integration for a particular period of time. It captures the differences between the yields on identical assets in different countries at a given time. For instance, it measures whether or not interest rates have become more similar over time when compared to each other or to a benchmark rate. On the other hand, beta convergence identifies the speed of integration. For instance, it measures the speed of convergence of national interest rates. A negative beta coefficient signals the existence of convergence and the higher the absolute value of the beta coefficient, the higher the speed of convergence (Komarek et al., 2009, p.3). These two methods based on the law of one price are often criticized to disregard the presence of market frictions and transaction costs (Kleimeier and Sander, 2005, p.6).

In literature, another widely used empirical method to test the law of one price and the co-movement of prices, interest rates or asset returns across countries is the cointegration analysis. It is also criticized for being a restrictive method since it does not

take into account the impact of transaction costs and market frictions that restrict the adjustment of interest rates towards long run equilibrium (Balke and Fomby, 1997 in Poghosyan, 2009, p.260).

The more the individual segments of the financial markets of countries become integrated, the more financial asset prices are affected by global (i.e. European) factors associated with symmetric shocks rather than by local (i.e. national) factors associated with asymmetric shocks (Komarek et al., 2009, p.2).

In money markets, comparable assets with identical cash flows and similar risk factors permit the measurement of price differences as an indicator of the degree of integration (Ferrando and Vesala, 2005, p.58). For instance, to find out the level of integration in the inter-bank market, the mortgage market or the short-term corporate loan market in the EU, banking interest rate differentials for cross country credit transfers may be analyzed (Yin and Huang, 2006, p.2).

In government bond markets, the degree of integration can be measured by using yield differences relative to a benchmark, such as German government bonds which are considered to be risk free. However, in corporate bond markets, the degree of integration cannot be measured by yield differences relative to a benchmark as in the case of government bond markets since corporate bonds are not homogeneous enough and have different characteristics such as credit rating, liquidity and cash flow structure.

Equity markets become more integrated if the country specific factors in equity returns decrease while the sector specific factors increase in importance. It means that the price differentials in equities are explained by sectoral factors rather than country factors. Therefore, the measurement of equity market integration by the law of one price gives the relative importance of the cross-sectional standard deviation in sector vis-à-vis country index returns (Ferrando and Vesala, 2005, p.58).

Price-based measures are particularly preferred because data are more accurate. They also allow for a more straightforward interpretation and are able to reveal long-term trends (Kleimeier and Sander, 2005, p.5). However, they do not take into account the transaction costs or any other market entry barriers.

2.2.4.2. News Based Measures

The law of one price holds for news based measures as well. In integrated markets, expected returns on assets with the same risk characteristics from different countries should depend on common news rather than local news. Therefore, markets are considered to be fully integrated when local shocks are moved away and prices are mainly explained by common risk factors. In a financially integrated area, portfolios should be well diversified so that news of a regional character have little impact on prices, whereas common or global news are relatively more important (De Haan et al., 2009, p.112). In case of non-integrated financial markets, local news may continue to influence asset prices to a great extent.

Under news based measures, price movements of benchmark assets are used as a proxy for common news. For instance, to measure the integration of government bond market, a German 10-year government bond yields may be used as a proxy for global news. Its yield should react mainly to common euro area news rather than purely German factors and government bond prices of other countries should all react to common news factors the same way the German benchmark bonds do (Baele et al., 2004, p.18). In equity markets, the returns on similarly risky assets should only react to common factors across the integrated area rather than purely local news.

2.2.4.3. Quantity Based Measures

Although price-based measures are considered as the best indicators showing the existence of financial integration despite its deficiencies, given the substantial heterogeneity of many financial services, price-based indicators are not always possible to use. Furthermore, measures of financial integration based on price similarities or differences may be misleading in some financial sectors, such as insurance, due to their own differing product characteristics in each country.

Therefore, quantity-based indicators should necessarily be used as a measure of integration to replace or complement price based indicators. Quantity-based measures quantify the effects of frictions on the demand for and supply of investment opportunities (Bruno and De Bonis, 2009, p.4). As such, among many others, Spiegel (2009, p.754)

considers the changes in the volume of cross-border activities as an alternative measure of financial integration.

First, following the supply side point of view, cross-border presence of foreign financial intermediaries in local markets can be used as a sign of financial integration. As financial markets become more integrated, the nationality of a financial intermediary and a customer becomes less important. Quantity based indicators include the importance of foreign financial intermediaries in terms of the number and production of foreign financial intermediaries operating in domestic markets and of the share of assets and liabilities held by them (Yin and Huang, 2006, p.2). For instance, if the share of the investment of an EU Member State in other EU Member States increases relative to that of the rest of the world, this suggests an enhancement in financial integration (Baltzer et al., 2008, p.10).

Cross-border branching by financial intermediaries may provide opportunities for domestic users such as wide range of cheaper and more quality products. However, Ferrando and Vesala (2005, p.58) claim that these quantitative measures need to be interpreted prudently, because an entry by a foreign financial intermediary via the purchase of an existing local intermediary does not necessarily imply the integration because the acquired intermediary may continue to operate as before in the local market without resulting in price convergence at the end.

It is important to note that foreign branches of financial intermediaries do not have competitive power in retail financial markets against domestic players which enjoy competitive advantages due to their widespread distribution network. Therefore, the most effective way of accessing the retail markets is mainly through mergers with or acquisitions of local financial intermediaries. Thus, the number and value of cross-border M&A may constitute a useful indicator of foreign presence in domestic markets. However, this should be interpreted prudently as M&A are mostly the result of the financial deregulation and globalization rather than the regional integration through establishing single financial markets.

Second, following a demand side point of view, the portfolio composition of financial intermediaries can be used as a sign of financial integration. The portfolio composition according to domestic-foreign composition of financial assets provides a quantitative measure for the degree of integration. In this context, home bias implies that domestic investors hold larger proportion of their wealth in domestic assets than the standard portfolio theory would suggest (Ferrando and Vesala, 2005, p.57). Home bias is the degree to which agents invest in domestic assets even though risk is shared more effectively when foreign assets are held (Baele et al., 2004, p.21). A decrease in home bias towards domestic assets shows an increase in financial integration. When financial markets are perfectly integrated, home bias is expected to be totally disappeared.

To measure home bias, the share of foreign assets over total assets should be calculated. For instance, the increasing share of assets invested in equity funds with a cross border investment strategy or the increasing portfolio diversification across borders by financial intermediaries such as pension funds and life insurance companies acting as institutional investors indicate an increase in financial integration. The indicator of home bias proposed by Adam et al. (2002, p.17) is the share of foreign assets and liabilities held by national banks of each country benchmarked against those that banks would hold if they lent to all countries in proportion to the relative size of the corresponding credit market.

2.2.5. Benefits of Financial Integration

In a broader sense, the benefits of financial market integration can be examined from macro-economic point of view (growth effects of financial integration) and from consumer point of view (consumer benefits of financial integration).

2.2.5.1. Macro Economic Benefits

Financial integration leads to growth of the economies of the countries in the integrated area. It is theoretically and empirically argued that financial integration indirectly leads to economic growth through financial development. Whereas significant effects of financial development on growth are well documented in several theoretical and empirical studies, the evidence of the effect of financial integration is mixed.

Beckmann, et al. (2002, p.3) argue that the removal of obstacles in cross-border financial activities is a prerequisite of higher growth rates and reduced unemployment since the integration level of financial markets is an important determinant of financial development which in turn generates economic growth. Therefore, if it is proven that financial integration leads to financial development, then it can be concluded that financial integration provides economic growth by generating financial development.

2.2.5.1.1. Effect of Financial Development on Economic Growth

In the literature, both theoretical reasoning and empirical evidence suggest a positive relationship between financial development and economic growth. As described by Levine (1997), financial markets and intermediaries (1) facilitate risk management, (2) allocate resources, (3) monitor investments and improve corporate control, (4) mobilize savings and (5) facilitate the exchange of goods and services. The development of efficient financial markets and intermediaries reduce transaction and information costs by providing these five functions which increase economic growth through capital accumulation and technological innovation.

First, financial markets help reduce information and transaction costs by efficiently managing risks through pooling. By pooling the funds of various small savers, large and high return investment projects can be financed. Without financial markets, funds would only be used for liquid and low return projects. Besides reducing liquidity risk, they can also mitigate risks by diversifying them between sectors, regions or countries. Therefore, through the elimination of liquidity risk and diversification of risks, financial intermediaries can increase investment in the high return, illiquid assets and accelerate growth.

Second, financial markets allocate resources more efficiently. Without financial markets and intermediaries, individuals may not have the time nor the capacity to collect and process information and thus would be reluctant to invest (Levine, 1997, p.694). Due to high information costs, they would prefer to withhold their savings and do not invest in projects they have little information. Therefore, Greenwood and Jovanovic (1990) claim that financial markets and intermediaries that are better at screening viable firms and

managers will stimulate a more efficient allocation of scarce resources and consequently faster growth. In line with this claim, De Haan et al. (2009, p.9) indicate that financial markets lower the cost of channeling funds between borrowers and lenders, which allocate resources for other purposes, such as investment and innovation. London Economics (2002, p.5) further explains that the improved allocation of financial resources to investment projects impacts economic growth also through higher investment in human capital, physical capital and R&D.

Third, financial markets and intermediaries closely monitor investments and exert corporate control. Levine (1997, p.696) demonstrates that besides reducing the costs of acquiring information *ex ante*, financial markets and intermediaries mitigate the information acquisition and enforcement costs of monitoring managers and exerting corporate control *ex post*. Therefore, by lowering monitoring costs and providing corporate control, they direct the capital to more efficient and profitable investments which in turn promotes growth.

Fourth, financial markets and intermediaries mobilize savings in a better way, which is a costly procedure for individual savers due to transaction and information costs. They can pool the savings of many individuals in a more efficient and effective way. Their better savings mobilization function provide capital accumulation that promote economic growth by increasing savings, exploiting economies of scale and overcoming investment indivisibilities (Levine, 2004, p.22). The function of better mobilization of savings also promotes the use of better technologies by effectively mobilizing resources for profitable and efficient projects and thus encourages economic growth.

Finally, financial markets and intermediaries facilitate product specialization by increasing the number of transactions due to their role in reducing the transaction costs. More specialization will at the end promote the exchange of goods and services and leads to productivity gains. Moshirian (2004, p.275) argues that increasing differentiation and innovation of financial products would in turn contribute to an increase in welfare.

Economic growth can be either supply-leading through growth in financial development or financial development can be demand-leading through economic growth

(Ward and Zurbruegg, 2000, p.490). Beside theoretical arguments, several empirical studies document that there is a causal supply-leading relationship running from financial development to growth.

While many gaps remain, cross-country investigations (King and Levine, 1993; Beck et al., 2000), industry-level studies (Jayaratne and Strahan, 1996); Rajan and Zingales, 1998), firm-level studies (Kunt and Maksimovic, 1998) and time-series studies (Rousseau and Wachtel, 1998) point that financial development has a large, causal effect on long-run economic growth.

The relationship between financial development and economic growth in Europe is empirically confirmed by Oks (2001) but he cannot find a clear causal relationship for all Central and Eastern European countries in his sample. Financial development and economic growth relationship is examined also for Turkey over the period of 1970-2004 in the study of Aslan and Küçükaksoy (2006). Granger causality test results show that financial development leads to economic growth and support the supply leading hypothesis for Turkey.

2.2.5.1.2. Effect of Financial Integration on Financial Development

The link between financial integration and financial development is of the utmost importance, as there is strong evidence that financial development is linked to economic growth (Baele et al., 2004, p.8). Therefore, the question of how financial integration affects financial development is the preliminary question for assessing the effects of financial integration on economic growth.

Financial integration promotes financial development of the less financially developed countries by providing the entry of the more efficient financial intermediaries from the more financially developed markets. The entry of the efficient financial intermediaries of the more developed financial markets to the less developed financial markets will first of all provide new technologies as well as a wide range of higher quality and cheaper products. For instance, enhancing the availability of cross-border insurance products will at the end improve financial market participants' ability to insure and the range of insurance products will be increased (Fecht et al., 2007, p.1).

Second, financial integration brings more efficient, easier, cheaper and diversified investment opportunities to the firms of the less developed financial markets. More productive investment opportunities will then reallocate the funds to the most productive investments (De Haan et al., 2009, p.109).

Third, it increases the efficiency by stimulating competition in domestic markets (Levine, 2001, p.697). This will reduce cost of intermediation in the countries with less developed financial markets. Japelli and Pagano (2008, p.6) conclude that financial integration expands less developed financial markets since competitive pressures from more sophisticated and lower-cost foreign financial intermediaries drive down the cost of financial services for firms and households. London Economics (2002, p.9) also argues that decreasing costs allow investors to rebalance their portfolios more efficiently and increase rates of return net of transaction costs by stimulating the demand for financial services, thus the size of the less developed financial markets.

Finally, Beckmann, et al. (2002, p.5) argue that financial integration does not only affect the size and efficiency of the financial market but also its structure by improving national regulatory systems of the less developed financial markets. The process of integration requires adopting the best-practice regulations of the developed financial markets in the areas such as financial supervision, accounting standards and corporate governance. Masten et al. (2008, p.299) point out that improvements in the regulatory and institutional framework will at the end enhance the overall stability of the financial markets and reduce problems of asymmetric information and thus boost the growth of the economy.

To sum up, by intensifying competition, improving efficiency, reducing costs and increasing the size and quality of financial services, financial integration spurs financial development which generates growth for the economy.

Beside the well documented theoretical ground of the effect of financial integration on economic growth, the results of the few empirical studies and quantification efforts of growth effects of financial integration are mixed although most of them find a causal relationship between financial integration and growth. For instance,

Prasad et al. (2003) and Masten et al. (2008) find that there is a positive effect of financial integration on growth but arises only when financial integration is combined with an appropriate institutional framework.

Cecchini Report (1988) tries to quantify the effects of financial integration for the first time and claims that it can increase the European income by about 1,5% over a six-year period. A more recent study for the European Commission by London Economics (2002) shows that the reduction in transactions and capital costs associated with integrated financial markets can increase the EU GDP by 1,1% in the long-run. IN addition, Heinemann and Jopp (2002) estimate the potential effect of financial integration on the EU GDP as around EUR 40 billion.

Giannetti et al. (2002, p.2) find that the growth effect of financial integration is 1% per year for Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, Portugal and Spain. The effect is much smaller in the Netherlands, Sweden and the UK being the most financially developed Member States. In line with them, Guiso et al. (2004) conclude that further financial integration in the EU will yield a significant growth dividend not only in the old Member States but especially in the new Member States from Central and Eastern Europe (CEEC).

These findings are also in line with theoretical arguments stating that the growth effect of financial integration is higher in less developed countries. Giannetti and Ongena (2005, p.5) remind that the neoclassical theory predicts that financial integration can foster growth in developing markets since it permits capital from rich countries to be invested in economies with low savings but high growth opportunities. Guiso et al. (2004, p.4) argue that financial integration is likely to spur the efficiency of the financial intermediaries and markets of less financially developed countries by reducing the cost of financial services to their firms and households and by improving their regulatory standards which promote the development of their financial markets.

Moreover, Heinemann and Jopp (2002, p.31) highlight that consumers in developing countries of the integrated area would also tend to benefit more from further integration than consumers in financially developed countries since cross border contacts

between financial intermediaries and consumers widen the product choice for consumers in financially less developed countries while large economies already attract more foreign suppliers even without financial integration.

Since financially less developed countries are likely to benefit most from financial integration, it is important to understand why financially leading countries do not oppose the integration. Guiso et al. (2004, pp.28-29) list two possible reasons why financially developed countries support integration even more than financially less developed countries. First, even though their manufacturing industry does not benefit from financial integration, their financial industry actually gains from integration by benefiting from widening opportunities. Second, enhanced competition and economies of scale in financial intermediation stemming from integration can be beneficial only for relatively more competitive and efficient financial markets of the integrated area.

2.2.5.2. Consumer Benefits

Financial integration is not only beneficial for financial intermediaries and the economy as a whole, but also for the consumers of financial products. In an integrated financial market, consumers have first the benefit of choosing the most efficient financial service provider from a wide range of financial intermediaries. They also have increased product alternatives and have the chance to choose the product that suits them best from a wide range of financial products. The increased competition resulting from integration increases the pressure on the price of financial products of a given quality. Therefore, with the integration, consumers have the possibility to reach a wide range of cheap but high quality financial products.

Furthermore, individuals having more frequent contact with foreign financial intermediaries of the integrated area will be more aware of the characteristics of foreign assets. So, they will have the possibility to make more efficient investments and diversify their investment portfolio rather than having a portfolio restricted only to their national assets. Not only private investors in financial products but also buyers of financial products will benefit from the portfolio diversification benefits of the financial market integration.

Skipper (1997) lists some additional consumer benefits of financial integration such as improvements in customer service and beneficial domestic spillovers of the integration, such as additional and high quality employment and societal loss reduction.

The integration of each financial market has its own benefits. For instance, integration of national insurance markets offers benefits to both buyers (policyholders) and sellers (insurers) of insurance. European Commission (2007a, p.44) identifies the benefits for insurers such as increased risk diversification, a wider area for investing assets and economies of scale, and the benefits for policyholders such as wider choice of insurance suppliers, broader choice of insurance products and lower prices.

2.2.6. Costs of Financial Integration

Even though it is generally accepted by scholars that the benefits of financial integration outweigh the implied costs, financial integration may also be harmful under certain conditions. Baele et al. (2004, p.9) point out that financial integration may not always lead to higher welfare for all agents and may not be beneficial for all the integrated areas when the areas with structurally different financial systems decide to integrate their markets.

Agenor (2001, p.19) argues that the entry of foreign financial intermediaries, which have lower operational costs, can create pressures on less competitive and less profitable domestic providers to merge in order to remain competitive and thus increases concentration. Foreign intermediaries, by using their power of economies of scale based on their large size and of economies of scope based on their multi-product offerings and their multi-country operations would make local operators disappear and would then dominate the market at the disadvantage of the local consumers (Skipper, 1997, p.23). Therefore, the integration has the risk of the elimination of domestic market operators and the creation of financial conglomerates that are too big to fail and that would reduce the overall efficiency of the financial sector due to their monopoly power in the market. They would also service the market selectively. For instance, they would prefer to operate only in the most profitable line of businesses. Moreover, mergers and acquisitions cannot lead to broad range of cheap and innovative products if the financial

conglomerate chooses to continue the operations of the acquired domestic company as it was before the acquisition.

Giannetti et al. (2002, p.52) claim that financial integration inevitably creates some losers in both financially developed and less developed countries. In countries that are less financially developed, financial intermediaries which are afraid of losing their monopoly rents to potentially more efficient intermediaries of the integrated area may resist to integration. At the same time, the industrial sectors of these countries may promote the integration since it gives them an opportunity to expand. On the other hand, in financially developed countries, the financial sector gains from integration, while the industry does not gain much and may even lose its profit due to increased competition. Therefore, in financially developed countries, financial sector is likely to be in favor of integration while industry may be less favorable or even against it. Guiso et al. (2004, p.27) explain that resistance to financial integration can also come from national governments which are afraid of losing their supervisory power.

As a result, market players and politicians may resist or promote financial integration, taking into account its potential costs and benefits. To find the equilibrium between market forces, De Haan et al. (2009, p.110) argue that collective action or public action would be necessary. They explain that through collective action, market participants can agree on standard technical features of financial instruments, the definition of common practices or the establishment of reference indices such as the establishment of EONIA (basic interest reference rate for overnight unsecured interbank deposits) and the EUREPO (reference rate at which one prime bank offers funds in euros to another prime bank). Taking into account the contribution of financial integration to economic growth, public authorities may intervene as a catalyst or facilitator of collective action as in the case of the development of TARGET which is an interbank payment system for the real-time processing of cross-border transfers throughout the EU (De Haan et al., p.112).

3. EUROPEAN SINGLE INSURANCE MARKET AND INTEGRATION OF THE INSURANCE MARKETS OF THE EEA MEMBER STATES

3.1. EUROPEAN SINGLE INSURANCE MARKET

European single insurance market means that in the Member States[3], restrictions on the provision of insurance services across national frontiers are not permitted. Both insurance companies and consumers should be free to operate and buy insurance products anywhere in the single market, under the same conditions with local companies and consumers.

Brittan (1990, p.413) points out that to establish a single insurance market in the EU, insurance and reinsurance companies situated in any one of the Member States must be completely free to operate throughout the EU, either through freedom of establishment (FOE) or through freedom of services (FOS). In other words, single insurance market requires that an insurance or reinsurance company, authorized in its home Member State, be allowed to pursue its activities throughout the EEA by establishing branches in other Member States or by directly providing services from its home Member State, without being required to have a license in each of the Member State in which it wants to operate.

In such a market, prior approval of rates and policy conditions should be removed. But, insurance companies should be subject to the same non-discriminatory supervisory rules which ensure sufficient consumer protection.

Labilloy (2003, p.4) emphasizes that the main aim under the construction of the European single market in insurance services is to ensure that European insurance companies benefit within this large market from equal conditions of competition, regardless of their home Member State. From companies' point of view, the aim is to

[3] In this dissertation, if not specified otherwise, the term "Member States" signifies 30 European Economic Area (EEA) Member States (the 27 EU Member States, Norway, Liechtenstein and Iceland) which take part of the European single insurance market.

make them more competitive, from consumers' point of view it is to provide them with cheap, high quality and diversified insurance products.

European single insurance market covers the Member States of the European Economic Area (EEA) which is actually composed of the 27 Member States of the EU and three of the four Member States of the EFTA, namely Norway, Liechtenstein and Iceland (excluding Switzerland) which take part of the EU's internal market. The EEA agreement was signed in 1992 between the Member States of the EU and Norway, Liechtenstein and Iceland. It allows these three countries of the EFTA to participate in the EU's single market and to enjoy free movement of goods, services, persons and capital without being member of the Union. They have to adopt the related *acquis communautaire* whereas they are not represented in the EU institutions and thus they do not take part of the decision making process of the EU.

In conclusion, at present, the European single insurance market is made up of 30 countries (27 Member States of the EU together with Norway, Liechtenstein and Iceland) which benefit from the freedom to provide insurance services throughout the EEA.

3.1.1. Creation of the European Single Insurance Market

The final aim of the founders of the European Economic Community (EEC) after the Second World War was to keep peace and increase prosperity of the European citizens through creating an internal market without frontiers in which the free movement of goods, services, persons and capital are assured. However, in financial services, the task of completing the single market was more difficult because of the large differences in national markets.

Drabbe (1994, p.135) states that the primary objective of the Member States in regulating insurance markets is to ensure that insurance companies meet their liabilities towards policyholders and the second objective is to strengthen the position of the policyholders vis-à-vis the insurance sector. He concludes that the same objectives are not attained by the same means and claims that it is this second objective of consumer protection which is at the root of the diversity of insurance regulation in the Member States.

Before the integration process, insurance legislation was subject to some state control in every Member State but the subject of supervision varied considerably. De Haan et al. (2009, p.13) report that in France, Italy and Luxembourg all lines of business were supervised whereas in Belgium, life insurance and compulsory motor third party liability insurance and in the Netherlands only life insurance were supervised.

The extent to which this supervision was exercised differed on a bigger scale. Due to different regulatory needs and cultures of the Member States, a variety of legal forms of insurance supervision ranging from liberal to more conservative approaches emerged. For instance, while the UK and the Netherlands followed a very liberal supervisory approach, Germany, Italy and France exercised substantive and more comprehensive system of supervision.

Ennsfellner and Dorfman (1998, p.37) state that in Europe, two distinct regulatory and supervisory philosophies called “Continental Model” and “Anglo Saxon Model” emerged before the European integration process.

3.1.1.1. Continental Model

The Continental model envisages a close supervision on insurance companies in order to protect the policyholders as the weaker part of the contractual relationship. This model ensures the financial strength of the insurance companies in order to make sure that they meet their liabilities against the policyholders. It envisages a priori control and authorization of tariffs and policy conditions with the aim of protecting consumers. Countries which favored continental model attached importance to the protection of the consumer as a weaker party against the insurance company, as well as to the indispensable role of the insurance sector in the economy of the country.

Ennsfellner and Dorfman (1998, p.37) argue that the advantage of this model is to provide stability and transparency of markets but the disadvantage is that it provides this stability with strict regulation and at the cost of limited product diversification and low levels of competition.

The Continental model has been historically applied in Germany, Austria, Italy, to some extent in France and in several other countries where there were controls on the premiums to be charged for compulsory motor third party liability insurance (Pickering and Matthews, 1997, p.7).

3.1.1.2. Anglo Saxon Model

The Anglo Saxon model is a liberal approach which emphasizes on the operating freedom of the companies. According to this model, insurance regulation is more flexible and insurance companies can set premiums without prior regulatory control and can define their own products. Drabbe (1994, p.135) points out that the supervision of insurance products is done after the product has been marketed and on an ad hoc basis, but he adds that, in order to protect the policyholder, additional regulations may be introduced, such as the conduct of business rules.

Therefore, in the absence of prior control of tariffs and policy conditions for the protection of consumers, this model is based on strict solvency requirements for the companies. The advantage of the model is to provide more competition and deregulation for the sector whereas its disadvantage is at the risk of less protection of the policyholders. This model has been historically applied in the UK and the Netherlands.

In developing their supervisory systems over time, each Member State has found its own balance between regulation and consumer protection on the one hand and competition and a wider choice of products on the other hand (Drabbe, 1994, p.136). As a consequence, forming the European single insurance market required the combination of national insurance markets that differed not only in regulatory traditions but also in the philosophy of how to provide insurance (Ennsfellner and Dorfman, 1998, p.37).

The European Commission supported the Anglo Saxon model during the creation of the European single insurance market by claiming that a Community-wide system of prior supervision of tariffs and products was not feasible and realistic and that ex-post and non-systematic control was necessary for the integration of the insurance markets of the Member States.

Finally, the Member States followed the proposals of the European Commission and thus systematic and ex-ante control of tariffs and policy conditions were abolished. A single license system based on minimum harmonization and home country control was established. For those countries which traditionally followed the Continental model, the switch to this more liberal model leads to an important deregulation process to achieve an adequate balance between control and freedom. However, this process was ultimately to the benefit of consumers who have a wide choice of products with competitive pricing and a high level of protection at the same time.

3.1.1.3. Legal Basis

The legal basis of the EU *acquis* in the field of insurance is the Chapter 2 and Chapter 3 of the Treaty on the Functioning of the European Union[4] relating to the right of establishment and right to services successively.

Under Chapter 2 relating to the right of establishment, Article 49 (ex Article 43 TEC) prohibits all restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. This prohibition applies to the restrictions on the setting-up of companies, agencies or branches by nationals of any Member State established in the territory of another Member State. Freedom of establishment also includes the right to take up and pursue activities as self-employed persons.

In the European single insurance market, freedom of establishment (FOE) means the right for any insurance company having its head office in one of the EU Member States to carry out insurance business in other Member States by setting up a branch, an agency or an office managed by the company's own staff. This allows a company registered in a Member State (home country) to operate in another Member State (host country) by way of FOE, under the same conditions provided for domestic companies in the host country.

Under Chapter 3 relating to services, Article 56 (ex Article 49 TEC) prohibits all restrictions on freedom to provide services within the EU in respect of nationals of

[4] Consolidated version of the Treaty on the Functioning of the European Union, OJ-C 115 of 09.05.2008 (known as Lisbon Treaty).

Member States who are established in a Member State other than that of the person for whom the services are intended. As long as restrictions on freedom to provide services are not abolished, Member States should apply such restrictions without distinction on grounds of nationality or residence to all persons providing services (see Article 61).

In the European single insurance market, freedom of services (FOS) gives the insurance companies the right to sell their products across national frontiers without prior authorization from the host Member State's regulatory authority and without having to set up an establishment there (Ellis, 1990, p.11). FOS enables companies registered in a Member State to perform occasional and transitional activities in the other Member States on the same grounds with local companies.

The concept of provision of services by way of FOS is totally different from that of FOE. Labilloy (2003, p.34) underlines the fact that the former is characterized by its temporary nature whereas the latter presupposes a durable establishment in the host Member State.

3.1.2. Principles of the European Single Insurance Market

European single insurance market is based on a single set of prudential rules for taking up and pursuit of business. This does not mean that the rules are exactly the same in every Member State and that all the rules are totally harmonized. Therefore, the recognition of supervisory legislation of the other Member States (mutual recognition) is indispensable. This could only be achieved through the establishment of a set of minimum regulatory standards (minimum harmonization). It is a prerequisite in such an environment where prior authorization of the host Member States are not required (single license) and supervision of the insurance companies are undertaken by their home country supervisory authority (home country control).

These principles can be considered as the prerequisites of the establishment of a single market in insurance. Drabbe (1994, p.136) concludes that these principles greatly facilitate the integration and thus the cross border business since the administrative procedures to set up new establishments in other Member States (by way of FOE) or the

provision of direct cross border services (by way of FOS) became much simpler and were tied to defined time limits.

3.1.2.1. Mutual Recognition Principle

Following the idea that the integration of the insurance markets cannot be fully achieved if each Member State imposes a different regulatory framework, the EU has relied on the principle of mutual recognition of regulation between Member States.

Booth (1991, p.484) argues that there are effectively two methods for the integration of the segregated insurance markets of the EU Member States. First, each Member State may apply exactly the same detailed regulations for their insurance markets so that the consumers know that they buy products regulated by exactly the same set of rules anywhere in the EU. This is not at all the way chosen by the EU to integrate the insurance markets of its Member States. According to Booth (1991), if regulation was harmonized in such a way, an illiberal regime would be created and it would be impossible to create a single insurance market.

The second method, which is chosen by the EU in its process towards the establishment of the internal market, is the recognition of the regulation of other Member States. This method is called “mutual recognition” and in insurance sector, it means that each Member State has its own regulatory system but allows the insurance companies operating under the regulatory systems of the other Member States to operate in its domestic market.

The mutual recognition principle assumes that, although Member States’ rules might differ in substance, they should be considered to be equivalent in effect (Young, 2004, p.399). It implies that Member States accept a product, tailored to the legal environment of a given country, as fit for being in free trade within the entire EU (European Commission, 2000, p.8). Therefore, Savov (2006, p.6) emphasizes that the divergent rules across the EU do not matter for the companies since they have to comply only with the rules of their home Member States.

Pickering and Matthews (1997, p.7) claim that mutual recognition leads to more liberal regulations since governments with more heavily regulated markets have to relax their controls so that their domestic insurers are not at a disadvantage when competing with insurers operating in more liberalized markets. If one Member State imposes strict and conservative regulatory framework, then its insurers may become uncompetitive in the single market because foreign insurers based in other Member States under more liberal regulatory system may easily enter its domestic market to fulfill the demands of the consumers such as better and cheaper products. Therefore, Member States would try to create the most desirable, and thus the most liberal, regulatory framework in order to make their insurers competitive in the single market.

3.1.2.2. Minimum Harmonization Principle

According to Monkiewicz (2007, p.394), the essence of mutual recognition lies in the acceptance by the Member States of some mutually agreed set of minimum regulatory standards to be followed in their respective national regulatory practice. In order that Member States mutually recognize their rules, some minimum level of harmonized regulation is necessary because of stricter or conversely more liberal regulatory approaches in different Member States. Therefore, the need for community-level harmonization of national rules leads to the principle of “minimum harmonization”.

Čejková et al. (2005, p.26) highlight that Member States are entitled to adopt legal standards different to EU Directives only where these are stricter than those set by the respective EU Directive. In other words, Member States do not have the option of creating a more liberal environment than that created by the EU Directives in order to ensure equal competition between insurance companies and to prevent unreasonable liberalization which can endanger the rights of consumers.

In the insurance sector, in conformity with the principle of minimum harmonization, the rules such as licensing, solvency or winding-up are harmonized at the minimum level in order to create a level playing-field. However, several areas relating to consumer protection, competition, taxation and contract law still continue to be covered by the host country’s own regulations.

3.1.2.3. Home Country Control Principle

Cabral et al. (2002, p.9) explain that under the principle of "home country control", an undertaking operating in another Member State (host country) is supervised by the supervisory authority of the country of origin (home country) where it is legally established.

Therefore, in the European single insurance market, prudential supervision of insurance and reinsurance companies are at the hands of the home Member State and as regards to their financial position, the companies have to report only to the authorities from which they received their license. Labilloy (2003, p.17) notes that the host Member State cannot exercise supervision to verify compliance by the company in question with the harmonized conditions under which the single authorization was granted to it by the home Member State.

The home country control principle would only be established through mutual recognition and minimum harmonization principles. Savov (2006, p.7) claims that the home country rule alone cannot solve the integration problem and even assuming a pure home country control, undertakings located in countries with differing rules will face different regulatory costs. Therefore, a minimum level of regulatory convergence (minimum harmonization) is required to establish the home country control principle.

3.1.2.4. Single License Principle

Under single license principle, mutual recognition principle is also applied to licenses. Single license principle indicates that the companies are free to operate in other Member States by way of FOE or FOS on the basis of single authorization and supervision from the country in which they are registered. Thus, the dual licensing system (licensing in both the home and host Member State) has been cancelled and has been replaced by a notification procedure. The single license is also called "European passport" which provide the undertakings to operate freely in all Member States with only the license taken from the home country authority.

Cabral et al. (2002, p.9) explain that single license in the insurance sector means that insurance companies having their head office in a Member State may, directly or indirectly, provide services throughout the EU on the basis of a single European passport issued by the home country authority. In other words, they do not have to seek advance authorization for policies which they sell in another Member State (Brittan, 1990, p.417).

3.1.3. Legislative Harmonization in the European Single Insurance Market

During the creation of the European single insurance market, the effort was to remove all barriers in national regulations that prevent or limit the creation and functioning of the single market. Sterzynski (2003, p.44) points out that deregulation, which means the reduction of the existing legal limitations on the competition and the liberalization of the market access, is central for running of the European single insurance market.

Contrary to this idea of deregulation, Nemeth (2001, p.20) indicates that what has been done in the EU may not be called as deregulation but as reregulation, since the establishment of a liberal European legal framework simply means the replacement of old and sometimes rigid norms which are not fit for cross-border insurance activities, with new and more flexible norms. She adds that (p.83), be it deregulation or reregulation, the removal of market entry barriers by means of negative integration had to be accompanied by the establishment of a certain regulatory framework.

Although it is not solely enough, legislative harmonization is a prerequisite of the integration of the insurance markets of the EU Member States. To achieve mutual recognition of licenses and supervisory systems between Member States and the supervision of insurers by the home Member State authorities, it was necessary to bring about at least a minimum level of legislative harmonization Therefore, European single insurance market is founded on a common prudential framework which harmonizes the essential rules with the aim of protecting the customers and allowing insurance companies to establish and provide services freely throughout the EU.

European Commission (2007a, p.35) defines the basic aim of the EU legislation in the field of insurance as *"to create a framework for an integrated insurance market in*

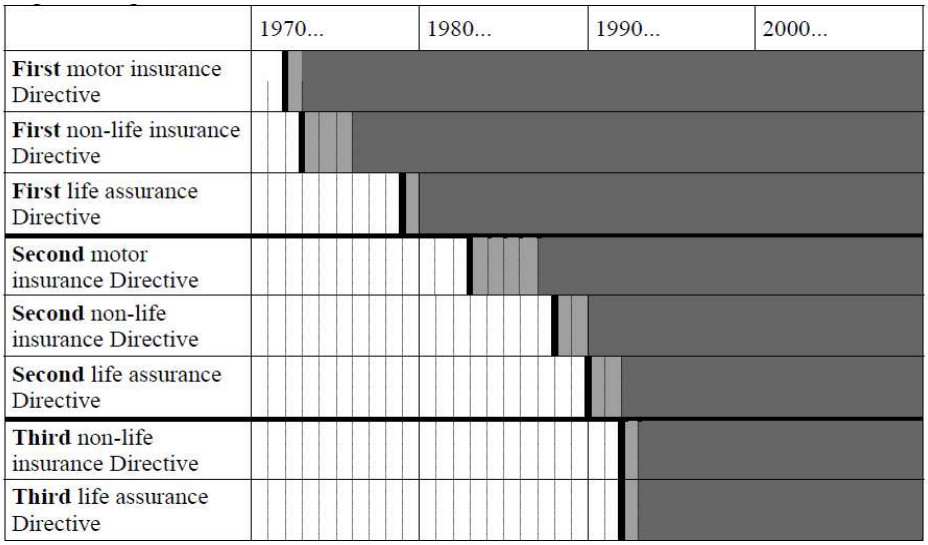
which insurance contracts can be arranged between insurers and policyholders in different Member States freely without any restrictions, while ensuring that consumers still enjoy an adequate level of protection".

Following this aim, the legislative framework for the creation of a single insurance market is gradually achieved by three generations of life and non-life insurance directives and lasted for more than thirty years. The process started in 1961 with the launch of the General Programme which established a timetable for introducing freedom of insurance services. The target time for reinsurance was the end of 1963, for non-life insurance the end of 1965 and for life insurance the end of 1967. Because of the traditional international character of reinsurance, it was relatively easy to accomplish this first step (Bickelhaupt, 1964, p.22). However, the deadlines for other targets are postponed due to significant regulatory and supervisory differences in the Member States traditionally followed Continental Model on the one hand and Anglo Saxon Model on the other hand.

The move towards an integrated life and non-life insurance market is shown in Graph 1. The process mainly took place in three stages between 1973 and 1994. The Council enacted six directives in total, separately for the field of life and non-life insurance. Motor insurance directives are enacted separately due to specific character of this line of business.

The first stage (non-life directive in 1973 and life directive in 1979) ensures the freedom of establishment limited by the host country control principle, the second stage (non-life directive in 1988 and life directive in 1990) ensures the freedom to provide services (limited to policies for large risks) and the third stage (both non-life and life directives in 1992) ensures the single license and home country control principles.

Other directives followed, partly extending the scope of the directives, partly concerning other fields of insurance to enable the development of a single insurance market (Nemeth, 2001, p.23).



Graph 1: Stages of the European Insurance Market Integration

Source: Beckmann, et al. (2002a, p.4)

Özşar (2007, p.30) indicates that, at least from the legislative point of view, it is generally accepted that the insurance markets of the EU Member States, together with those of Liechtenstein, Norway and Iceland became a vast single insurance market only with the entry into force of the third generation directives in 1 July 1994 because they have made it possible for insurers to sell their products anywhere in the EEA and for consumers to have access to any EEA insurer, including the ones not established in their country of residence.

3.1.3.1. First Generation Directives

The first set of EU insurance directives ensured the freedom of establishment.[5] An insurance company registered in one Member State was allowed to set up subsidiaries, branches or agencies in another Member State on the same basis as its domestic insurance companies. However, consumers from one Member State were prohibited from buying insurance directly from an insurer established in another Member State through FOS.

[5] First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life insurance (OJ L 228, 16.8.1973) and First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life insurance (OJ L 63, 13.3.1979)

The host Member State was responsible for prudential supervision of the activities of all insurance companies, domestic or not, operating in that Member State. This principle is known as “host country control”. It means that any insurance company registered in one Member State has the right to establish in other Member States, only under the prior authorization and control of the host Member State where it wants to be established. This authorization was given separately for each lines of business.

Ennsfellner and Dorfman (1998, p.50) give the example of a German who wants to buy an insurance policy from a French insurer. According to first generation directives, a German could not purchase insurance directly from a French insurer, but could purchase insurance from a French insurer established in Germany and supervised by German authorities.

Whereas First Non-Life Directive ensuring FOE was adopted in 1973, the First Life Directive, which aimed to achieve the same objectives with the First Non-Life Directive, was adopted only in 1979 simply because life business was more complicated due to differing role and definition of life insurance companies and products between Member States. Composite insurers operating in both life and non-life business was another area of diversification. While they were authorized in some Member States, they were not in the others. First generation directives imposed a prohibition of new composite insurers in order to prevent the fact that the generally more profitable life insurance business was used to balance the losses of the normally not so profitable non-life insurance business (Merkin and Rodger, 1997 in Nemeth, 2001, p.26). The existing composite insurers are allowed to continue to operate by keeping separate accounts for life and non-life funds. Composite insurers are still important in the insurance markets of Austria, Belgium, Czech Republic, France, Italy and Spain.

Despite being a big step towards an integrated insurance market, the first generation directives left a lot at the hands of the host Member States. The main difficulties were the remaining national restrictions against foreign insurers, the need to comply with different insurance regulations of the host Member State and the impossibility of direct cross border sales without physical establishment.

To sum up, although the First Generation Insurance Directives provided insurers with better access to other national markets, subject to authorization on specified conditions and supervision by the host state, the liberalization process was not significantly advanced and the host country control principle did not really enhance the process of creating an integrated European insurance market (Sterzynski, 2003, p.43). Matthews (1998, p.79) argues that these Directives did not create a single insurance market since each branch or agency of an insurer established in another Member State was still required to behave as part of the national market that it wished to enter.

3.1.3.2. Second Generation Directives

The first step towards freedom to provide insurance services by way of FOS was the co-insurance Directive enacted in 1978.[6] Co-insurance in the EU means that at least two insurers (one of them being the leading insurer) from two different Member States provide insurance coverage for large risks which are situated within the EU. In order to facilitate the participation of the insurers in such arrangements, the Directive abolished the requirement that all coinsurers be authorized in the Member State where the leading insurer was established (Nemeth, 2001, p.27).

However, Denmark, France, Germany and Ireland (four Member States out of nine Member States of that time) failed to implement the provisions of this Directive and thus European Commission applied to the European Court of Justice (ECJ) against these countries in 1983-84.[7] The ECJ decision in 1986 regarding these insurance cases stated that the requirements of permanent establishment and prior authorization constitute a restriction to the freedom of services.

On the other hand, the ECJ dismissed the application of the European Commission against the national provisions requiring that the risk covered in a co-insurance contract exceed a certain sum by stating that policyholder protection can be used for general interest justification. It means that the Court drew a clear distinction

[6] Council Directive 78/473/EEC of 30 May 1978 on the coordination of laws, regulations and administrative provisions relating to Community co-insurance (OJ L 151, 7.6.1978).
[7] These four cases are known as the insurance cases: C 252/83 Commission vs. Denmark, C 220/83 Commission vs. France, C 205/84 Commission vs. Germany and C 206/84 Commission vs. Ireland.

between the provision of big commercial and industrial risks called "large risks" and small/medium risks called "mass risks". In large risks, the idea is that the policyholder is aware of the potential dangers and advantages of buying an insurance policy from an insurer not established in its own country. Therefore, the policyholder does not need any special protection and thus the supervision may be left to the country of establishment of the insurer (home country control principle).

However, mass risks, where the policyholder needs protection, remained subject to supervision of the policyholder's country of residence (host country control principle). It means that for mass risks, the Member State where the risk is situated may insist on authorization and apply controls on cross-border business. As a result, from that time on, the scope of co-insurance contracts became limited to only large risks.

Ellis (1990, p.2) concludes that with this decision of the ECJ, for large risks host Member States lost their right to insist upon the setting up of an establishment. Indeed, as a consequence of these rulings, the European Commission decided to proceed with a new directive envisaging freedom to provide services for large risks and keeping host country control for mass risks.[8] Nemeth (2001, p.26) interprets the results of the rulings as *"half a step further towards the completion of the single insurance market"* as it delayed the Commission's ambitious plans to move directly into guaranteeing freedom to provide services for all risks.

After the entry into force of the freedom of establishment (FOE) with first generation directives, the second generation directives (in 1988 for non-life business and in 1990 for life business) paved the way to cross border selling of contracts covering

[8] Directive 88/357/EEC defines large risks as:
(1) risks related to marine, aviation and transit (classes 4, 5, 6, 11 and 12)
(2) risks related to credit and suretyship where the policyholder is engaged professionally in an industrial or commercial activity or in one of the liberal professions (classes 14 and 15)
(3) risks related to fire and natural forces, other damage to property, general liability and miscellaneous financial loss/employment risks (classes 8, 9, 13 and 16) if the company satisfies two out of the following three criteria:
(a) 500 employees;
(b) an annual turnover of 24 million ECU;
(c) an annual balance sheet total of 12.4 million ECU.

large risks through freedom of services (FOS).[9] The Directives ensured the insurers to directly sell insurance contracts covering large risks from one Member State to residents of another Member State without physical establishment through branches or agencies and without the requirement to be authorized by the host Member State. In other words, insurers became able to write business in other EEA Member States without actually having registered offices in those locations. The authorization of an insurance company by its home Member State was sufficient to cover large risks in all other Member States by simply informing the host Member State's supervisory authority. Therefore, cross-border marketing of insurance policies covering large risks became possible, but in effect, only large and medium-sized customers became able to buy commercial property and liability insurance coverage in the insurance markets of all Member States (Ennsfellner and Dorfman, 1998, p.51).

On the other hand, to cover mass risks in another Member State, the insurers still had to ask for authorization from the host Member State. Ellis (1990, p.16) explains that in mask risks, host Member States were also entitled to control the policy conditions as well as the nature, spread and location of assets representing technical reserves.

In the Second Life Directive, in line with the reasoning of the Second Non-Life Directive, freedom of services was envisaged only for the policyholders who took the first step on their own initiative to buy a life insurance product from a life insurance company established in another Member State. Here, the idea is that such policyholders do not need any special protection since they take their own initiative.

The second generation directives also envisage some harmonization of national laws and taxes concerning direct general insurance. However, the directives are mainly considered unsatisfactory towards establishing the European single insurance market since the liberalization process took place only in areas where the need to protect

[9] Second Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life insurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC (OJ L 172, 4.7.1988) and Second Council Directive 90/619/EEC of 8 November 1990 on the coordination of laws, regulations and administrative provisions relating to direct life assurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 79/267/EEC (OJ L 330, 29.11.1990).

customers was insignificant and thus neither personal lines of business in non-life sector nor the consumers who did not take the first step in buying life insurance policies were subject to FOS (Ennsfellner and Dorfman, 1998, p.51; Sterzynski, 2003, p.43).

3.1.3.3. Third Generation Directives

Even after the first and second generation directives, personal lines of business were still not subject to FOS, host country control principal was applied and in most of the Member States such as Germany and Italy insurance tariffs and new products had to be approved by the insurance supervisory authorities. Under these circumstances, third generation of life and non-life directives entered into force in 1 July 1994 simultaneously and created the European single insurance market at the legislative level.[10]

First, the directives totally liberalized the market by abolishing prior control of insurance premium and policy conditions for all insurance risks and all policyholders. Therefore, insurers were free to set their own prices and tariffs and to launch new products for both large and mass risks without having to obtain prior approval. Cummins and Weiss (2004, p.217) point out that the directives introduced true price and product competition in European retail insurance markets for the first time in both life and non-life insurance. To compensate the lack of prior approval, the insurer was obliged to follow certain duties of disclosure to the policyholder both before and throughout the contractual relationship.

Second, substantive insurance supervision was abolished so that prices and policy conditions can be freely set between the insurer and policyholder. Substantive and ex-ante supervision was replaced by the EU-wide minimum standards for financial supervision in the form of solvency control (Hess and Trauth, 1998, p.92). In effect, as a result of these liberalization measures with third generation directives, the European single insurance market totally abandoned the Continental model, in favor of the Anglo Saxon model.

[10] Third Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC (OJ L 228, 11.8.1992) and Third Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC (OJ L 360, 9.12.1992).

Third, the directives established the single insurance market for the European insurance industry by introducing single license and home country control principles for both large and mass risks. Following the single license principle, known as European passport, once insurance companies have obtained a license in their home Member State, they may now conduct business throughout the single market by way of FOE or FOS without additional permission of the host Member State. Their financial supervision, including the business pursued either through FOE or FOS, is the sole responsibility of the home Member State. Such financial supervision should include its state of solvency, technical provisions, assets and eligible own funds. Strengthening the solvency provisions was one of the most important steps for the introduction of the home country control principle.

The directives, at least in theory, standardized the taking-up and pursuit of insurance companies operating across Europe. Prior official authorization is sufficient for the taking up of the insurance business. The host Member State cannot adopt provisions requiring prior approval or systematic notification of general and special policy conditions or scales of premiums[11].

Any insurer with the head office in the territory of a Member State should seek authorization from the competent authorities of its home Member State. This authorization is valid for the entire EEA and is granted to a particular class of insurance with the condition of meeting the authorization requirements. Member States cannot consider the application for authorization in the light of the economic requirements of the market.

Any insurer wishing to operate in another Member State by way of FOE should notify the supervisory authority of its home Member State about its intention to establish a branch within the territory of another Member State and should provide some necessary information. Unless the supervisory authority of the home Member State has reason to doubt the adequacy of the system of governance or the financial situation of the insurer, it has to communicate that information to the supervisory authority of the host Member State in order that the undertaking establishes the branch and starts business.

[11] See Art. 154 of the Solvency II Directive 2009/138/EC

Any insurer who wish to pursue business in another Member State for the first time by way of FOS should also notify the supervisory authority of the home Member State, indicating the nature of the risks it proposes to cover. The supervisory authority of the home Member State has to communicate this intention to the Member State where the undertaking intends to pursue business in order for the undertaking to start business by way of FOS.

To sum up, Ennsfellner and Dorfman (1998, p.52) argue that the European single insurance market became a legal reality by 1 July 1994 with the entry into force of the third generation of directives whereas the implementation of their provisions is not always complete and satisfactory.

3.1.3.4. Other Legislation on Insurance

In life insurance sector, all the three generation directives adopted in this field since 1979 are consolidated in one coherent text with the adoption of Directive 2002/83/EC.[12]

In non-life insurance, Tourist Assistance Directive 84/641/EEC basically adds an extra 18th class called tourist assistance to the 17 classes of non-life business and refers to assistance provided for persons who get into difficulties while travelling, while away from home or while away from their permanent residence.[13] Credit and Suretyship Directive 87/343/EEC[14] for credit insurance and Legal Expenses Insurance Directive 87/344/EEC[15] for bearing the costs of legal proceedings are also enacted.

[12] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (OJ L 345, 19.12.2002).
[13] Council Directive 84/641/EEC of 10 December 1984 amending, particularly as regards tourist assistance, the First Directive (73/239/EEC) on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (OJ L 339, 27.12.1984).
[14] Council Directive 87/343/EEC of 22 June 1987 amending, as regards credit insurance and suretyship insurance, First Directive 73/239/EEC on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (OJ L 185, 4.7.1987).
[15] Council Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance (OJ L 185, 4.7.1987).

For completing the single market in the insurance sector and for its well functioning, the EU has also provided the legislative framework in other fields such as motor insurance, reinsurance, annual and consolidated accounts of insurance companies, solvency, winding-up, insurance groups and insurance mediation.

3.1.3.4.1. Motor Insurance

In the field of motor insurance which is not legislated under non-life directives because of its importance in the insurance sector and its fundamental characteristic to the free movement of vehicles in the EU, five series of directives were enacted from as early as 1972 to 2005.[16] With the first three directives, the EU took major steps towards establishing a single market in the field of motor insurance by introducing compulsory motor insurance, abolishing border checks on insurance, setting up minimum amounts for such insurance coverage, providing a better protection of victims of accidents and covering all passengers (including the family of the driver) in the vehicle by compulsory insurance (Özşar, 2007, p.111). The Fourth Motor Insurance Directive completed the system by establishing a more efficient mechanism for quick settlement of claims. The Fifth Motor Insurance Directive improved the provisions of the EU Motor Insurance Directives and determined the minimum coverage of the compulsory motor insurance in the case of personal injury and damage to property. Finally, in the interest of clarity, all these five directives are repealed by Directive 2009/103/EC which is a codified version of all the previous motor insurance directives.[17]

3.1.3.4.2. Accounting

Insurance Accounts Directive 91/674/EEC sets out the basic framework for the annual accounts and consolidated accounts of insurance companies.[18] It also ensured to

[16] First Motor Insurance Directive 72/166/EEC of 24 April 1972 (OJ L 103, 2.5.1972), Second Motor Insurance Directive 84/5/EEC of 30 December 1983 (OJ L 8, 11.1.1984), Third Motor Insurance Directive 90/232/EEC of 14 May 1990 (OJ L 129, 19.5.1990), Fourth Motor Insurance Directive 2000/26/EC of 16 May 2000 (OJL 181, 20.07.2000) and Fifth Motor Insurance Directive 2005/14/EC of 11 May 2005 (OJL 149, 11.6.2005).

[17] Directive 2009/103/EC of the European Parliament and of the Council of 16 September 2009 relating to insurance against civil liability in respect of the use of motor vehicles, and the enforcement of the obligation to insure against such liability (OJ L 263, 7.10.2009).

[18] Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings *(*OJ L 374, 31.12.1991).

provide sufficient harmonization as regards the definition and calculation of technical reserves (Boléat, 1995, p.51).[19] Pickering and Matthews (1997, p.15) argue that Accounting Directives improved the transparency of accounting information necessary to ensure adequate prudential supervision of cross-border insurance activities in the European single insurance market.

Furthermore, in order to contribute to a better functioning of the single market, Regulation 1606/2002 envisages that consolidated financial statements of the EU publicly traded companies, including publicly traded insurance companies, should be prepared in accordance with a single set of high quality international financial reporting standards (IFRS) set by the International Accounting Standards Board (IASB).[20]

3.1.3.4.3. Insurance Groups

Insurance Groups Directive 98/78/EC provides for a supplementary supervision for the related undertakings of the insurance company, participating undertakings in the insurance company and related undertakings of a participating undertaking in the insurance company by the supervisory authority of the home Member State.[21] The Directive is crucial in the sense that it prevents double gearing and capital leverage.[22]

However, the Directive has resulted in group supervision being carried out by too many supervisory authorities at too many levels and it is criticized by the European Commission (2007c, p.10) itself by not providing for a group or lead supervisor, by not defining clearly enough the rights and duties of the different supervisory authorities involved in the supervision of a group and by not being clear on how the cooperation between supervisors should be organized.

[19] Note that the Directive 2003/51/EC (OJ L 178, 17.7.2003) which is known as the Modernization of Accounting Directives and Directive 2006/46/EC (OJ L 224, 16.08.2006) significantly amended the Accounting Directives including the Directive 91/674/EEC.
[20] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L 243, 11.9.2002).
[21] Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group (OJ L 330, 5.12.1998).
[22] Double gearing is the use of the same capital to cover the separate solvency margin requirements of the different insurance undertakings of the group. Capital leverage is the withdrawal of capital by the indebted insurance group from its subsidiaries.

3.1.3.4.4. Insurance Mediation

For the proper functioning of the single market in insurance, intermediaries which have a significant role in the distribution of insurance and reinsurance products throughout the EU need to operate freely. Insurance Mediation Directive 2002/92/EC provided that insurance and reinsurance intermediaries registered in their home Member State can freely take-up and pursue mediation activities in the EU by way of FOE and FOS, simply after the notification of the competent authority of the home Member State to the competent authority of the host Member State about the intention of the intermediary to start business.[23] Therefore, in line with the single license principle, intermediaries are now free to sell their services anywhere in the EU, but only after being registered in their home Member State by meeting strict consumer protection requirements (Sterzynski, 2003, p.43).

The Directive also impacted the reported number of intermediaries (but not a real change) in Member States due to the harmonization of the definition of intermediaries that needed to register. For instance, the number of intermediaries considerably increased in Italy because people involved in the sale of insurance products, including collaborators of insurance agents and commission based salesman who were not registered before the Directive are now all registered (CRA International, 2009, p.133).

3.1.3.4.5. Reinsurance

Directive 64/225/EEC removed the restrictions on the FOE and FOS for the providers of reinsurance.[24] It did not however harmonize reinsurance supervision rules. This situation resulted in significant differences in the level of reinsurance supervision in the Member States and thus reinsurers had to comply with different supervisory rules in the various Member States in which they conduct business. This created barriers to the European single reinsurance market. Therefore, the Reinsurance Directive 2005/68/EC

[23] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation (OJ L 9, 15.1.2003).
[24] Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession (OJ 56, 4.4.1964).

aims at establishing a prudential regulatory framework for reinsurance activities in the EU and requires that all reinsurance companies be authorized in their home Member State after meeting strict requirements.[25] Once they have done so, they will be free to carry out their activity anywhere in the EU through the single reinsurance passport.

3.1.3.4.6. Winding-up

Winding-up Directive 2001/17/EC applies to reorganization measures and winding-up procedures of the insurance companies.[26] Under the Directive, in line with the home country control principle, only the competent authorities of the home Member State will be able to decide on the reorganization measures and the winding-up process.

3.1.3.4.7. Solvency

Solvency rules stipulate the minimum amounts of financial resources that the insurers should have in order to cover their liabilities against policyholders. Ensuring that insurers have adequate capital requirements in relation to the nature of their risks is very crucial to protect policyholders in the single insurance market. This is why capital requirements have been in place since the first generation directives in 1970s but their importance have been increased with the liberalization of the sector in 1990s.

In line with Financial Services Action Plan (FSAP), solvency requirements of life and non-life insurance companies were amended in 2002. However, these amended regulations, known as Solvency I, were criticized for being too simple and robust. CEA (2006a) lists the basic shortcomings of Solvency I as its inability to cover all the risks of the insurer in order to determine its proper level of capital requirement and its insufficiency to allow a timely supervisory intervention to the insurers having insolvency problems.

This is why prudent insurers have adopted their own solvency calculation systems and new risk management practices and have begun to hold more capital than the

[25] Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC (OJL 323, 9.12.2005).
[26] Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (OJ L 110, 20.4.2001).

legal requirements (O'Brien, 2006, p.6). In addition, many national supervisors set additional local requirements resulting in a patchwork of rules in place across Europe (CEA, 2006a, p.2). Since many Member States have started to implement their own reforms by concluding that the current EU minimum requirements are not sufficient, the cost has increased for both insurers and policyholders, the competition has been reduced and the supervision has lost its effectiveness (Acar, 2009, p.478). Finally, differing rules have started to significantly hamper the functioning of the European single insurance market.

Therefore, for the sake of the good functioning of the single market, the EU decided to reform the legislation on solvency rules to raise the level of harmonization, to increase the financial soundness of the insurers and to provide a better policyholder protection.

The reform is done with the Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance which will enter into force in the beginning of 2013.[27] It consolidates most of the existing insurance directives for the sake of simplicity. Table 3 shows that the Directive 2009/138/EC brings together the directives on life insurance, non-life insurance, reinsurance, insurance groups, winding-up and solvency.

HM Treasury (2006, p.17) explains that a single framework directive may yield material benefits for the single market such as *"simplifying the regulatory framework, limiting the scope for inconsistency and duplication between different pieces of the legislation and reducing compliance costs for firms and supervisors"*. Therefore, further harmonization in the European single insurance market will be guaranteed with this Directive.

[27] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (OJ L 335, 17.12.2009)

Table 3: EU Insurance Acquis Before and After the Directive 2009/138/EC

<table>
<tr><th>Before 01.01.2013</th><th>After 01.01.2013</th></tr>
<tr><td>Life:</td><td rowspan="15">Directive on Taking-up and Pursuit of the Business of Insurance and Reinsurance 2009/138/EC</td></tr>
<tr><td>Life Directive 2002/83/EC</td></tr>
<tr><td>Non-Life:</td></tr>
<tr><td>First Non-Life Directives 73/239/EEC and 73/240/EEC</td></tr>
<tr><td>Co-insurance Directive 78/473/EEC</td></tr>
<tr><td>Tourist Assistance Directive 84/641/EEC</td></tr>
<tr><td>Credit Insurance and Suretyship Insurance Directive 87/343/EEC</td></tr>
<tr><td>Legal Expenses Insurance Directive 87/344/EEC</td></tr>
<tr><td>Second Non-Life Directive 88/357/EEC</td></tr>
<tr><td>Motor vehicle liability insurance Directive 90/618/EEC</td></tr>
<tr><td>Third Non-Life Directive 92/49/EC</td></tr>
<tr><td>Solvency Directive 2002/13/EC</td></tr>
<tr><td>Others:</td></tr>
<tr><td>Reinsurance Directives 64/225/EEC and 2005/68/EC</td></tr>
<tr><td>Insurance Groups Directive 98/78/EC</td></tr>
<tr><td>Winding-up Directive 2001/17/EC</td></tr>
<tr><td>Accounting Directive 91/674/EEC</td><td>Accounting Directive 91/674/EEC</td></tr>
<tr><td>Insurance Mediation Directive 2002/92/EC</td><td>Insurance Mediation Directive 2002/92/EC</td></tr>
<tr><td>Motor Insurance Directive 2009/103/EC</td><td>Motor Insurance Directive 2009/103/EC</td></tr>
</table>

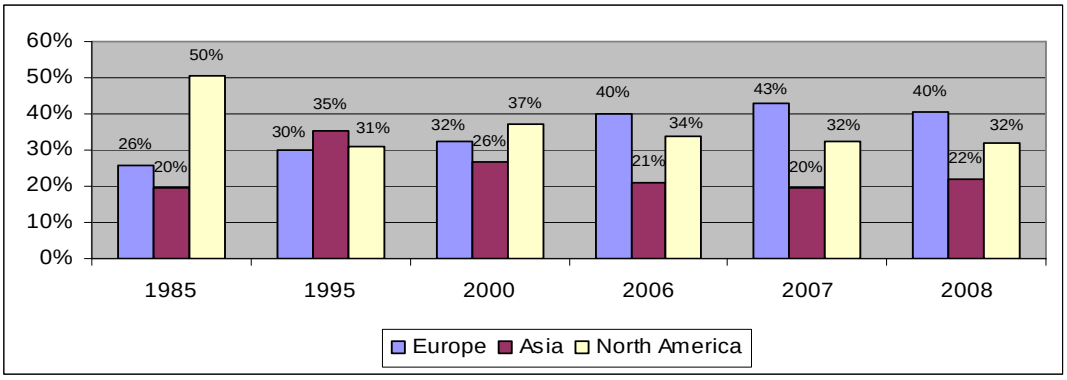
Source: own Table

Directive 2009/138/EC is known as Solvency II Directive because while it only recasts the existing Directives, it provides totally new and sophisticated provisions on solvency requirements for insurance and reinsurance companies. It is a Lamfalussy type Framework Directive based on three pillars which mainly focuses on elaborating the basic principles of the solvency system (level 1 measures). The more detailed and technical rules will then be put in place by the European Commission in the form of implementing measures (level 2 measures).

Solvency II envisages risk-based capital requirement calculations and based on a three pillar approach which is designed to be mutually reinforcing (European Commission, 2007c, p.5). Pillar 1 consists of the quantitative requirements, including the rules on the calculation of capital requirements (called SCR and MCR), valuation of assets and liabilities, technical reserves, investments and own funds. While Pillar 2 focuses on the effective supervisory review process as well as qualitative requirements including the rules on governance and risk management of the insurance companies, Pillar 3 consists of the rules on financial reporting and transparency.

3.1.4. Size of the European Single Insurance Market

It is worth to examine the world insurance market to understand the size of the European single insurance market compared to the insurance markets of the other major continents and regional blocks. Graph 2 indicates that market share of the European continent increased from 25% to 40% between 1985 and 2008 while market share of North America considerably decreased. Although market share of Asia significantly increased between 1985 and 1995, it has been steadily decreasing since 1995.



Graph 2: Insurance Premium Production in Major Continents (in % of the total)
Source: own Graph based on data from Swiss Re sigma studies
Europe covers the EEA and non-EEA European countries

European single insurance market is the biggest insurance market in the world in terms of premium production. In life insurance, it is the largest market in the world while in non-life insurance it follows the USA. European single insurance market that is composed of the insurance markets of the EEA Member States is compared to the insurance markets of some other regional blocks in Table 4. Since premiums in the EEA grew faster than worldwide premiums, market share of the European single insurance market reached 38% of the total world insurance premiums in 2008 from its level of 29% in 1994. It is comparable to the insurance markets from developed countries in terms of premium volume, insurance penetration and insurance density. Compared to other regional blocks in the world, it is comparable to NAFTA composed of the USA, Canada and Mexico rather than MERCOSUR composed of developing countries from South America or ASEAN composed of developing countries from Southeast Asia.

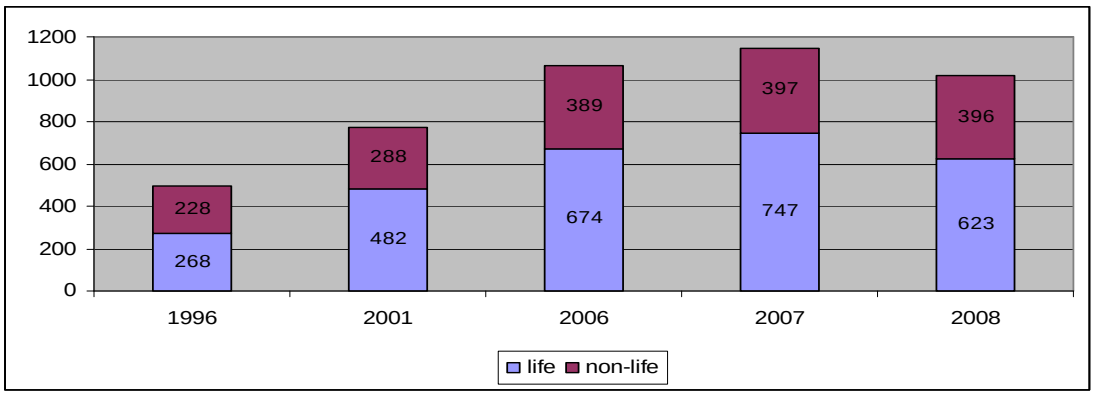
Table 4: Insurance Markets in the World and Regional Blocks (2008)

	Premium production (USD million)	Share of world market (%)	Premiums as % of GDP	Premium production per capita (USD)
World	4.218.115	100	6,9	625
Developed countries	3.706.098	87,9	8,5	3.602
Developing countries	512.017	12,1	2,7	89
EEA*	1.597.029	37,9	8,0	3.199
NAFTA	1.362.359	32,3	8,0	3.054
MERCOSUR**	56.437	1,3	2,9	240
ASEAN	44.438	1,1	2,9	84

Source: own Table based on data from Swiss Re (2009)
* excluding Iceland
** excluding Paraguay

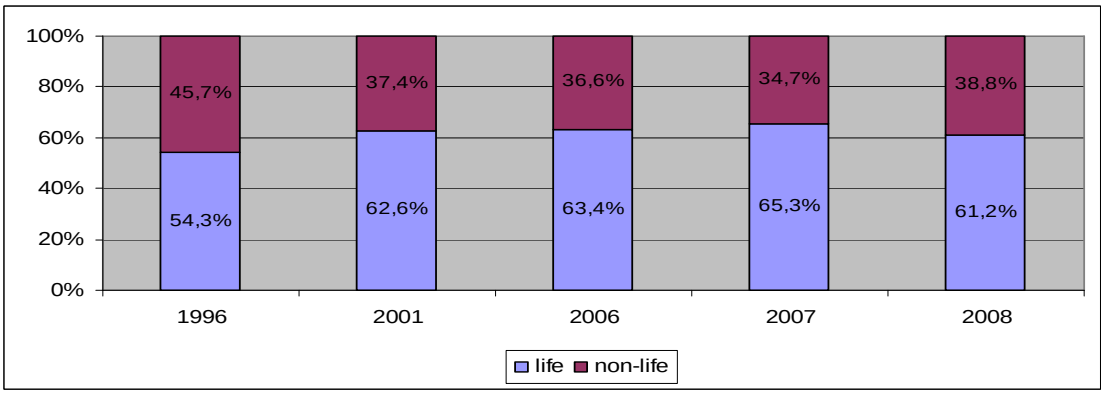
3.1.4.1. Premium Production

Total insurance premium production in the European single insurance market is illustrated in Graph 3. From its level of EUR 496 billion in 1996, it reached EUR 1.144 billion in 2007 and sharply decreased by more than 10% to EUR 1.019 billion in 2008 due to global financial crisis. Since the creation of the European single insurance market, the performance of life business of the EEA was much better than that of the world average. Life premiums almost tripled from EUR 268 billion in 1996 to EUR 747 billion in 2007 before it declined by 16% to EUR 623 billion largely due to the global financial crisis which mostly affected life business. On the other hand, performance of non-life business was not as good as life business. Non-life premiums increased from EUR 228 billion in 1996 to EUR 396 billion in 2008 with an increase of almost 70%. Non-life premiums which largely depend on two lines of business, motor and accident&health, have been little affected by the crisis of 2008 except for a few lines of business, such as credit insurance, that have strong links to economic activity (CEA, 2009a, p.7).



Graph 3: Total Premium Production in the EEA (EUR billion)
Source: own calculations based on data from CEA (2009a)

Life business accounts for more than half of the total premium production and its share has been steadily increasing since 1996. Graph 4 indicates that while the share of life premiums in total premium income in 1996 was 54%, it was 65% in 2007 before it declined to 61% in 2008 due to global financial crisis. The average share of life business in the EEA is in line with the average of industrialized countries in the world.

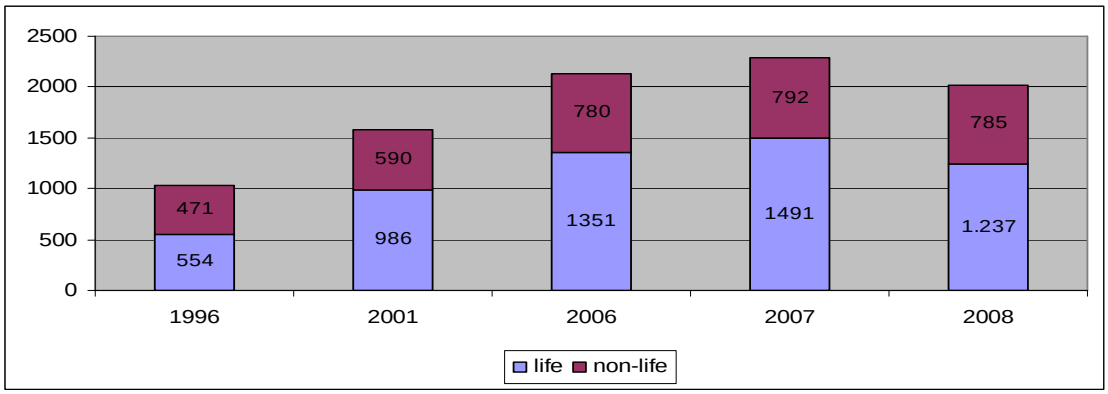


Graph 4: Share of Life and Non-Life in Total Premium Income in the EEA
Source: own calculations based on data from CEA (2009a)

3.1.4.2. Insurance Density

Insurance density which means per capita amount spent on insurance is almost five times bigger in EEA than the world average. Graph 5 shows that following the rapid increase of total insurance premiums, insurance density in EEA increased from EUR 1.025 in 1996 to EUR 2.283 in 2007 before it decreased to EUR 2.022 in 2008. EUR 1.237 was spent on life insurance and the remaining EUR 785 on non-life insurance.

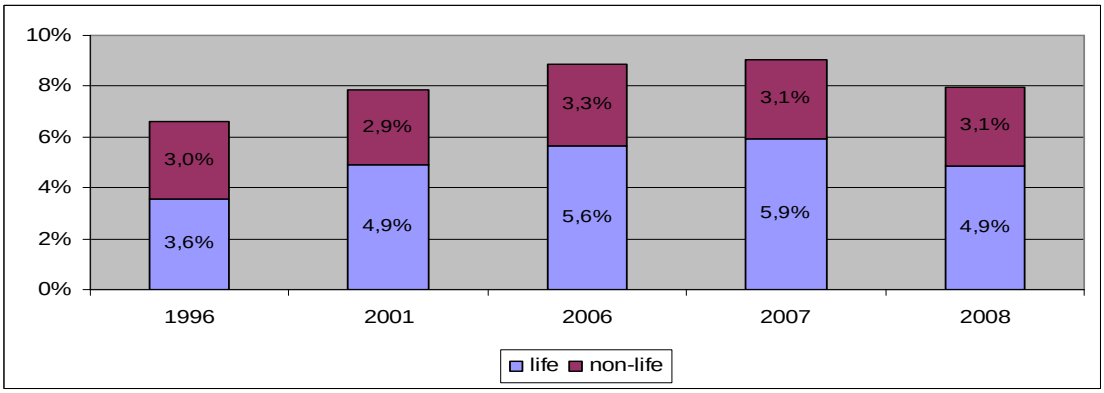
Following the higher increase in life premiums, life premium income per capita almost doubled non-life premium income per capita in 2007.



Graph 5: Insurance Density in the EEA (EUR)
Source: own calculations based on data from CEA (2009a)

3.1.4.3. Insurance Penetration

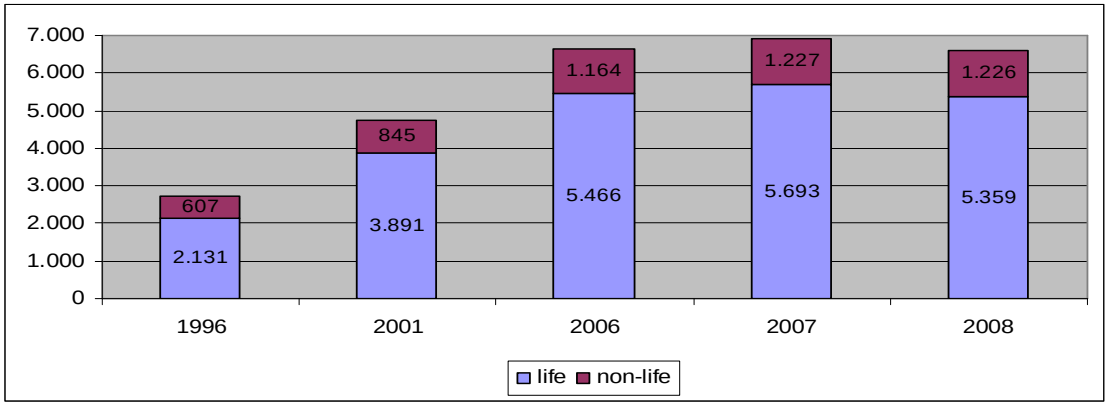
Insurance penetration which means total gross written premium income as a percentage of GDP is higher in EEA than the world average. Graph 6 shows that insurance penetration in EEA increased from 6,6% in 1996 to 9% in 2007 before it decreased to 8% in 2008 following the drop in overall premiums as well as the economic slowdown. Life insurance penetration rate far surpasses the penetration rate of non-life insurance. Whereas life insurance penetration dramatically increased from 3,6% in 1996 to 5,9% in 2007 before it sharply fell to 4,9% in 2008, non-life penetration remained more or less stable at around 3% during the same period.



Graph 6: Insurance Penetration in the EEA
Source: own calculations based on data from CEA (2009a)

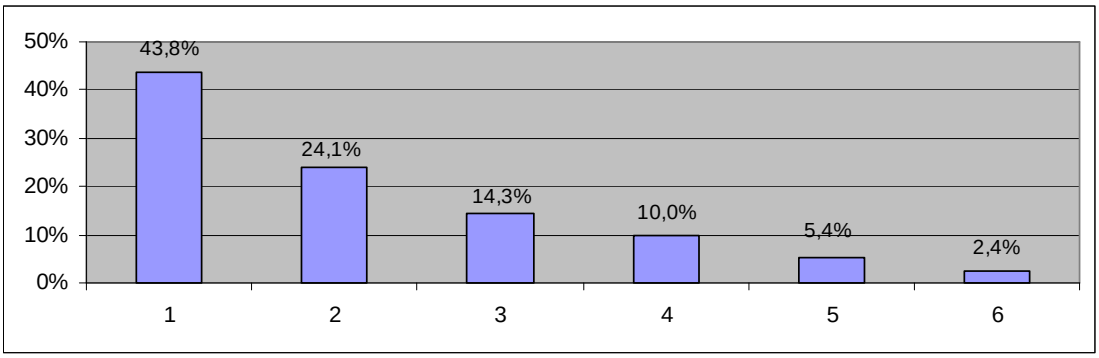
3.1.4.4. Insurance Investments

Insurance industry is one of the largest institutional investors in Europe. Graph 7 demonstrates that the total value of the EEA insurers' investment portfolio increased from EUR 2.738 billion in 1996 to EUR 6.920 billion in 2007 before it declined to EUR 6.585 billion in 2008. Total investments represented 51,5% of the GDP of the EEA in 2008. The investments of life insurance accounted for more than 80% of total investments of the sector.



Graph 7: Investments of Insurers in the EEA (EUR billion)
Source: own calculations based on data from CEA (2009a)

Graph 8 shows that in EEA, fixed income securities which consist of debt securities and other fixed income securities were the largest component of the investment portfolio, with a market share of almost 44% in 2008. This is followed by the investments for the benefit of life-assurance policyholders who bear the investment risk and shares and other variable-yield securities with 24% and 14% respectively. Loans, deposits, investments in affiliated enterprises and lands and buildings have relatively smaller shares representing 18% of total investments.



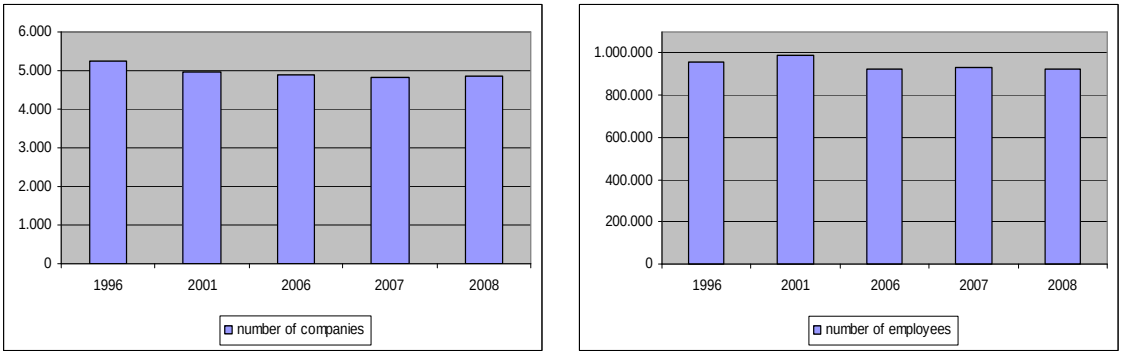
Graph 8: Distribution of Investments of Insurers in the EEA (2008)

Source: own calculations based on data from CEIOPS (2009)

(1) Debt securities and other fixed income securities (Directive 91/674/EEC, Article 6, Assets C.III.2); (2) Investments for the benefit of life-assurance policyholders who bear the investment risk (Directive 91/674/EEC, Article 6, Assets D); (3) Shares and other variable-yield securities and units in unit trusts (Directive 91/674/EEC, Article 6, Assets C.III.1); (4) Participation in investment pools, loans guaranteed by mortgages, other loans, deposits with credit institutions, other investments and deposit with ceding undertakings (Directive 91/674/EEC, Article 6, Assets C.III.3-4-5-6-7 and C.IV); (5) Investments in affiliated enterprises and participating interests (Directive 91/674/EEC, Article 6, Assets C.II); (6) Lands and buildings (Directive 91/674/EEC, Article 6, Assets C.I)

3.1.4.5. Insurance Market Operators

Since the creation of the European single insurance market, beside the remarkable increase in premium volume, the number of companies carrying out insurance activities has a declining trend due to mergers and acquisitions (M&A) in the sector. As a result of the consolidation since mid-1990s, the number of people employed in insurers remained stable. Graph 9 depicts the decreasing trend in the number of companies from more than 5.000 in 1996 to less than 5.000 in 2008 and the stability of the employment which is slightly under 1 million between 1996 and 2008.

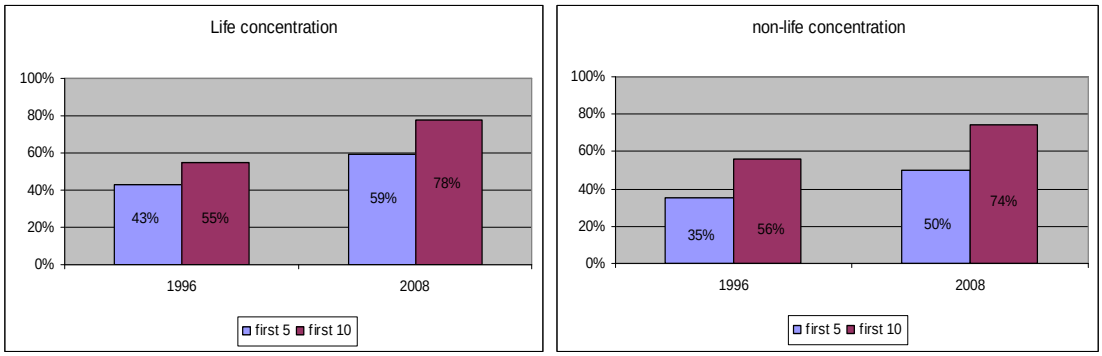


Graph 9: Number of Companies and Employees in the EEA Insurance Market

Source: own calculations based on data from CEA (2009a)

The concentration rate measured in terms of gross written premiums of the largest companies as a percentage of total gross written premiums in the sector is remarkably high due to mergers and acquisitions in the sector and it has still an increasing trend. Since the creation of the European single insurance market, the market share of the largest companies has considerably grown and today a few large operators dominate the whole market. Overall, concentration is higher in life business than in non-life business and higher in the EU-15 Member States than in the new Member States.

Graph 10 indicates that the market share of the biggest five life insurers in EEA increased from 43% in 1996 to 55% in 2008 while the market share of the biggest ten life insurers increased from 59% to 78%. Concentration in non-life sector is somehow smaller but has also an increasing trend. The market share of the biggest five non-life insurers in EEA increased from 35% in 1996 to 56% in 2008 while the market share of the biggest ten non-life insurers increased from 50% to 74%.



Graph 10: Life and Non-Life Insurance Concentration in the EEA
Source: own calculations based on data from CEA (2010a)

CRA International (2009, p.142) reports that the increase in insurance market concentration is not the result of market integration because it is mainly driven by domestic consolidation due to existing market forces.

3.2. INTEGRATION OF THE INSURANCE MARKETS OF THE EEA MEMBER STATES

3.2.1. History of the European Financial Integration

The current level of economic and financial integration reached by the EU Member States is the result of the process that started in 1957 with the Treaty of Rome creating the European Economic Community. The aim of the founding fathers was to create a common market where goods, services, capital and persons could move freely. So, first, a free trade area was gradually established and with the introduction of a common external tariff, the customs union was finally realized in 1968.

In order to complete all features of a common market based on free movement of goods, services, capital and persons, the Single European Act was signed in 1986 and by 1993 the common market based on four freedoms was established.

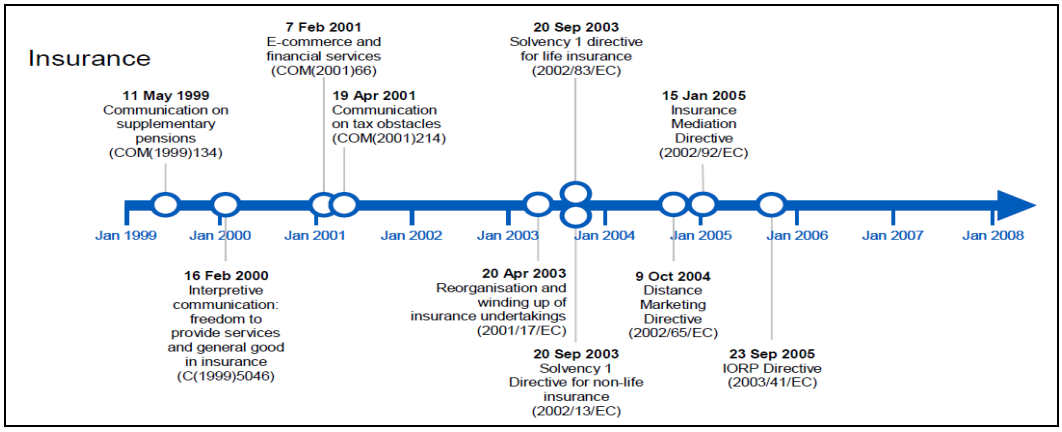
With the Maastricht Treaty signed in 1992, a very significant step was taken for the integration and Member States agreed to establish an economic and monetary union with the introduction of euro from 1999. Monetary and exchange rate policy have been transferred to the European Central Bank (ECB). With its harmonized economic, monetary and some of the fiscal policies, the EU can be considered, today, as an economic and monetary union.

However, it is still not a total economic union in terms of Balassa (1961) categorization since fiscal policies are not transferred to a supranational body and politically, the EU cannot be considered as a federal entity as it is in the case of the USA.

As obstacles of various nature to the integration of financial services continued to exist, Financial Services Action Plan (FSAP)[28] covering policy initiatives to be implemented by 2005 is launched in 1999 for removing the remaining barriers to the cross border activities of financial services (Dierick, 2005, p.69). FSAP covered policy initiatives in the areas of financial regulation and supervision with the aim of fully

[28] Communication from the Commission - Implementing the framework for financial markets: action plan, COM(1999) 232 final, 11.05.1999

integrated financial markets. Graph 11 introduces the timeline of FSAP measures in insurance business such as solvency, winding-up, mediation, distance marketing and institutions for occupational retirement provision which were necessary to create the European single market in insurance services.



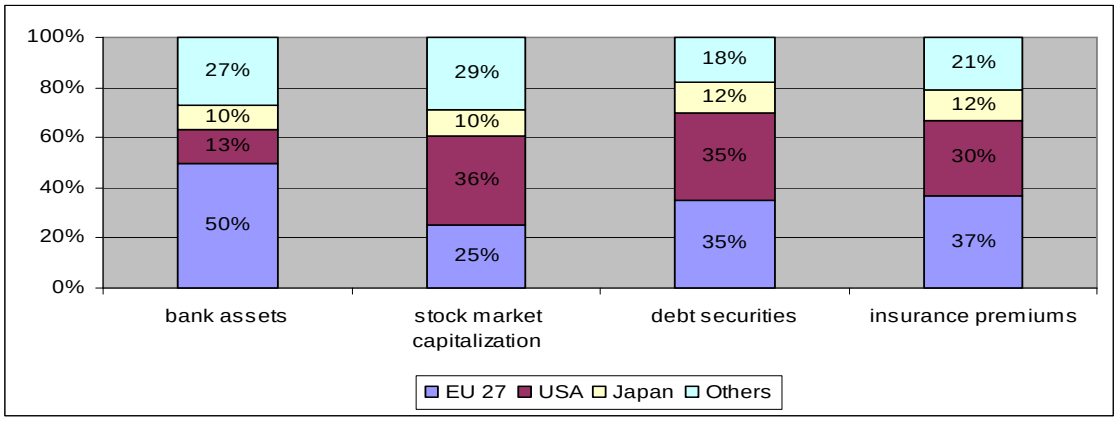
Graph 11: FSAP Measures Related to Insurance

Source: CRA International (2006, p.6)

On the other hand, the post FSAP work covering the period between 2005 and 2010 focuses mainly on implementing existing rules and enforcing co-operation rather than proposing new laws.[29] The ultimate aim behind all these measures for deepening the financial integration was to make Europe more efficient and competitive, and to contribute to sustainable economic growth (European Commission, 2009a, p.7).

Graph 12 shows that the EU financial market significantly contributes to world financial activity together with the USA and Japan. With its bank-based financial system, the EU covers half of the bank assets in world. While the market share of the EU in stock market capitalization is well behind the USA, the trend is towards a market-based system. Finally, the EU has the biggest insurance market, producing 37% of total premiums written in world in 2008.

[29] See European Commission White Paper, Financial Services Policy 2005-2010, 05.12.2005



Graph 12: EU Contribution to the World Financial Market (2008)

Source: own Graph based on data from European Commission (2009a) and Swiss Re (2009)

3.2.2. Integration Level of the European Financial Markets

Establishment of the economic and monetary union has been a major catalyst for the integration of financial markets. Sørensen and Gutiérrez (2006) examine the degree of financial integration in eurozone by applying cluster analysis technique and demonstrate that the eurozone countries have become more homogeneous since the introduction of euro. However, they also find that while Germany, France, Belgium, and to some extent Austria, Italy and the Netherlands tend to cluster together, Spain and Portugal form a separate cluster. Therefore, considerable differences remain between countries, leaving scope for further integration in future (Sørensen and Gutiérrez, 2006, p.8).

Related to financial integration of new Member States, Baltzer et al. (2008, p.31) find that their financial markets are significantly less integrated than those in the euro area. However, Poghosyan (2009, p.262) show that their financial markets have gradually become more integrated with old EU Member States.

On the other hand, the speed and scope of financial market integration have not been the same across all segments of financial markets. While the money and public debt markets are well integrated, in the equity, corporate bond and credit markets, integration has proceeded more slowly and is still incomplete (Japelli and Pagano, 2008, p.9).

3.2.2.1. Integration of Money Markets

The primary money market of the euro area, i.e. the open market operations of the ECB, has been well integrated since the introduction of euro. On the other hand, the level of integration differs considerably in different segments of the secondary money market which is divided into cash market, market for short-term interest rate derivatives and market for short-term securities.

Regarding the cash market, while the unsecured deposit market in which banks exchange liquidity without collateral is almost completely integrated at all maturities, in the secured (repo) market in which wide range of participants exchange liquidity against collateral the degree of integration is lower. Bernhardsen and Ejerskov (2005, p.196) conclude that among money market segments, the least integrated is the market for short-term securities which consists of government securities and private securities.

3.2.2.2. Integration of Bond Markets

Among others, Adam et al. (2002), Baele et al. (2004) and more recently Weber (2009) argue that the convergence of interest rates in European government bond markets has been particularly significant since the introduction of euro and are explained by common shocks rather than idiosyncratic (country specific) shocks.

Yield spreads of euro area government bonds relative to benchmark bonds (10-year German government bonds) converged toward almost zero before they began to diversify from the end of 2008 due to financial crisis. European Commission (2009a, p.9) announced increasing spread divergences between the German benchmark and other euro and non-euro area bonds since the beginning of market turbulence in 2008.

Baltzer et al. (2008, p.31) find that in government bond markets only the largest economies of new EU Member States (the Czech Republic, Poland and to a lesser extent Hungary) exhibit signs of integration.

On the other hand, corporate bond market which is small compared to the size of the EU economy remains relatively less integrated. Literature shows that yield spreads

are mostly driven by bond's credit rating, time to maturity or liquidity but the country of issuance effects have not completely disappeared.

3.2.2.3. Integration of Equity Markets

Equity markets returns are increasingly correlated. Baele and Ferrando (2005, p.217) argue that the increasing importance of common news as a driver of stock market returns indicates a considerable integration. Literature considers the potential of sector diversification which is larger than geographic diversification and the decreasing trend in home bias in the equity holdings of investment and pension funds as the signs of integration in equity markets.

However, cross border trading still remains more expensive and less common than domestic transactions. In addition, divergences in clearing and settlement systems hamper the integration of these markets. As a result, even if European wide entities such as Euronext emerged, national markets continue to prevail and country effects are still important in explaining stock price changes.

European Commission (2009a, p.9) announced that euro area equity markets have been hit significantly by the market turbulence since 2008 and the cross-country dispersion has started to exceed the cross-sector dispersion with increasing differentials.

3.2.2.4. Integration of Credit Markets

There has been a major progress in creating a single wholesale banking market which provides financial services for large corporate and public sector clients. Wholesale activities of banking markets such as investment banking are fairly integrated and competitive.

However, the retail banking markets which provide financial services to individual consumers remain fragmented compared to wholesale financial services. Cabral et al. (2002) empirically find that financial integration in retail banking proceeded slowly after the launch of euro. Retail banking products such as consumer credits, mortgages, small commercial loans and saving accounts behave according to local patterns and are still not integrated.

Hartmann et al. (2003, p.202) claim that *"as the absolute amount of euro area cross border loans to non-banks remains small compared to interbank loans, strong home biases both in lending and in borrowing seem to persist"*. Banks should still spend considerable resources to adapt their retail products to national markets. In addition, Dierick and Vesala (2005, p.137) emphasize that the cost of cross border payments is still higher than the cost of domestic payments. Finally, the preference of European banks to have subsidiaries through cross-border mergers and acquisitions rather than establishment of branches reveals the fact that the single market in banking is more an illusion than a reality (Dermine, 2003 in Hartmann et al., 2003, p.201).

European Commission (2009a, p.12) announced that the financial crisis has pushed the banks to move their geographic focus towards domestic markets, which shows at least a temporary decline in banking integration.

3.2.3. Integration Level of the European Insurance Markets

Assessing the integration level of the European insurance markets, both theoretically and empirically, is even more difficult than that of the other financial intermediaries because of the specific characteristics of insurance. One way to describe the level of integration of the European single insurance market is to evaluate the existing regulatory and supervisory barriers to cross border activities. A different, but necessary and complementary strategy is to look at the price and quantity indicators.

3.2.3.1. Measurement at Legislative Level

The EU insurance legislation envisages to create a single market in life and non-life insurance by establishing the principles of mutual recognition, minimum harmonization, home country control and single license. The EU insurance legislation is almost completed in creating freedom of establishment and freedom of services through three generation directives. Since there are no more discriminations between foreign and domestic market players, it is generally accepted that from the legislative point of view, the EU insurance markets, together with those of Liechtenstein, Norway and Iceland, have become a single insurance market since the entry into force of the third generation of life and non-life insurance directives in 1 July 1994.

The EU insurance legislation is developed mostly through directives which are binding legislative tools and which require Member States to achieve a particular result without dictating the means of achieving it (Craig and De Burca, 2002). Thus, Member States are free to choose the means for achieving this result. They are also free to adopt stricter standards than the minimum standards envisaged in the directives. In addition, some Member States have been granted derogations in the implementation of some of the provisions of the insurance directives.

Therefore, there are still several areas where the existing framework leaves considerable scope for interpretation. This leads to textual and interpretative divergences of the same directive and results in a fragmented regulatory framework across the EU (HM Treasury, 2006, p.17). Moreover, Member States must follow minimum standards required in Directives, but may require more rigid or conservative standards. This makes divergences in national legislation which may sometimes disrupt the single market. For instance, Motor Insurance Directive 2009/103/EC determines minimum coverage for motor insurance policies and then each Member State is free to determine its amount of coverage as long as it is not less than the minimum amounts determined in the Directive. Table 5 indicates that minimum amounts covered by MTPL insurance differ between Member States. While some Member States apply the minimum coverage determined in the Directive, some others apply higher amounts. For instance, for personal injury per claim the coverage is unlimited in some Member States while the coverage in Greece, Italy and Portugal are still below the minimum amount requirements. In Member States which oblige to provide unlimited coverage, the insurers have to increase the premiums. Such price differences due to regulatory differences create an important barrier to the integration of the insurance markets.

Table 5: Minimum Amounts Covered by MTPL Insurance in the EU

Member State	Personal Injury (EUR per claim)	Damage to Property (EUR per claim)
Directive 2009/103/EC*	5.000.000	1.000.000
AT	5.000.000	1.000.000
BE	Unlimited	100.000.000
CZ	1.322.978	1.322.978
DE	7.500.000	1.000.000
DK	12.908.382	2.554.784
ES	70.000.000	15.000.000
FI	unlimited	3.300.000
FR	unlimited	1.000.000
GB	unlimited	1.074.864
GR	500.000	100.000
HU	5.116.972	1.705.474
IE	unlimited	1.000.000
IT	774.685	774.685
LU	unlimited	unlimited
NL	5.000.000	1.000.000
PL	1.229.583	245.917
PT	1.200.000	600.000
SE	27.802.695	27.802.695

Source: Europe Economics, 2009, p.87

* The amounts are updated to 5.600.000 and 1.120.000 with the Notice Regarding the Adaptation in Line With Inflation of Certain Amounts Laid Down in the Motor Insurance Directive 2009/103/EC (OJC 332/1, 9.12.2010)

There are also persisting transposition and implementation problems of the EU legislation. As for the transposition of directives, late transposition and/or wrong transposition are the two basic problems. The wrong implementation of the already transposed directives is another problem.

First, late transposition means that directives are not transposed to national legislation within the timeframe determined in the directive. Member States sometimes fail to timely transpose the directives to national legislation. The EU average transposition deficit is 0,7% as of 1 November 2009, which is well below the target of 1% (European Commission, 2009b, p.7). Austria, Portugal, Czech Republic, Iceland, Poland, Italy, Luxemburg and Greece are the Member States remaining above the ceiling of 1% target.

In financial services, the situation is much better. Only Greece, Belgium, Spain and Ireland have 5 outstanding directives still to transpose in the area of financial services. Currently, out of 16 directives which are more than two years beyond their transposition deadline and are not transposed by at least one Member State, there is no insurance related directive. However, there were late transposition problems in insurance sector as well. For instance, Insurance Mediation Directive 2002/92/EC was transposed into national legislation only by Austria, Denmark, Ireland and the UK before its transposition deadline of January 2005 (Bovenzi et al., 2007, p.5). Winding-up Directive 2001/17/EC and Reinsurance Directive 2005/68/EC had considerable transposition delays as well.

European Commission has the power to refer Member States failing to transpose the directives by the time of their deadline to the ECJ. The number of such cases in insurance is below the average. Nevertheless, European Commission has recently referred some Member States to the ECJ for late transposition:

- European Commission referred Greece to the ECJ for failing to transpose Directives 2002/12/EC and 2002/13/EC on solvency requirements of life and non-life insurance companies by the time of their deadline on 20 September 2003.

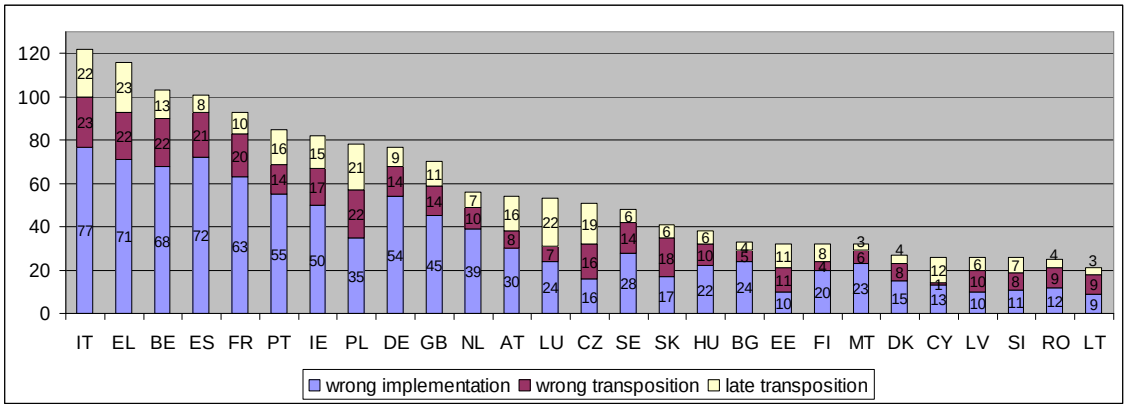
- European Commission referred the UK (case C-164/04) and Sweden (case C-116/04) to the ECJ for failing to transpose Directive 2001/17/EC on winding-up of insurance companies by the time of its deadline on 20 April 2003.

- European Commission referred Greece to the ECJ for failing to implement the Fifth Motor Insurance Directive 2005/14/EC by the agreed date of 11 June 2007.

- European Commission sent formal requests to the Czech Republic, the Netherlands, Poland and Portugal concerning their non implementation of the Directive 2005/68/EC on reinsurance (infringement procedure) before sending the cases to the ECJ.

Second, it is important that EU legislation be transposed correctly in order not to hamper the single market. Graph 13 shows that against 292 late transposition cases, there are 343 wrong transposition cases. European Commission (2009b, p.15) announced that the EU average deficit of directives that have not achieved their full effect due to either late or incorrect transposition is 1,5% as of 1 November 2009. Most of the Member States are still above the 1% target level of the European Commission.

Third, wrong implementation of the correctly transposed directives is the most common and important problem. As can be seen from Graph 13, out of 1.256 infringement cases for wrong transposition or wrong implementation of directives as of 1 November 2009, 913 of them (73%) are the cases for wrong implementation and the remaining 27% are the cases for wrong transposition. The infringement cases for wrong implementation of directives in Italy, Greece, Spain, Belgium and France are well above the EU average.



Graph 13: Transposition and Implementation of the EU Directives

Source: own Graph based on data from European Commission (2009b)

Number of single market directives not yet communicated to the Commission as having been transposed (late transposition), number of directives transposed but for which an infringement proceeding for non-conformity has been initiated by the Commission (wrong transposition), number of infringement cases opened for wrong application (Situation as of 1 November 2009).

Not only in case of late or incorrect transposition of Directives, but also in case of their wrong implementation, European Commission has the power to refer the case to the ECJ. However, average speed of infringement resolution is 28 months and when the cases are referred to the ECJ, the EU average to comply with the judgments is 17 months, which are a very long period of time.

The following recent infringement procedures of the European Commission against Member States for incorrect transposition or implementation of the insurance legislation give an idea about the lack of insurance integration at legislative level:

- European Commission opened an infringement case against Greece because it imposed on companies providing third-party motor insurance the requirement of belonging to the Greek association of insurance companies. Commission decided that this mandatory membership is contrary to the insurance *acquis* and that it restricts the principles of freedom of establishment and free provision of services. Given that Greece has adopted legislation abolishing this mandatory membership requirement, the case has been closed without referring Greece to the ECJ.

- European Commission referred Ireland to the ECJ over rules on compensation for drivers of uninsured vehicles with the idea that they are against the Second Motor Insurance Directive 84/5/EEC.

- European Commission referred Belgium to the ECJ over its national rules on supplementary health insurance provided by private sickness funds with the idea of non compliance with the EU insurance directives.

To sum up, the level of integration of the European single insurance market creating FOE and FOS at legislative level is at an advanced stage although there are persisting problems due to lawful regulatory differences because of the characteristics of the directives as well as due to late and wrong transposition of directives and/or their wrong implementation. However, this does not prove the (non)existence of the integration in real life. Therefore, we need some further analysis of price based, news based and quantitative based measures to check the level of real life integration of the European insurance markets.

3.2.3.2. Measurement by Price Based Indicators

Integration theory explains that financial markets are integrated when the law of one price holds, that is when identical financial products (such as securities with identical

cash flows) have the same price. For instance, if a firm issues bonds in two Member States, it must pay the same interest rate or if it raises equity, it must pay the same amount in both Member States. Similarly, when this firm (or a household) wants to borrow from a bank, the borrowing should be on the same terms irrespective of the location of the bank. Risk premia in bond markets, return of investments in equity markets and interest rates in money markets are easily comparable as long as the data is available.

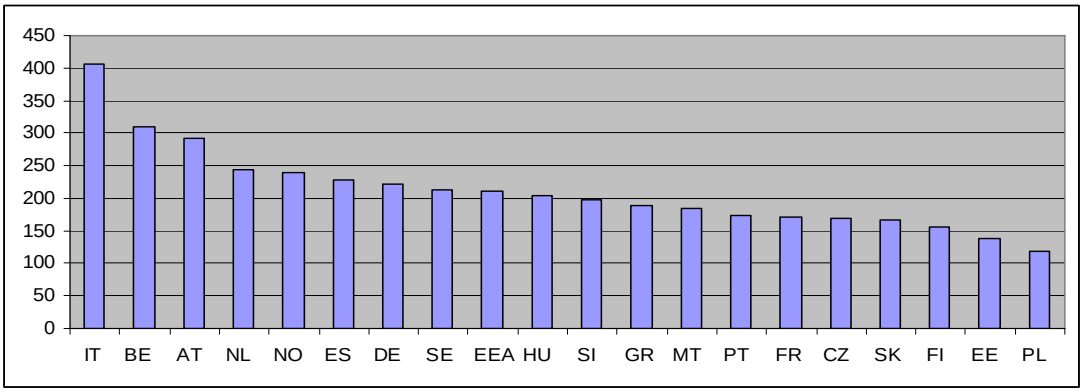
The law of one price can only be applied when price comparisons are meaningful, which requires that goods and services in question are homogeneous and when comprehensive and high quality price data exist. In this context, the law of one price is not applicable to insurance products mainly for two reasons.

First, it is quite difficult to find identical insurance products in order to compare their price since insurance is a complex and multi-product business. Furthermore, the same product of each insurer with the same name may have very different conditions (such as coverage limits), thus, very different prices. For instance, the motor insurance liability package proposed in a given Member State can include guarantees which do not exist in another Member State. High prices observed in motor insurance products in the UK may largely be explained by this situation, as the UK motor policies are comprehensive and almost always include own damage cover, while this is not the case in most of the other Member States where own damage is not automatically included in policies (CEA, 2010c, p.30). It is the same with householder's all risks insurance which includes coverage against natural catastrophes in certain Member States but not in others (CEA, 2004a, p.9).

Second, even if the same comparable insurance products are found, their prices are not expected to be the same due to country and consumer-specific diversities. One may claim that the law of one price may be applicable to compulsory insurances, such as motor third party liability (MTPL) insurance. However, country and consumer-specific diversities, such as driver habits, average age of drivers, road conditions, number of claims, cost of compensation, fraud and taxes, largely remain for MTPL policies and affect the prices. CEA (2004a, p.9) argues that *"just because an MTPL policy is twice as*

expensive in a given Member State, it cannot be assumed that the margin of the insurer selling it is twice as high, or its productivity is only half as high".

Price differentials due to country and consumer-specific diversities remain within the European single insurance market. As can be seen from Graph 14, the MTPL prices show significant differences between European countries, ranging from EUR 119 in Poland to EUR 407 in Italy in 2008. The average price level in Italy is twice as high as in Greece (EUR 189). In Belgium (EUR 309) and Austria (EUR 292), it is well above the EEA average (EUR 211).



Graph 14: MTPL Prices in the EEA (2008) (EUR)

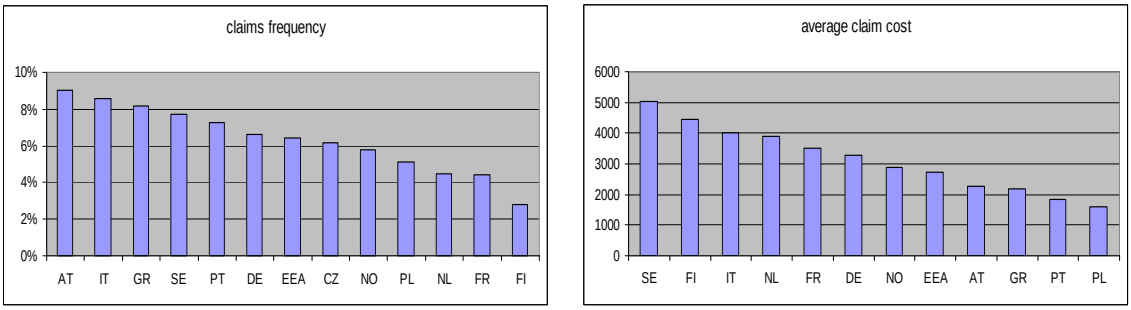
Source: own Graph based on data from CEA (2010c)
2007 data for BE and HU

These price disparities are not due to the lack of integration but to the differences in risk profiles and consumer habits. These country-spe cific features have an impact on both the risk of the policyholder to have an accident (claims frequency) and the cost of the claims resulting from accidents (claim costs) which are the two key determinants of the MTPL prices. An increase or decrease in one of the two determinants may have a different impact on the price level between countries, depending on the level of the other determinant. For example, while France and Portugal have similar price levels, France has a low claims frequency with a relatively higher average claim cost while Portugal has a higher claims frequency with a lower average claim cost (CEA, 2010c, p.36).

Graph 15 highlights the differences in MTPL claims frequency and average claim cost between some Member States. Austria has a claims frequency close to 10%,

while in France and Finland it is 5% and 3% respectively. According to the results of the empirical analysis made by Europe Economics (2009) to see whether some country-specific characteristics were capable of explaining the differences in MTPL prices across the EU, the experience of the driver is the most robust factor which affects the prices. Road safety, more specifically the number of road accidents, and traffic conditions (road density, vehicle density, the condition of roads) are among the other important factors which influence claims frequency and which vary also greatly from country to country (CEA, 2010c, p.43).

On the other hand, it can be concluded from Graph 15 that in Finland and the Netherlands the average claim cost is higher than other Member States with around EUR 4.000, while in Poland and Slovakia it is less than EUR 2.000. Key factors influencing claim costs are vehicle repair and medical care prices as well as fraud levels. The empirical findings of Europe Economics (2009, p.328) reveal that higher per capita health expenditure is positively associated with higher MTPL prices. In addition, high fraud rates, which can be seen in one country and not in another, increase the prices. CEA (2010c, p.46) reports that in 2008, the number of detected fraudulent claims represented 0,9% of all motor claims and 3,9% of all claims expenditure in the UK, whereas 2,8% of claims in Italy appear to involve fraud and represent 2,4% of total claims paid by insurers. Local differences in fraud (8% of claims involving fraud in Southern Italy against only 1% in the North) partially explain the price differences within countries.



Graph 15: MTPL Claims in the EEA (2008)

Source: own Graph based on data from CEA (2010c)
2007 data for NL and GR

Furthermore, there are external factors such as regulatory requirements and taxation that affect the MTPL prices. For instance, in some countries MTPL insurers are

obliged by law to provide unlimited coverage whereas Motor Insurance Directive envisages some minimum coverage. This forces the insurers operating in these countries to increase the MTPL prices as they take extra risks. Moreover, taxation may have a crucial effect on the final price of the insurance products. For instance, the tax burden is almost 60% in Denmark, while the Czech Republic, Estonia and Norway do not impose any tax on motor insurance premiums. Especially in southern European countries there are several parafiscal taxes on motor insurance. In some of the countries there is also fire brigade tax on motor insurance with very different rates.

In conclusion, the integration level of insurance markets cannot be measured by price-based indicators, because law of one price is not applicable to insurance products since they are not identical and their prices are mostly affected by country and consumer-specific diversities, such as drivers experience, road safety, traffic conditions, vehicle repair and medical care prices and fraud levels, all affecting claims frequency and average claim cost which are the two key determinants of the MTPL prices. In line with these arguments, Expert Group on Insurance and Pensions (2004, p.10) emphasizes that given the complicated nature of insurance products, in part reflecting differences in country and consumer specific conditions, simple price comparison is generally not meaningful and not a useful guide to the degree of the integration of insurance markets. Therefore, quantity-based indicators are necessary to measure the integration level of insurance markets.

3.2.3.3. Measurement by Quantity-Based Indicators

To replace price-based indicators which are not applicable in insurance business and to complement the measures at legislative level, quantity-based indicators of integration is used to track the integration level of the European single insurance market. From the supply side point of view, the volume of cross-border activities, i.e. the share of the EEA insurers operating in other Member States in terms of number and premium production are used as a sign of integration. From the demand side point of view, demand of policyholders towards the products of foreign players is also used as a sign of integration.

First of all the convergence of insurance markets and market players is investigated since divergences in insurance market indicators make the integration difficult and costly. In prioritizing failures of the integration process, European Commission (2003, p.7) proposes to take into account the comparisons of the overall economic significance in the sectors concerned. Therefore, the value added of the sector (premiums to GDP) and the employment generated by the sector are analyzed. Since integrated markets are likely to converge and comove, the convergence of market indicators such as insurance density, product types and size of insurers in terms of their investments, assets and financial strength are examined. European Commission (2003, p.7) notes that while not necessarily causally related to the absence of integration, analysis of efficiency indicators may provide insights on gaps in the integration process. Therefore, integration indicators are supplemented by efficiency indicators such as cost efficiency and profitability.

Although they are important determinants of foreign market entry decision of insurers, the analysis of convergence of the insurance density and penetration, types of insurance products and type, size and efficiency of market players in different Member States may well give an incomplete picture of integration. Therefore, market share of foreign insurers in domestic markets, i.e. premiums written in the home Member State by host insurers is analyzed as the main integration indicator. For the calculation of this indicator, three different kinds of foreign presence are taken into account. First, foreign presence through direct cross-border sales without physical establishment is examined. Second, foreign presence through locally established branches and agencies is analyzed. Foreign branches are subdivided into EEA and non-EEA branches in order to capture the shares of EEA and non-EEA insurers separately. The existence of these two types of foreign presence will show that competition takes place on an EU-wide basis in a well integrated market where companies operate in several Member States through either freedom of services or freedom of establishment. Third, foreign presence through merger with or acquisition of domestic insurers is investigated. M&A activities in the EEA are subdivided into domestic and cross-border activities in order to capture the Europeanization of the insurers. The existence of this type of foreign presence will show that competition takes place on a multi-domestic basis with cross-border entities where

customers are confined to their national markets dominated by few large European insurance groups (European Commission, 2007a, p.44).

The main data sources that are used in this study are the Statistical Annex of the CEIOPS[30] Financial Stability Reports of the years 2006-2009, the dataset of the CEA European Insurance in Figures 2009 that contains data for the period 1996-2008 and OECD Insurance Statistics Yearbook 2010 that contains data for the period 1999-2008. The data set is partly augmented by Eurostat statistics, the European Commission reports and Swiss Re sigma studies.

For market convergence indicators, the data published by the European Insurance and Reinsurance Federation (CEA) is preferred. Since CEIOPS (now EIOPA) presents data according to type of insurers, i.e life, non-life and composite, it is impossible to calculate the share of life and non-life business. In addition, while the dataset of the CEA includes Turkey, CEIOPS does not. These are the basic rationale behind the preference of the CEA dataset.

For cross-border activities, the main limitation is the scarcity of data and thus several data sources are used. In case of the lack of data, special importance is given to the size of the sample so that it represents a significant share of total market. Since several sources are used, a great effort has been made to make the data coming from different sources comparable. CEIOPS and OECD dataset are used to calculate foreign presence in the EEA and individual Member States.

This study relies on the data presented by CEIOPS in most of the cases for several reasons. First of all, it is more comprehensive. It covers data for EEA and non-EEA branches separately, which is indispensible to capture the level of market integration in practice. Second, it covers all EEA countries (with considerable exceptions due to missing data), some of which are not covered by OECD as some of the EEA countries are not members of OECD. Third, it does not only cover data on the premiums written by EEA branches in domestic markets but also premiums written by domestic insurers in other EEA countries under freedom of services.

[30] European Insurance and Occupational Pensions Authority (EIOPA) superseded CEIOPS from 1.1.2011

Since the dataset of CEIOPS does not cover the market share of foreign-controlled companies, OECD dataset is also used to calculate the total foreign presence in the insurance markets of the EEA countries. OECD Statistics Yearbooks contain data on total foreign insurance presence in domestic markets, defined as the sum of the market shares of foreign-controlled companies and non-EEA branches and agencies in terms of premiums in both life and non-life business.

3.2.3.3.1. Convergence of Insurance Markets

It is crucial to understand the differences of market indicators between Member States since foreign market entry decision is not directly related to the creation of a single market which rather facilitates the market entry by liberalizing the market.

Moshirian (1999) studies the outward international insurance services provided by the United Kingdom and Germany and concludes that demand for insurance, level of national income and market structure in the host countries contribute to the decision of expansion of multinational insurance companies.

Outreville (2008, p.481) further adds that location-specific advantages such as the size of a market, human capital (education), regulatory barriers, cultural distance as well as good governance (corruption and government effectiveness) provide an explication of the internationalization of insurance companies in some locations.

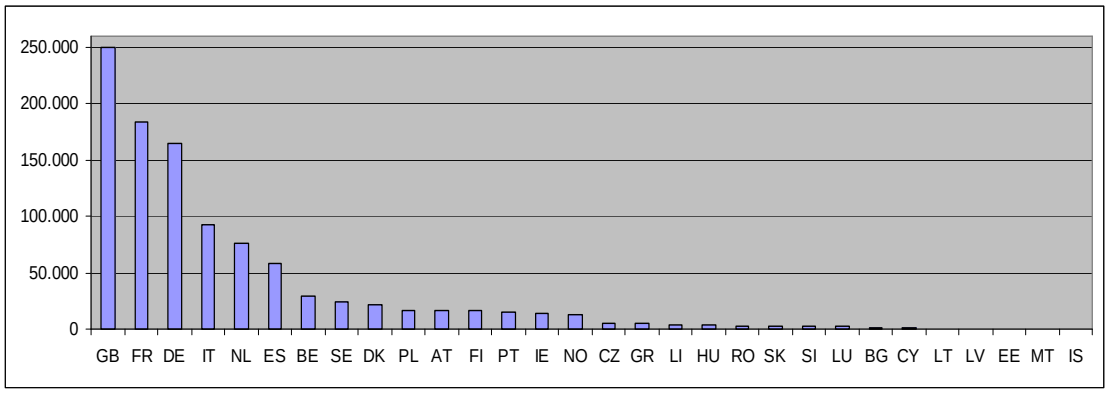
Ma and Pope (2008, p.330) identify three main determinants for the participation to foreign life insurance markets, which are the level of liberalization, competition and size of the host country insurance market. First, it is expected that markets with less adversarial regulation toward foreign insurers will be more attractive to international insurers. This is not a determinant for the EEA insurers as full liberalization is assumed to be created in 1994 with third insurance directives. Second, international insurers prefer foreign markets that are relatively more competitive as opposed to concentrated markets. Moreover, they prefer relatively inefficient markets where there are opportunities of higher profit margins. Third, it is hypothesized that bigger insurance markets in terms of life insurance consumption (density) and the magnitude of the role life insurance plays within the economy (penetration) are more attractive to foreigners.

Ye et al. (2009, p.466) find that socio-economic and market structure factors such as life expectancy, foreign market share, income, dependency ratio, financial development, level of competition, economic growth and market liberalization have positive impacts, whereas combined ratio and social security expenditure have negative impacts on foreign participation in life insurance markets.

As a result, the literature reveals that the creation of a single insurance market where there are no market entry barriers may significantly improve the desirability of the markets with less concentration, high profitability, high insurance density and high insurance penetration as host country markets for foreign insurers. Therefore, the Europeanization of the insurance markets would depend on the markets indicators of the Member States rather than the establishment of the single insurance market itself.

3.2.3.3.1.1. Insurance Density

The size of insurance markets varies considerably between Member States as it is shown in Graph 16. Total premium production in new Member States from Central and Eastern Europe is far behind the average of the old EU-15 Member States. Premium production in Member States deviates greatly from the mean which is EUR 34 billion. The UK has the largest insurance market with a premium production of EUR 250 billion in 2008 while Iceland is the smallest with EUR 279 million. The UK, France and Germany consist of almost 60% of total premium production of the European single insurance market.



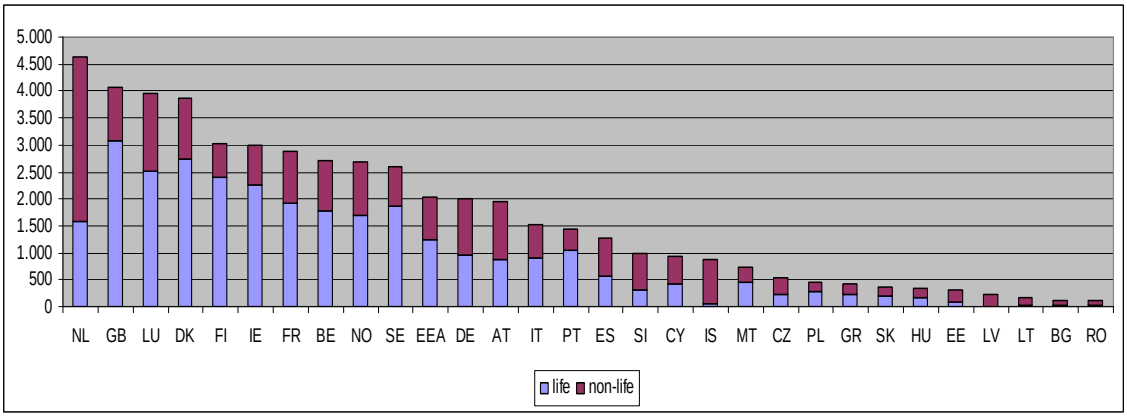
Graph 16: Total Premium Production in the EEA (2008)

Source: own Graph based on data from CEA (2009a)

The biggest life insurance market is the UK with more than EUR 188 billion followed by France and Germany with EUR 122 billion and EUR 80 billion respectively. The three countries consist of 62% of total life premium production in 2008. In non-life insurance business, the leader of the market is Germany with EUR 85 billion and followed by France and the UK with EUR 61 billion and the Netherlands with EUR 50 billion.

On the other hand, insurance density which shows the average premium production per capita is a better sign of convergence between Member States since it eliminates the country-size effect. Graph 17 shows that there are huge differences in insurance density between Member States which deviate largely from the EEA average of EUR 2.022 in 2008. Excluding Liechtenstein, it ranges from EUR 112 in Romania to EUR 4.637 in the Netherlands. Other high density countries are the UK, Luxembourg and Denmark where unlike the Netherlands, policyholder expenditure is higher on life products. Low density countries are Greece and new Member States where non-life products prevail in insurance expenditure.

The indicators in Graph 17 should be interpreted cautiously since they may also include cross-border premiums written through FOS. For instance, in Liechtenstein, the premium production per capita is EUR 106.443 due to high premium level written in EEA by way of freedom of services compared to premiums written domestically. When total premium level of EUR 3.8 billion written both within the country and in the EEA divided by the small population of the country, insurance density becomes astonishingly high. It also indicates that Liechtenstein is one of the few countries which has relatively important cross-border operations compared to its size in the European single insurance market.

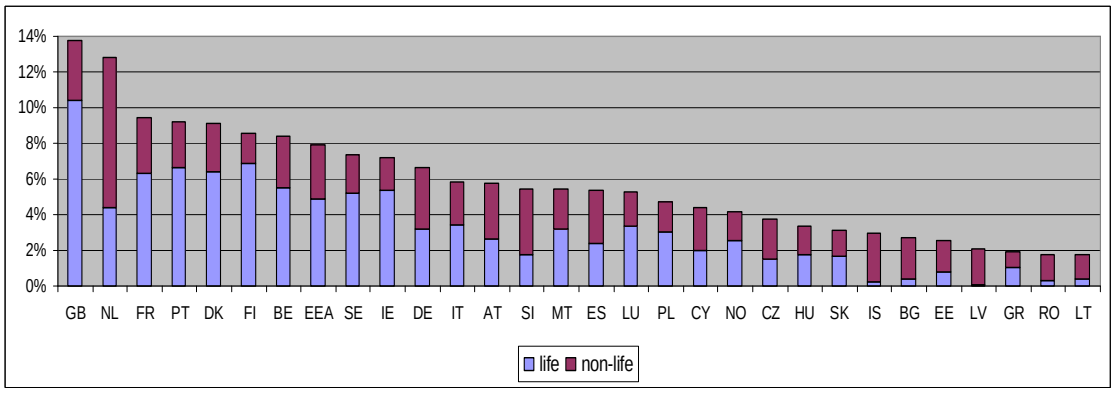


Graph 17: Insurance Density in the EEA Countries (2008)
Source: own Graph based on data from CEA (2009a)

3.2.3.3.1.2. Insurance Penetration

Insurance penetration which shows the total premium income to GDP varies between Member States. The variation in penetration rates shows the differentiation of the importance of the insurance sector in the national economies of the Member States.

Graph 18 indicates that while the average insurance penetration is 8% in EEA in 2008, it ranges from 1,7% in Lithuania to 13,8% in the UK. Only about half of the EU-15 Member States are above the EEA average. Life penetration is highest in the UK whereas non-life penetration is highest in the Netherlands due to the privatization of health insurance in 2006 in that country.

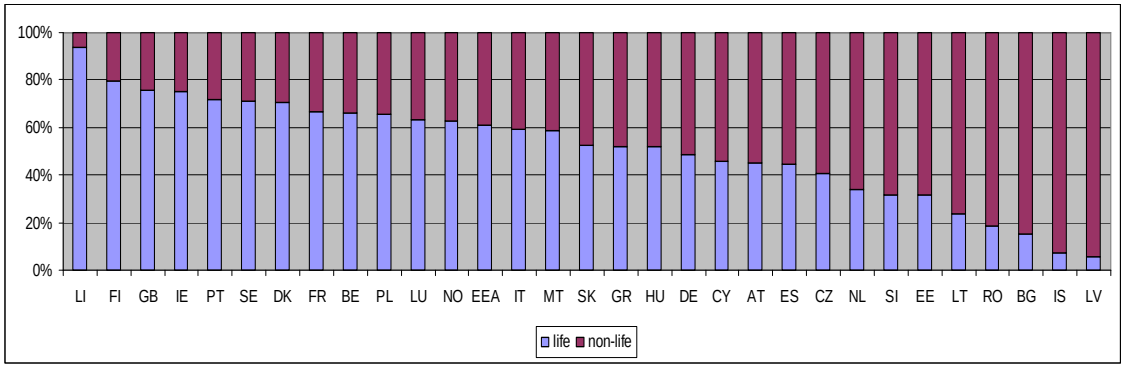


Graph 18: Insurance Penetration in the EEA Countries (2008)
Source: own Graph based on data from CEA (2009a)

3.2.3.3.1.3. Insurance Products

It is very difficult to quantify the product differentiation in the European single insurance market. The cover and indemnity of insurance policies differ both between and within Member States and thus price-based comparison is not meaningful. However, insurance markets of each Member State can at least be examined by line of business.

In 2008, life business in EEA consists of 61% of the market and the share of non-life business remains at 39%. While the European market is mainly dominated by life insurance products, in some few Member States non-life products still prevail. As can be seen from Graph 19, life insurance premiums consist of more than half of the total premiums in most of the Member States mainly except for Baltic countries, Romania, Bulgaria and the Netherlands. Therefore, any shocks which affect life insurance business, for instance, will have different impacts in Member States. They will affect the Member States with larger share of life business more than the Member States where non-life products prevail in the market.



Graph 19: Share of Life and Non-Life Premiums in the EEA Countries (2008)
Source: own Graph based on data from CEA (2009a)

Country specific factors affect the share of life and non-life business. For instance, in the Netherlands, the share of non-life business is 66% and it is not in conformity with the EEA average due to the privatization of healthcare system in the country in 2006.

Furthermore, even between the markets where life (or non-life) insurance products dominate the market, product differentiation may still persist. Life insurance

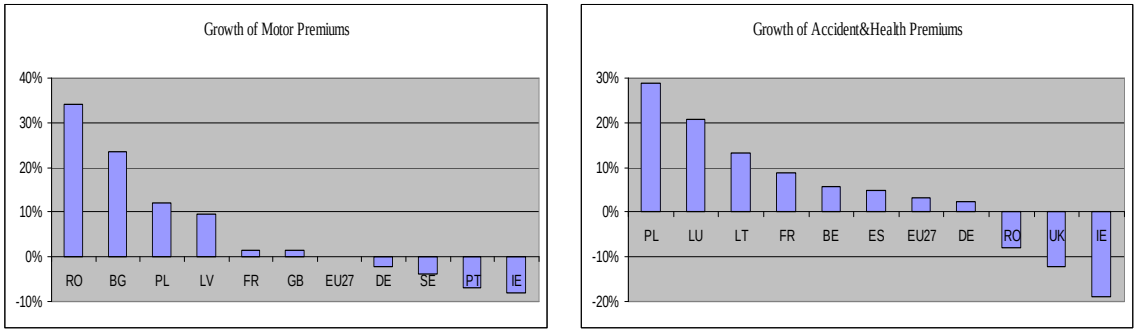
markets in Germany, Austria and Portugal are mainly dominated by non-linked life insurance products such as term insurance products while in France, the UK and Luxembourg the markets are dominated by linked life insurance products where the benefits are calculated by reference to the value of nominated investment funds.

On the other hand, as a result of product differentiation, insurance markets do not comove and any shocks which affect life insurance business, for instance, will have different impacts even between the Member States where life business dominates the market. This is why the developments in life insurance markets varied to a great extent among Member States during the financial crisis in 2008. Life premium income decreased by more than 25% in the UK and Ireland and by around 10% in France and Italy while it increased in Luxembourg, Spain, Portugal and Germany. The reason of this variation may be attributed to the life product differentiation in Member States. Whereas unit-linked products which were very much affected by the financial crisis are popular in the UK, Ireland and France, life insurance market in Germany was more resilient to the crisis due to high share of regular premiums.

Furthermore, in such a non-integrated market, country specific factors explain the lack of comovements. For instance, in 2008, in Spain, Portugal and Poland life premiums increased to a great extent while the European life insurance market declined sharply due to financial crisis. The differentiation of these three countries may be attributed to very different country-specific factors. CEA (2009a, p.11) highlights that in Spain, the increase in life premiums was mainly driven by high numbers of surrenders that were then most probably invested in other life insurance contracts, that in Portugal, life insurance market benefited from transfers originating from the banking sector and that in Poland, the dynamic development of bancassurance for life insurance products and the attractiveness of short-term life policies led to a boom in premiums.

Non-life insurance markets of the Member States differ as well. Non-life lines of business do not comove and markets are dominated by different lines of business. It is worth to analyze two lines of business, motor and accident&health, which account for more than 60% of the total non-life premium production in the European single insurance market.

Graph 20 illustrates nominal growth rates in motor premiums from 2007 to 2008 at constant exchange rates. While the average growth rate is zero in the EU-27, there is high growth in Romania and Bulgaria. The negative growth rate is more than 5% in Ireland and Portugal. The same kind of differentiation is valid for the growth rate of accident&health premiums. While the average growth rate is 3,1% in the EU-27, the growth rates in Iceland and Poland reaches almost 30%. The negative growth rate seen in the UK and Ireland is more than 10%.

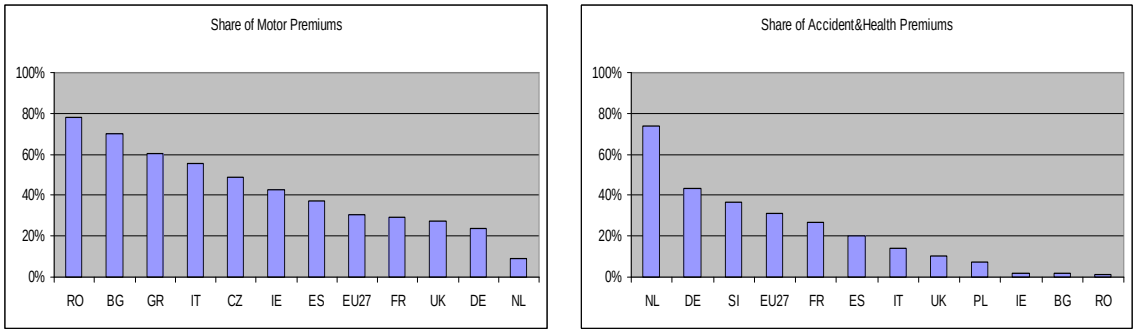


Graph 20: Growth of Motor and Accident&Health Branches in EEA (2007 to 2008)
Source: own Graph based on data from CEA (2009a)
Growth at constant exchange rates

Beside the differences in comovements, the importance of different lines of business in total premium production greatly varies from country to country. For instance, in 2008, liability products cover 20% of the non-life market in Ireland but 6% in Spain and maritime, aviation and transport (MAT) products cover 13,6% of the non-life market in the UK but only 1,8% in France and Italy.

As Graph 21 demonstrates, the average share of motor premiums in total non-life premiums is 30% in the EU-27. While Romania and Bulgaria have a share of 78% and 70% at one hand, the Netherlands is at the other hand with only 9%. In the insurance markets of the new Member States as well as in Greece and to some extent in Italy, traditional insurance products such as motor and fire insurance products dominate the market. On the other hand, in the UK, France and Germany where numerous types of products in several lines of business such as credit, liability and legal expenses are widespread, traditional insurance products such as motor insurance products have relatively smaller shares in the market.

Graph 21 also shows that the share of the accident&health premiums in total non-life premium production is 31%. While the Netherlands and Germany are far from the average with 73% and 43%, Bulgaria and Romania are on the other extent with less than 2%. Due to the privatization of health in the Netherlands in 2006, the share of accident&health branch is far above the EU-27 average.

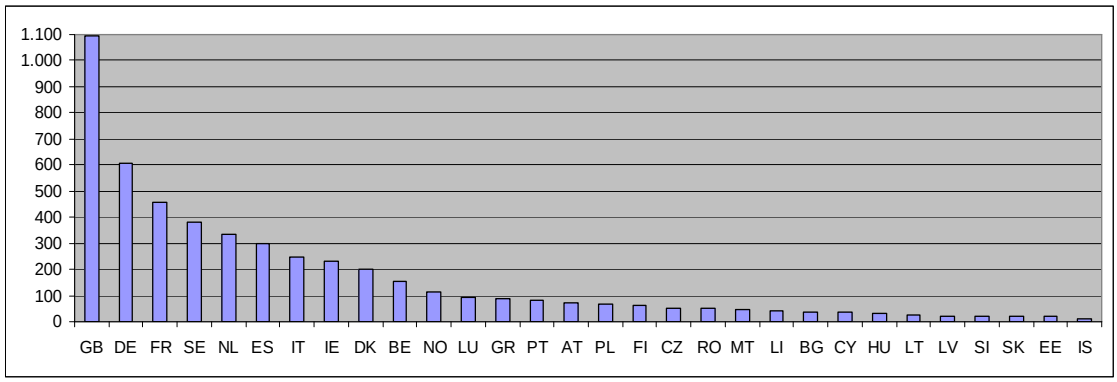


Graph 21: Share of Motor and Accident&Health in EEA Non-Life Business (2008)
Source: own Graph based on data from CEA (2009a)

3.2.3.3.1.4. Type and Size of Insurers

There are different types of insurance companies in Europe. The main model is joint-stock or limited-liability company but the model of mutual insurer, owned by the policyholders, is still widespread in France, Germany and to a lesser extent in the UK. Largely due to these small mutual insurers, the number of insurers in the EU-15 is substantially higher than in the new Member States where cooperatives are not common in the market.

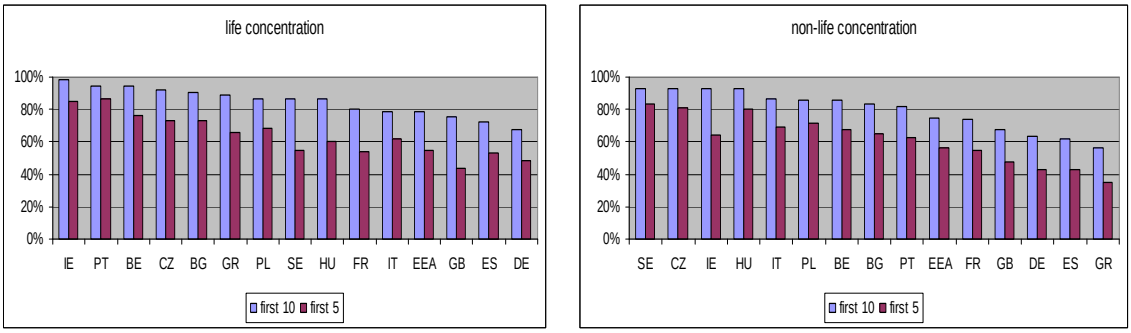
Number of insurers in the EEA countries in 2008 is demonstrated in Graph 22. The UK, Germany and France account for 42% of the insurers based in the European single insurance market. In 2008, while the number of insurers increased in the UK which is the biggest insurance market in the EEA, it declined in Sweden and the Netherlands, which have the fourth and fifth largest number of insurers in the EEA.



Graph 22: Number of Insurers in the EEA Countries (2008)

Source: own Graph based on data from CEA (2009a)
The numbers include national companies and branches of third countries (EEA and non-EEA).
FR excludes mutuals

On the other hand, not the absolute number but the size of the companies determines the competitive power of the market. Smaller insurers have more and more difficulties to survive in the market as increasing concentration is a prevailing trend in the European single insurance market since the second half of the 1990s, mainly as a result of the significant M&A activity in the sector. It can be seen from Graph 23 that the concentration ratio measured by premium production of the largest companies as a percentage of total premium production is very high in both life and non-life business. Life business is a relatively concentrated market in the Member States such as Finland, Slovenia, Ireland and Belgium with a concentration ratio of more than 90%, whereas in non-life business the concentration is highest in Slovenia, Finland, Sweden and Czech Republic. The sector is most fragmented in the bigger Member States such as Spain, Germany, the UK and France.

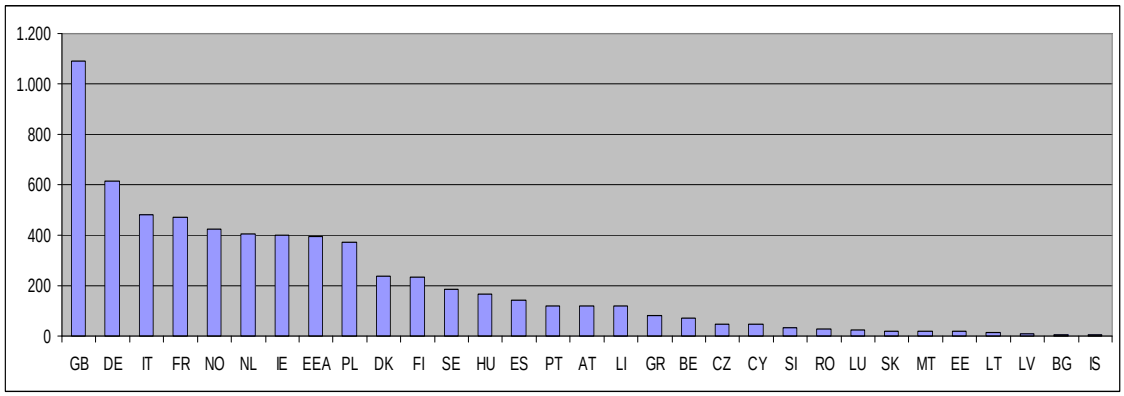


Graph 23: Life and Non-Life Concentration in the EEA (2008)

Source: own Graph based on data from CEA (2010a)

Increased concentration resulting from the consolidation in the sector means that companies are becoming larger in terms of premium income and assets. Life companies are larger than non-life companies. While the average premium production of the EEA life insurers is EUR 394 million, the average remains at EUR 118 million in non-life insurers.

Graph 24 shows that with slightly more than EUR 1 billion premium production on average, life insurers are much bigger in the UK than the ones based in other Member States. German, French and Italian life insurers follow British life insurers with an average premium production of EUR 615, EUR 480 and EUR 470 million respectively. Except the ones based in Poland and Hungary, life insurers from new Member States are at the other side of the scale with less than EUR 50 million premium production.



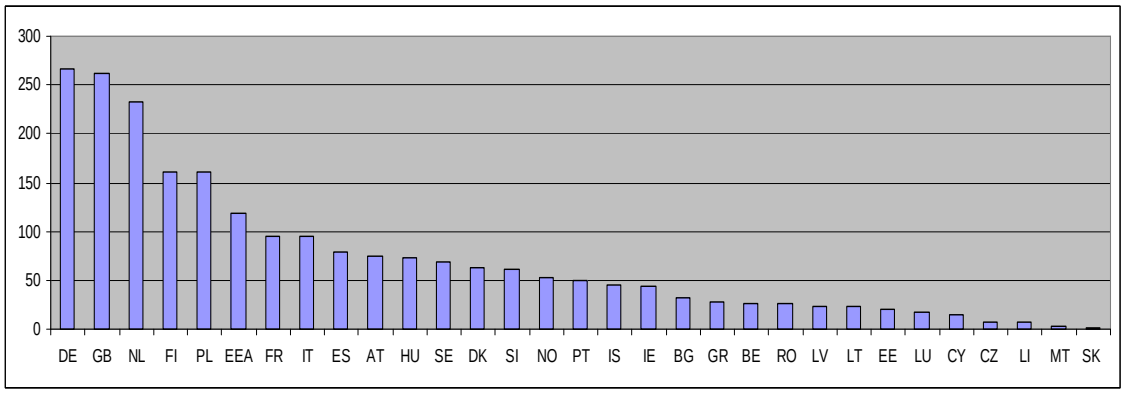
Graph 24: Size of Life Insurers in the EEA (2008) (EUR million)

Source: own calculations based on data from CEIOPS (2009)
Based on the average premium production of life insurers (excluding composite companies)

Non-life insurers are much smaller than life insurers. There are almost 3.000 non-life insurers in the European single insurance market compared to around 1.100 life insurers.[31] However, their total premium production is smaller than the production of life insurers. As can be seen from Graph 25, the biggest non-life insurers are established in Germany and the UK with around EUR 260 million premium production in 2008, followed by non-life insurers from the Netherlands with EUR 233 million. Insurers from Finland and Poland are above the EEA average while all the others are below. Insurers from the new Member States and Greece are at the other hand of the scale. With small

[31] Note that the Graphs 24 and 25 do not include almost 443 composite insurers operating in the European single insurance market in 2008.

premium production levels, their competitive power in the European single insurance market will be restricted.

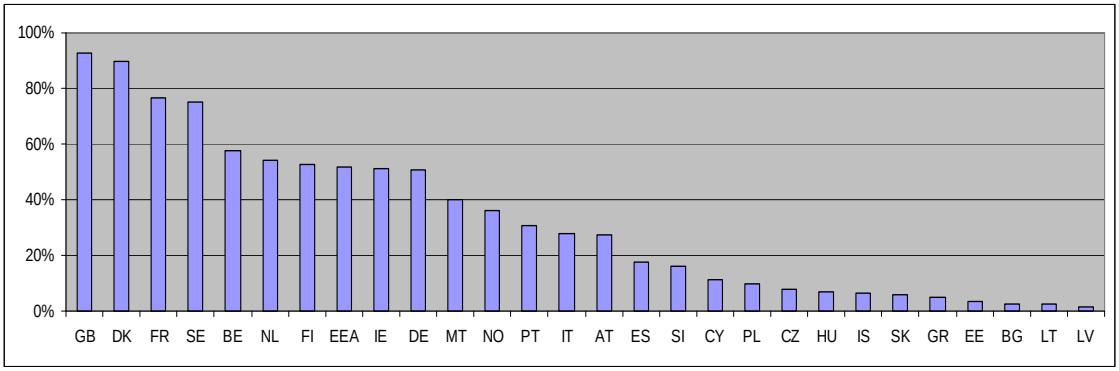


Graph 25: Size of Non-Life Insurers in the EEA (2008) (EUR million)
Source: own calculations based on data from CEIOPS (2009)
Based on the average premium production of non-life insurers (excluding composite companies)

Furthermore, the size of insurers seems in conformity with the market size of their home Member State. This again proves the lack of real market integration in the European single insurance market. Since their activities by way of FOS are very limited, in other words, since they are not using cross-border selling opportunities, their size is restrained by the size of their national insurance market.

3.2.3.3.1.5. Investments of Insurers

The largest investors among the EEA insurance markets are the markets of the UK, France and Germany with EUR 1.677, EUR 1.489 and EUR 1.262 billion in 2008, accounting for 65% of the total investment portfolio. The ratio of total investments to GDP which is provided in Graph 26 is a better sign of convergence between Member States as it eliminates the country-size effect. Like insurance penetration, the ratio of investments to GDP which provides an indicator of the relative importance of insurance to the economy, enables a comparison of the development of the insurance sector from country to country. While the average ratio of total investments to GDP is 51,5% in EEA in 2008, it shows large disparities between Member States, ranging from 1,7% in Latvia to 166% in Luxembourg. At one hand of the scale stand the UK, Denmark, France and Sweden mainly due to investments of life insurers, while at the other end there are Portugal, Italy, Austria, Spain, Greece and most of the new Member States.

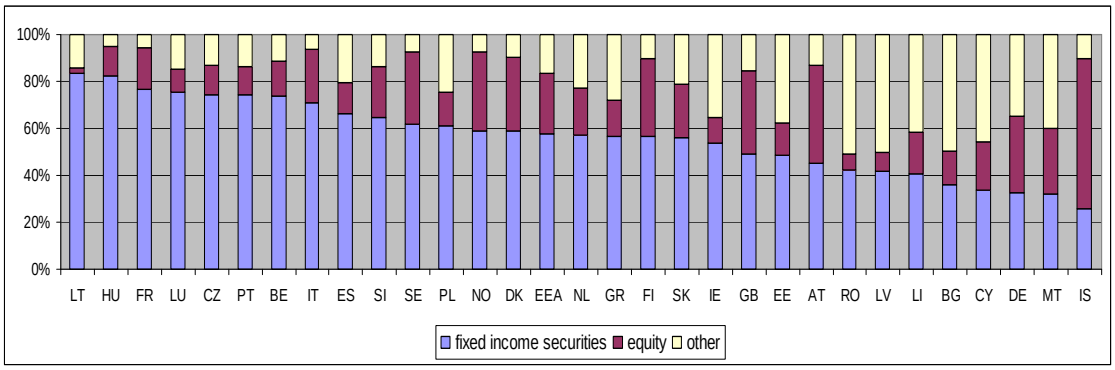


Graph 26: Investments of the EEA Insurers to GDP (2008)

Source: own Graph based on data from CEA (2009a)

Following the decrease in premium production in 2008 due to financial crisis, the average decrease of investments in EEA insurers was almost 5%. However, countries reacted very differently. In 2008, while the decrease in investments in the UK was 15% and in Sweden and Finland 12%, investments in Austria, Spain and to a greater extent in new Member States increased.

Graph 27 shows that the variation of allocation of insurers' investments between Member States is still substantial. This is why they are affected very differently in case of crisis. While fixed income securities account for more than half of the total investments in most of the Member States (58% in 2008), the share in Lithuania, Hungary, France and Luxembourg is more than 75%. The share of equities show bigger variations (26% in 2008) ranging from 2,7% in Lithuania to 64% in Iceland in 2008. The share of equities in Austria, the UK and Scandinavian countries is more than 30% while it is less than 10% in Latvia, Romania and Luxembourg. This is why the market shocks will be asymmetric in the European single insurance market and there is no mechanism to balance and compensate such asymmetric shocks.



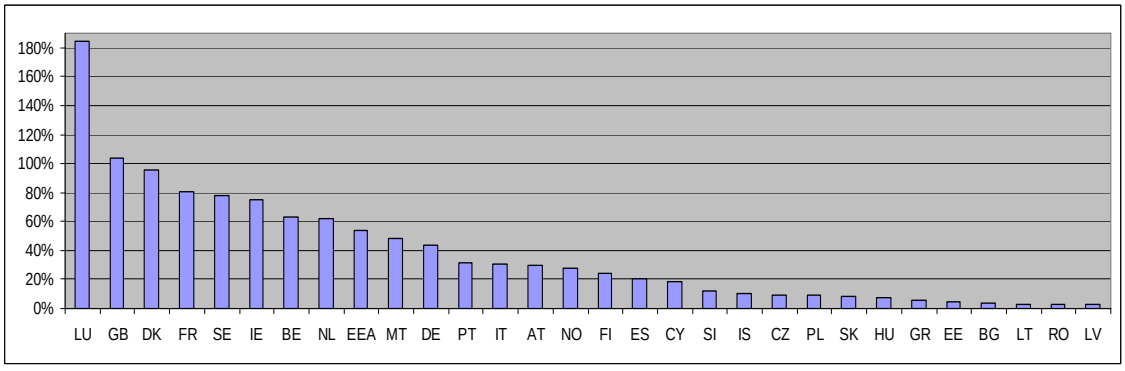
Graph 27: Allocation of Investments of the EEA Insurers (2008)

Source: own calculations based on data from CEIOPS (2009)

Fixed income includes debt securities and other fixed income securities; equity includes shares and other variable-yield securities, and investments in affiliated enterprises and participating interests; other includes lands and buildings, loans, deposits with credit institutions and other investments.

3.2.3.3.1.6. Competitiveness of Insurers

The asset size of the insurers is crucial for their competitive power in the market. The UK, France and Germany account for 66% of total assets of insurers in EEA in 2008. While total assets of insurers accounts for EUR 558 million in Latvia, it accounts for EUR 1.887 billion in the UK. To eliminate country size effects, Graph 28 demonstrates the ratio of total assets to GDP in 2008. In Luxembourg the ratio is 184%, in the UK 104% and in Denmark 95% while the average of EEA is 54%. Greece and new Member States are far below this average with less than 10% in most of them.

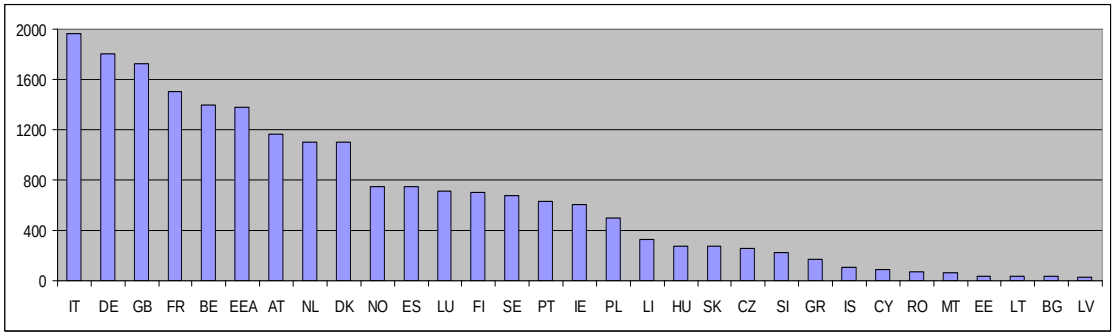


Graph 28: Assets of the EEA Insurers to GDP (2008)

Source: own calculations based on data from CEIOPS (2009) and CEA (2009a)

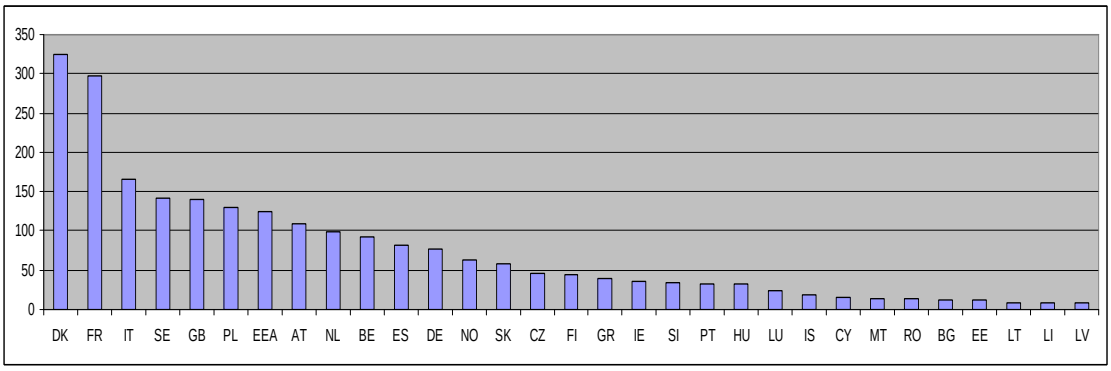
Assets are composed of total investment assets (Directive 91/674/EEC, Article 6, Assets C and D) and other assets (Directive 91/674/EEC, Article 6, Assets A-B-E and G)

Insurers with bigger amount of assets will have competitive power in the market. In the EEA, total assets per company differ a great deal between Member States. Graph 29 illustrates the amount of assets per insurer in the EEA. In terms of assets, average size of companies is EUR 1.4 billion in the EEA. Biggest companies are in Italy, Germany, the UK, France and Belgium respectively. The average amount of assets is relatively very small in new Member States but also in Greece, Portugal, Finland, Spain and Norway total assets per company are far below the EEA average.



Graph 29: Amount of Assets per Insurer in the EEA (2008) (EUR million)
Source: own calculations based on data from CEIOPS (2009) and CEA (2009a)

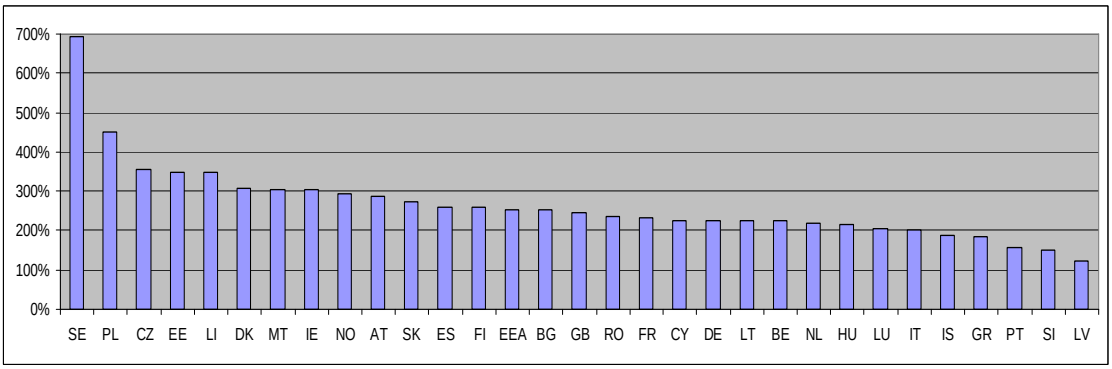
Furthermore, the amount of capital per insurer differs widely in the European single insurance market. Total capital of insurers in the UK and France with EUR 153 billion and EUR 136 billion respectively, accounts for almost half of the total capital of EEA insurers. They are followed by Denmark, Sweden and Germany. The amount of capital per company which eliminates the country-size effect is the best way to compare the size of insurers in terms of capital and to understand their competitive power in the European single insurance market. Graph 30 shows that the average amount of capital of the insurers in Denmark and France is ahead of the insurers in other Member States with EUR 324 million and EUR 296 million respectively. The insurers from Italy, Sweden, the UK and Poland are above the EEA average which is EUR 124 million, while all others are below this average. Except for Poland, Slovakia and Czech Republic, capital per company in new Member States are negligible.



Graph 30: Amount of Capital per Insurer in the EEA (2008) (EUR million)

Source: own calculations based on data from CEIOPS (2009) and CEA (2009a)
Capital and Reserves, Directive 91/674/EEC, Article 6, Liabilities A

Moreover, financial strength which is another indicator of competitiveness differs among insurers. Solvency ratio of the insurers, measured by dividing available solvency margin by required solvency margin calculated according to Solvency I Directives shows their financial strength. Graph 31 indicates that solvency ratio ranges from 123% in Latvia to 693% in Sweden. Financial strength is not related to size. Average solvency ratio in Poland, Czech Republic and Estonia are above the average with more than 300% while solvency ratio in the UK, France and Germany are below the average with less than 250%. Because of the financial crisis in 2008, the solvency surplus (the difference between available solvency margin and required solvency margin) became thinner especially in life business and it decreased to EUR 352 billion compared to its level of EUR 554 billion in 2007.



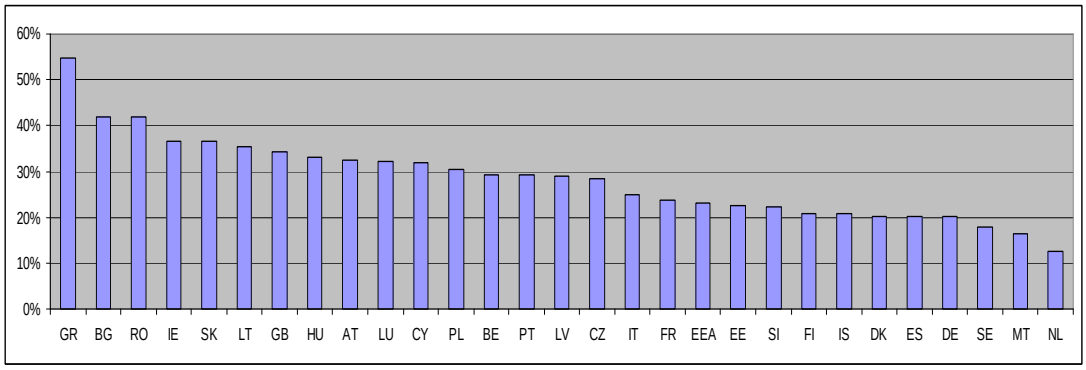
Graph 31: Solvency Ratio of the EEA Insurers (2008)

Source: own Graph based on data from CEIOPS (2009)

3.2.3.3.1.7. Efficiency of Insurers

Cost ratio in non-life business (covering non-life business of life, non-life and composite companies as well) shows the ratio of operating expenses to premiums earned. It gives an idea about the efficiency of the insurers.

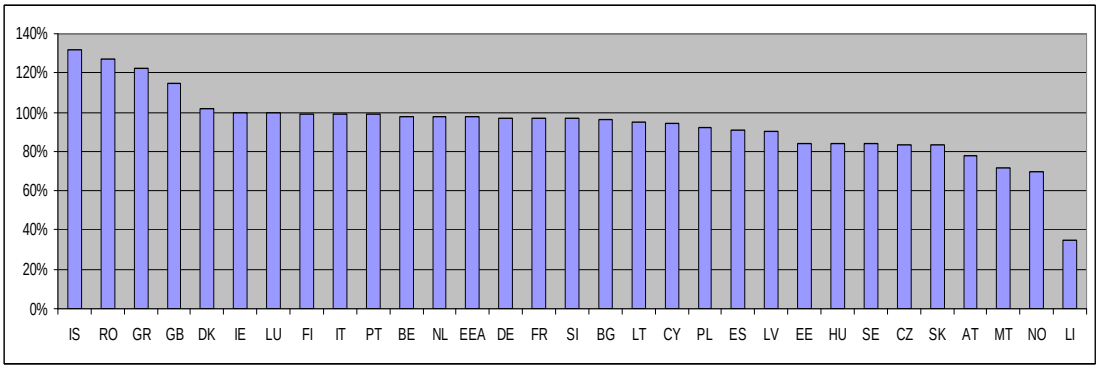
Net cost ratio which shows net operating expenses (acquisition costs and administrative expenses) to net earned premiums in the EEA in 2008 is illustrated in Graph 32. The weighted average of the cost ratio in non-life business is 23% which means that for every EUR 100 of earned premium, insurers have to spend EUR 23. Cost ratio ranges from 55% in Greece to 13% in the Netherlands. It means that insurers in the Netherlands are much more efficient than the insurers in Greece. Efficiency of insurers in Malta, Sweden and Germany are below the EEA average while insurers in Bulgaria, Romania and the UK are above the average.



Graph 32: Cost Ratio in the EEA Non-Life Insurance (2008)
Source: own calculations based on data from CEIOPS (2009)

Furthermore, it is generally accepted that profitable insurers are more efficient. Absolute profit or loss results of the insurers are not meaningful in comparing the profitability due to size effects. A common method to assess the profitability of non-life insurers is the combined ratio which expresses claims and expenses relative to premiums earned. Divergent combined ratios of the Member States suggest the existence of divergences in efficiency.

On the other hand, Graph 33 shows net combined ratio in non-life business (covering non-life business of life, non-life and composite companies) defined as net claims and net operating expenses divided by net premiums earned. EEA average was 98% in 2008. Combined ratio is more than 100% in Iceland (due to severe impact of the financial crisis), Romania, Greece and Denmark. It means that in non-life business of these Member States, claims and expenses together were higher than earned premiums. In contrast, non-life business of the new Member States, Austria and Sweden are relatively more profitable mainly due to country specific factors such declining in claims paid due to the decline in inflation rate in Latvia or declining claims frequency in Sweden due to few catastrophic related claims (CEIOPS, 2009, p.20).

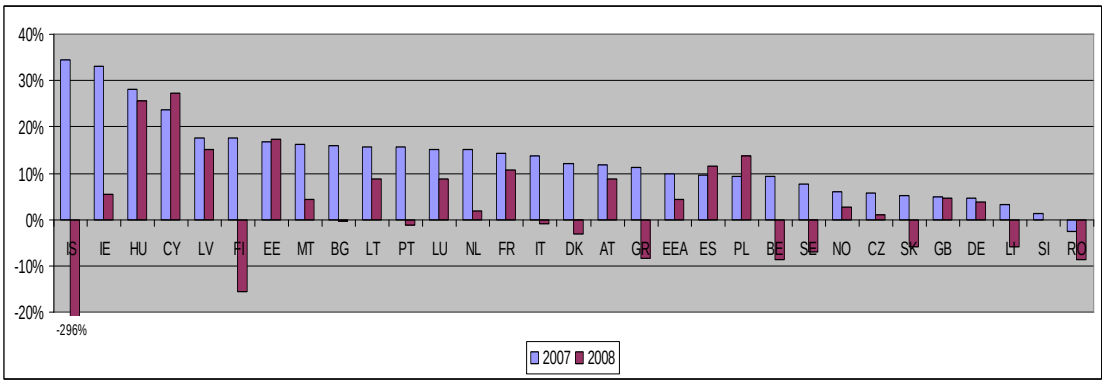


Graph 33: Net Combined Ratio of the EEA Insurers (2008)

Source: own calculations based on data from CEIOPS (2009)
Results of Liechtenstein and Norway show claims ratio and not combined ratio due to missing data

Rate of return, also called return on equity, which is defined as profit or loss divided by total capital and reserves, is another ratio to measure the profitability. So, the profitability of life and non-life insurers may also be captured by analyzing their rate of return. In Graphs 34 and 35, 2007 and 2008 results are presented together in order to see the effect of the financial crisis on the profitability of the insurers and to be able to compare their actual situation with their ex-ante crisis situation.

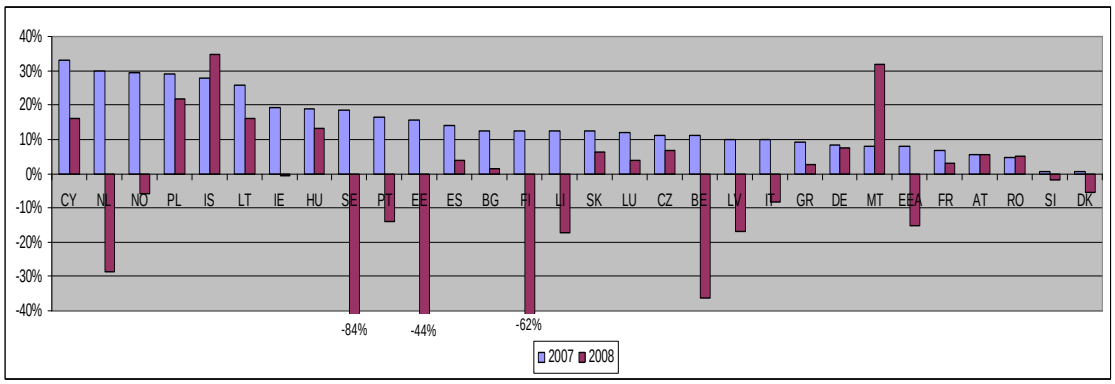
The weighted average rate of return in non-life insurers was 4,2% in 2008 against 9,8% in 2007. However, compared to life companies, they have survived relatively well in terms of profitability during the financial crisis. Iceland, Finland, Greece, Belgium and Sweden have negative rate of returns while in most of the other countries non-life insurers are profitable.



Graph 34: Rate of Return of the EEA Non-Life Insurers

Source: own calculations based on data from CEIOPS (2009)

While returns were still healthy in 2007 (7,8%), the weighted average rate of return in life companies was -15,2% in 2008. Life insurers which were more affected from the financial crisis than non-life insurers were, had serious profitability problems in 2008. Serious losses are seen in the life insurers of Sweden, Finland, Estonia and Belgium, while profitability of life insurers from Central and Eastern Europe is much less affected from the crisis. To eliminate the effect of the crisis on profit or loss accounts, the results of the year 2007 are analyzed. In 2007, big but divergent profits are seen in life insurers. The Netherlands, Norway and Poland were profitable while in France where life insurance is very important, profitability was much smaller.



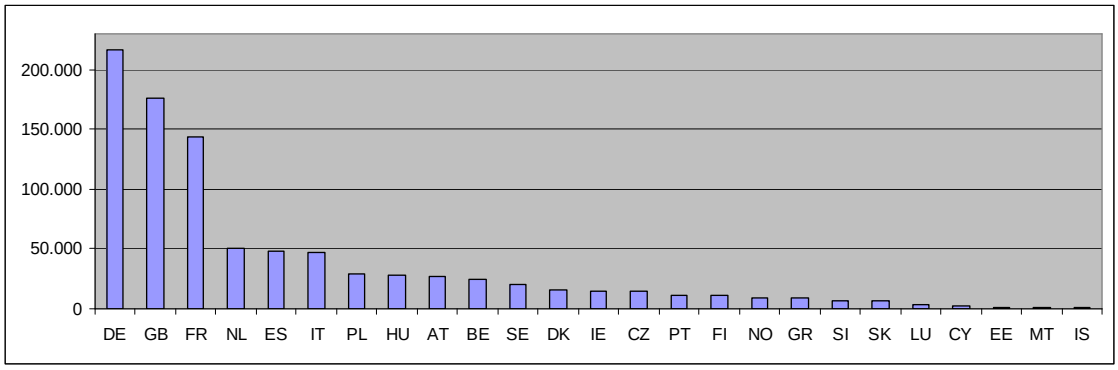
Graph 35: Rate of Return of the EEA Life Insurers

Source: own calculations based on data from CEIOPS (2009)
excluding profit or loss of the UK due to missing data

3.2.3.3.1.8. Productivity of Insurers

In the EEA, the number of persons employed in insurance companies is 926.000 in 2008. Graph 36 illustrates that Germany is the leader with 216.000 and with the UK and France they account for 62% of total employment of the European single insurance market. The share of insurance employment in total employment in EEA is 0,44%. While 0,56% of total employees work in insurance and reinsurance companies in the UK and France, the share of employees working in insurance and reinsurance companies to total employment in the country remains at only 0,19% in Italy and Poland.

EEA insurers have an average of 185 persons employed per insurer in 2008. In terms of employers per insurer, Germany is again the leader while the smallest insurers are in Luxembourg, Ireland and Sweden.

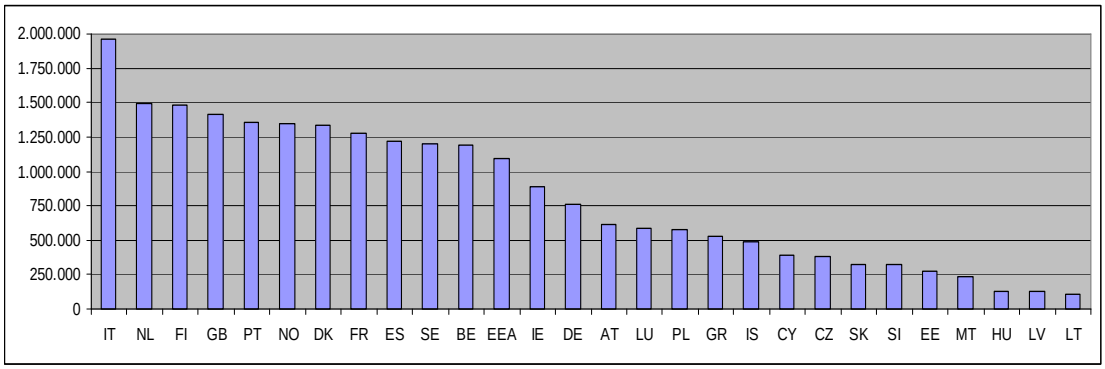


Graph 36: Number of Employees in the EEA Insurers (2008)
Source: own Graph based on data from CEA (2009a)

However, what makes the labor force comparable between countries is their level of productivity. Productivity per person employed differs from country to country in the European single insurance market. Furthermore, the gap in labor productivity ratios between Member States has not disappeared since the creation of the European single insurance market. In general, labor productivity in life insurers is higher, but still varies from one Member State to another.

Labor productivity is simply calculated by total premium production (as the output) to total number of persons employed (as the input). Graph 37 indicates that

productivity is highest in Italy with almost EUR 2 million premium production per employer in 2008, followed by the Netherlands and Finland with EUR 1.5 million.



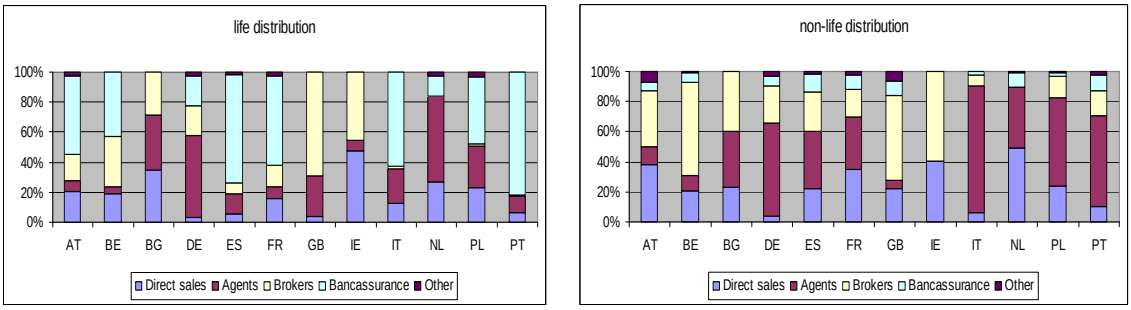
Graph 37: Labor Productivity in the EEA Insurance Market (2008)
Source: own calculations based on data from CEA (2009a)
EEA average excludes BG and RO due to missing data

3.2.3.3.1.9. Insurance Distribution Channels

Intermediaries have outmost importance for insurers to find customers and sell their products. Main intermediaries are agents, brokers and banks. Direct selling through company employees, internet or telephone, which facilitates the integration of the insurance markets, is another way to sell insurance products. Since the introduction of the Insurance Mediation Directive in 2005 with the aim of the integration of intermediaries, there has been a slight increase in the role of direct selling and a slight decrease in the role of brokers, in both life and non-life business (CRA International, 2009, p.135).

Graph 38 demonstrates that distribution channels in both life and non-life business differ widely between Member States. Brokers lead life insurance market in the UK (69%) and to some extent in Ireland (45%). Strong presence of brokers in Ireland can, to a large extent, be explained by the high proportion of life business that is underwritten abroad, relying mainly on broker networks (CEA, 2009a, p.24). While bancassurance is commonly used in Portugal (82%), Spain (72%), Italy (63%) and France (60%), agents are particularly widespread in the Netherlands (57%) and Germany (55%). However direct selling is not commonly used and its share is slightly higher than 25% only in Ireland, Sweden, Bulgaria and the Netherlands.

In the distribution of non-life insurance products, traditional intermediaries, agents and brokers are the largest suppliers. As Graph 38 illustrates, more than half of all premiums are collected by agents and brokers in most of the Member States. Agents are predominant in Italy (84%), Germany (%62), Portugal (61%) and Poland (59%) while brokers are dominant in Belgium (62%), Ireland (59%) and the UK (56%). Contrary to life business, the share of bancassurance is smaller in each Member State. On the other hand, direct sales are generally more developed in non-life business than in life business where products are much more complex. They are commonly used in the Netherlands (49%), Ireland (41%), Austria (38%) and France (35%).



Graph 38: Insurance Distribution Channels in the EEA Countries (2008)

Source: own Graph based on data from CEA (2010a)
2007 data for ES; agents also include brokers in NL
In GB, bancassurance in life business is included in other channels and its market share is estimated to be 14%.

The differences in distribution systems make the market entry difficult and costly. For instance, a Portuguese life insurance company offering his products in Portugal via bancassurance, in order to penetrate or survive in the British market where the dominant distribution strategy is the use of brokers, is forced to change its distribution strategy, which is an expensive and time consuming effort. One potential response would be the use of direct selling. The increasing role of direct selling especially through internet, which is still minimal in most of the Member States, would facilitate cross-border sales of insurance products.

3.2.3.3.2. Foreign Presence in the European Single Insurance Market

For the purpose of this study, integration is defined as the use of FOS and FOE. Therefore, market indicators may well give an incomplete picture of integration. As a

result, market share of foreign insurers in domestic markets, i.e. premiums written in the home Member State by host insurers is analyzed as the main integration indicator. There are three methods which may be used by the EEA insurers to operate in other Member States. First, they can operate without local establishment by making use of freedom of services. Second, they can set up a new branch or agency by making use of freedom of establishment. Third, they can acquire a local insurance company or buy its majority shareholding or cooperate with it by involving a minority shareholding. Only the use of the first two methods indicates the existence of integration among the insurance markets of the EEA Member States which compose the European single insurance market.

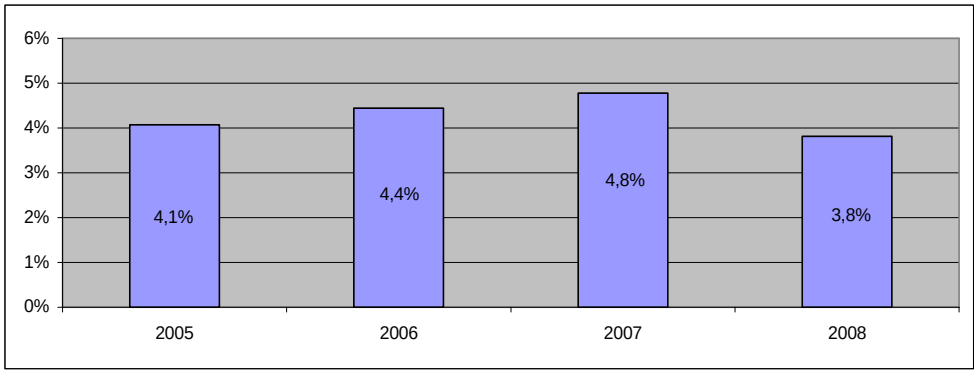
3.2.3.3.2.1. Freedom of Services

Cross-border insurance occurs when the buyer purchases insurance from an insurer domiciled in another country (Ma and Pope, 2003, p.236). In this case, insurers sell insurance products to residents of another Member State without having an establishment there. It is the best quantitative indicator to measure the level of integration. The increasing use of direct cross-border activities through FOS shows the increase in the level of integration within the European single insurance market.

Direct cross-border activities through FOS are restricted in the European single insurance market. Graph 39 shows that total premiums written under FOS without physical establishment account for only 3,8% of total premiums written in EEA in 2008. Since 2005, there has been a slight increasing trend which is sharply interrupted in 2008 due to financial crisis. From Graph 41 which shows the percentages of cross-border sales of business insurance by FOS over total written business premiums, it can be seen that cross-border activity of business insurance for the EU-25 is low but it has an increasing trend. The data on the premiums written through FOS is not available in some countries, including the UK. Therefore, Graph 39 shows the weighted average of the EEA sample which represents around 60% of the market in order to present the most proper result for the EU average. The Member States where the data is available report that EUR 28.9 billion is written through FOS in 2008. Without using weighted average, it represents 2,6% of total EEA premium production. When the UK is excluded, which is the biggest market where the data is not available, it then represents 3,5% of the total. In any case,

the results clearly indicate that the use of FOS is exceptional in EEA. Therefore, the integration in the European single insurance market is still missing, since the definition of integrated market that is adopted for the purpose of this study is the use of FOS (and/or FOE).

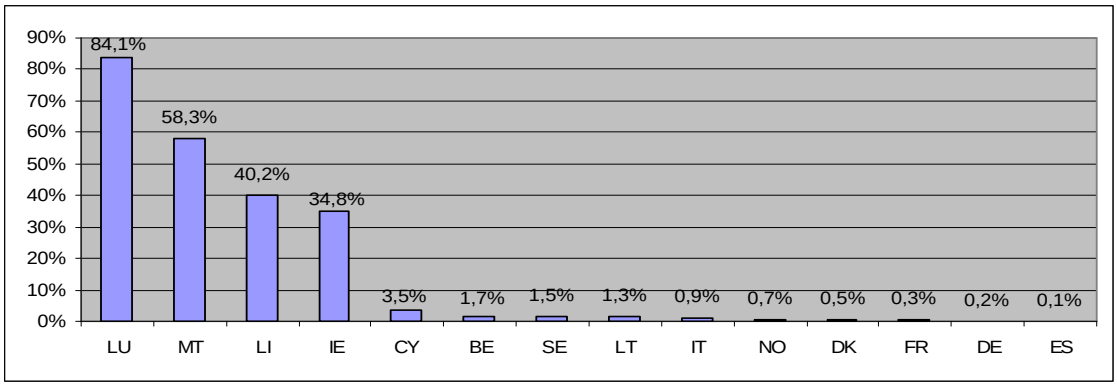
Moreover, the use of FOS in life business is more than in non-life business. Almost 75% of the premiums written through FOS in 2008 is written by life insurance companies while the remaining 25% is written by non-life insurance companies.



Graph 39: Share of premiums written in the EEA through FOS (in % of total premiums)

Source: own calculations based on data from CEIOPS (2009)
weighted average of the EEA sample represents around 60% of the market

As can be seen from Graph 40, premium production through FOS is relatively high only in four small Member States, namely Luxembourg, Malta, Liechtenstein and Ireland. Luxembourg and Ireland have always experienced a great deal of cross-border insurance activity, but this happens mostly in the form of foreign EU companies setting up in Ireland and Luxembourg and servicing to their own countries through FOS (CRA International, 2009, p.130). For instance, in Italy life policies are increasingly being manufactured by subsidiaries of Italian companies established in Ireland and Luxembourg in order to capitalize on their tax advantages (Swiss Re, 2008, p.9). The other EEA insurance markets remain mainly national. The use of FOS is even more limited in the new Member States from Central and Eastern Europe. Graph 41 shows that the ratio of cross-border sales of business insurance with only 0,5% of total premiums in 2005 is lower in new Member States than in EU-15 Member States.

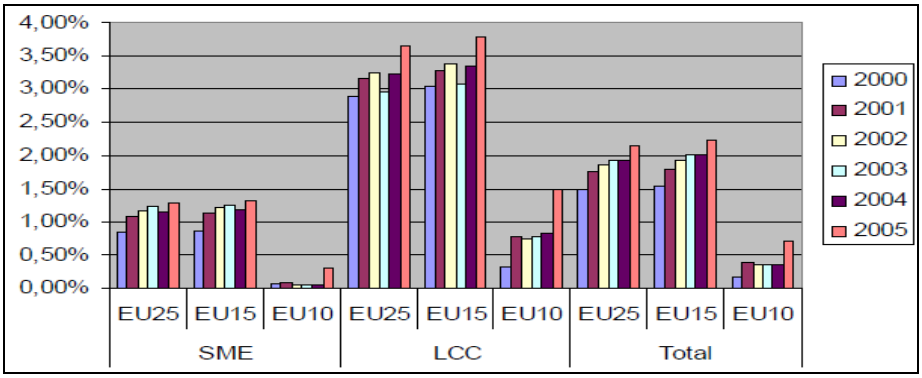


Graph 40: Share of Premiums Written in the EEA Countries through FOS (in % of total premiums) (2008)

Source: own calculations based on data from CEIOPS (2009)

Skipper (1997, p.2) lists three forms of direct cross-border insurance trade. First, pure cross-border insurance trade exists when an insurance contract results from the demand by an insurer domiciled in another Member State. This may occur via telephone, mail or internet. The second form of direct cross-border insurance trade is own-initiative cross-border insurance trade where the insured initiates the contact with the insurer who is based in another Member State. Mainly corporate individuals seek insurance abroad, in order to have lower premiums or more favorable contract terms than those that are locally available. Therefore, this type of cross-border insurance involves mostly wholesale insurance markets.

In the European single insurance market, cross-border insurance is typically used for large commercial and industrial risks in wholesale insurance markets in the form of pure or own-initiative cross-border insurance. Expert Group on Insurance and Pensions (2004, p.11) concludes that reinsurance and large risks showed the greatest degree of integration, while mass risks and occupational pensions showed almost no integration. Graph 41 shows that cross-border sales of business insurance through FOS are much lower for small and medium enterprises (SME) than for large commercial clients (LCC). While the situation is relatively more satisfactory for large industrial and commercial risks (3,5%), the volume of cross-border retail business is negligible (1%).



Graph 41: Business Insurance Premiums Written in the EU through FOS
Source: European Commission (2007a, p.45)

For instance, in motor insurance market which is the classical example of retail insurance business covering mask risks, only 0,6% of total premiums is written through FOS (Europe Economics, 2009, p.44) while the ratio is about 2,8% in property insurance market (Europe Economics, 2009, p.46).

Following Skipper (1997) classification of cross-border insurance trade, the third type of cross-border insurance trade is consumption-abroad cross-border insurance trade which occurs when an insured, temporarily residing or visiting abroad, enters into an insurance contract with a local insurer. Therefore, it involves mass risks from retail consumers and it mostly concerns expatriates and people living in border areas. The residents of a frontier zone may know and call a foreign insurer established in the territories of another Member State which is a few kilometers away. When such consumers and companies also have cultural and linguistic proximity, then they can easily have cross-border retail insurance business. This type of cross-border business that is explained with cultural and linguistic proximity can be seen between France and Belgium and between Ireland and the UK. On the other hand, expatriates, who are used to buy insurance policies from a specific insurer established in their home country, continue in most of the cases to work with this specific undertaking when they are expatriated. For instance, owners of holiday homes in another Member State tend to buy insurance coverage for these homes from their own domestic insurer established in their home Member State. However, the premium production of this type of activities is negligible due to its temporary and restricted nature.

In order to operate successfully in a foreign market, insurance companies need to know the local insurance contract law, fiscal treatment, market conditions and preferences of that country. Since these factors widely differ across Member States, a major, expensive and time consuming effort is required before the foreign market entry. Weidenfeld (1996, p.104) claims that insurers use freedom of services as an easy way of testing the marketability of their products in case of future establishment in that Member States through branches or subsidiaries. Therefore, freedom of services is used temporarily by large European insurance groups before establishing in the other EEA insurance markets and the ultimate aim is physical establishment in the Member State where they wish to operate.

In conclusion, with the exception of some few small Member States, volumes of direct cross-border business by way of FOS are still extremely low in EEA. Therefore, the integration is not advanced. The integration level in terms of FOS is relatively more advanced in life business. Assuming that cross-border activities through FOS are considered the principal means of market integration, its absence shows the lack of real market integration in the European single insurance market. The preferred method of entering the insurance market of another Member State is still the physical establishment. In addition, the use of cross-border business through FOS in retail insurance market is even lower compared to wholesale insurance market. Cases of individual consumers shopping around for the best insurance contracts on a European-wide basis are still extremely rare.

3.2.3.3.2.2. Freedom of Establishment

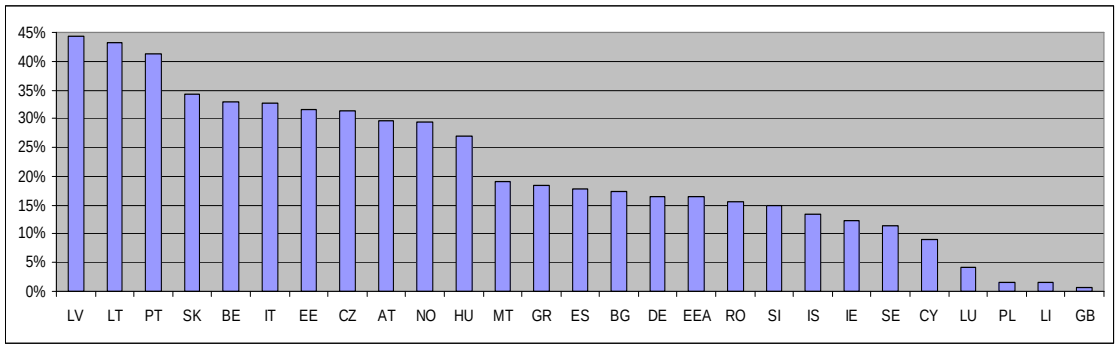
Establishment trade is an insurance transaction where the buyer and insurer are both located in the same country but the insurer is foreign-owned (Ma and Pope, 2003, p.236). In this case, insurers sell insurance products to residents of another Member State through locally establishing in that State.

Skipper (1997, p.4) lists mainly two forms of establishment insurance trade. A branch office is not a stand-alone insurance company, but legally a part of an insurance company. On the other hand, an agency is the legal representative of the foreign

insurance company and its powers to represent its principal may range from only sales operations to broader operations such as underwriting, pricing and claims handling.

Graph 42 indicates that around 15% of total insurers established in the EEA in 2008, are branch offices or agencies of the EEA insurers (almost 750 branches). If it is theoretically considered that each insurer operating in the European single insurance market has 29 branches (one in each Member State), it would then be almost 100.000 branches operating in the European single insurance market. Therefore, 750 branches operating in the European single insurance market represent only less than 1% of the theoretical potential.

Graph 42 also demonstrates that the share of the EEA branches is biggest in Baltic States and Portugal. Insurers from Baltic States write business in other Baltic States through FOE (for instance with head office in Estonia and branches in Latvia and Lithuania). The share of branches is relatively higher in small Member States. However, in terms of absolute value, Germany, Spain, Italy and Belgium are the leaders.



Graph 42: Share of the EEA Branches in Total Number of Insurers (2008)
Source: own calculations based on data from CEIOPS (2009)
EEA average excludes DK, FI, FR and NL due to missing data

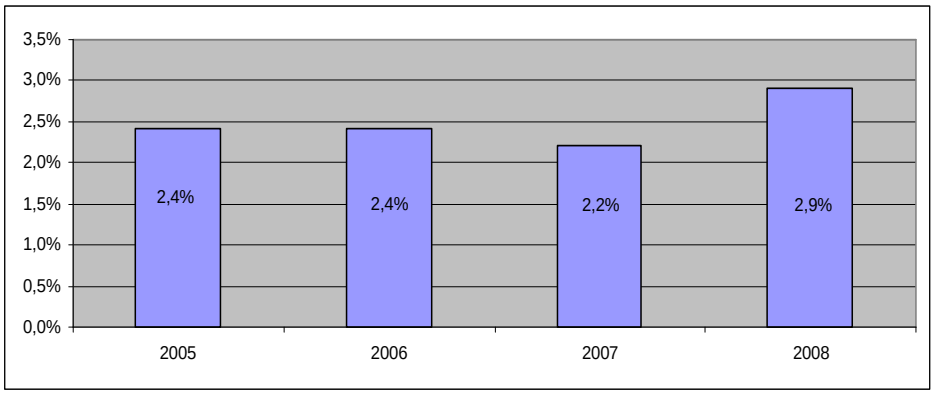
Branches are very often set up in neighboring countries. Labilloy (2003, p.39) reports that between two-thirds and three-quarters of branches of the EEA insurance companies are established in a Member State neighboring to the State in which they have their head offices. Austrian insurers have branches in Germany and Italy, Belgian

insurers have branches in Germany, France, Netherlands, Luxembourg and the UK, Irish insurers have branches in the UK and Swedish insurers have branches in Norway[32].

The share of branches in terms of premiums is smaller compared to their share in terms of absolute number. Although they account for more than 15% of the total number of companies, Graph 43 shows that the weighted average of the premiums written in the EEA through FOE have a share of 2,9% in total EEA premium production in 2008. The data on the premiums written through FOE is not available in some countries, including France and Germany. Therefore, Graph 43 indicates the weighted average of the EEA sample which represents around 65% of the market in order to present the most appropriate result for the EU average. The Member States where the data is available report that EUR 17.6 billion is written through FOE in 2008. Without using weighted average, it represents 1,6% of total EEA premium production. When France and Germany are excluded, which are one of the biggest markets where the data is not available, then the premiums written through FOE represents 2,6% of the total. In any case, the results clearly indicate that the use of FOE is exceptional in the EEA. Therefore, the integration in the European single insurance market is still missing, since the definition of integrated market that is adopted for the purpose of this study is the use of FOE and/or FOS.

On the other hand, the share of FOE has an increasing trend. Beckmann, et al. (2002a) find that in 1997 the share of non-life branches was 1,8% (p.9) and the share of life branches was 0,18% (p.13). Therefore, although it is still very limited, there is an increasing trend in the use of FOE in the European single insurance market.

[32] See OECD (2010) for a complete picture.

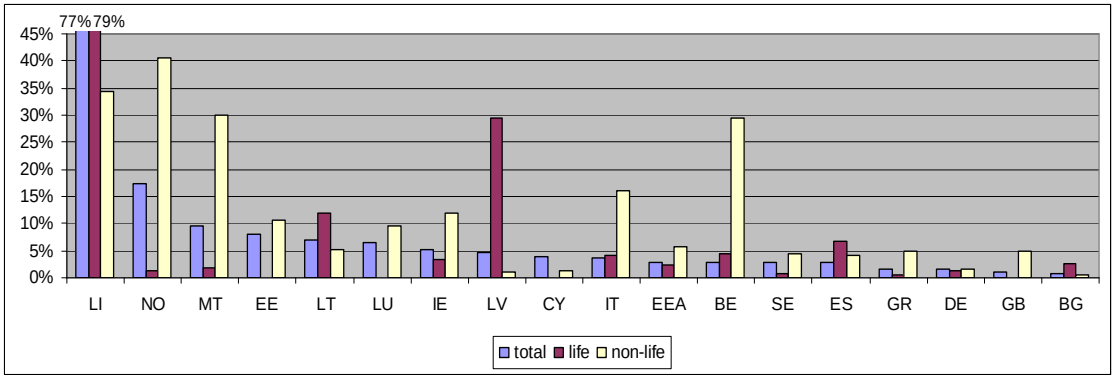


Graph 43: Share of Premiums Written by EEA Branches (in % of the EEA total)
Source: own calculations based on data from CEIOPS (2009)
weighted average of the EEA sample represents around 65% of the market

Moreover, in contrast to the results related to FOS, the use of FOE in non-life business is more than in life business. Almost 60% of the premiums written through FOE in 2008 is written by non-life insurance companies while the remaining 40% is written by life insurance companies. Therefore, it can be claimed that non-life insurance is relatively more integrated than life insurance in terms of FOE. Graph 44 indicates that the share of premiums written by the EEA branches of non-life insurers is 5,6%, while the ratio for life insurers remains at only 2,4% in 2008.[33] Non-life branching is much more important than life branching in most of the Member States.

Graph 44 also indicates that the level of premiums written by EEA branches established in Liechtenstein reaches almost 77% of the total activity in the country. Except for Norway (17%) where a large non-life insurance company became a branch of its Danish parent company in 2008, the share of premiums written by EEA branches is much lower than 10% in all the Member States. Smaller Member States from Central and Eastern Europe and Ireland have relatively higher shares compared to EU-15 countries.

[33] Taking into account the weight of life premiums in total premium production, weighted average of the ratio of total branching (2,9%) becomes closer to the ratio of life branching (2,4%) rather than the ratio of non-life branching (5,6%).



Graph 44: Share of Premiums Written by EEA Branches in the EEA Countries (in % of the country total) (2008)

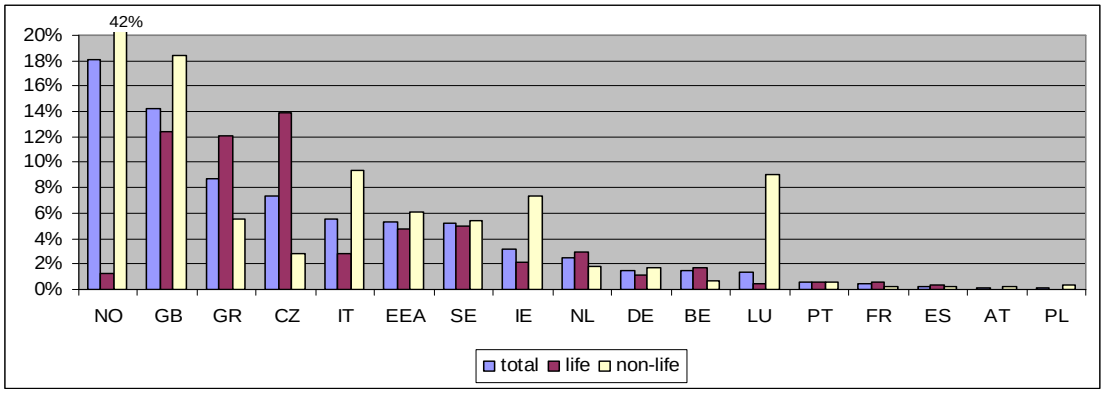
Source: own calculations based on data from CEIOPS (2009)
weighted EEA average represents 65% of the market in terms of premium production, while life average represents 75% of the life business and non-life average represents 60% of the non-life business
total includes the premium production of life, non-life and composite insurers
2007 data for DE

Furthermore, branching in different lines of business is not homogeneous. In line with cross-border activities through FOS, branching is smaller in retail business that covers mass risks. Motor insurance premiums written through FOE represent 1,7% of total motor insurance premiums and thus is lower than the EEA average (Europe Economics, 2009, p.40), but in property insurance it is above the average with 5,2% of the total property insurance premiums (Europe Economics, 2009, p.41).

To sum up, the extent to which the insurers in the EEA Member States make use of branches and agencies is still very limited (2,9% of the total premiums in 2008). Therefore, the integration in the European single insurance market is still missing, since the definition of integrated market that is adopted for the purpose of this study is the use of FOE and/or FOS. Branching in non-life insurers (5,6%) is more common than in life insurers (2,4%), thus the integration level in terms of FOE is relatively more advanced in non-life business. The share of EEA branches in total number of companies (15%) is much bigger than their share in terms of written premiums (2,9%) and thus the size of EEA branches is smaller than domestic companies. Furthermore, branching is less important in retail business that covers mass risks and in big Member States with high premium production than small Member States with lower premium production.

Third country insurers that are based outside the EEA may also establish branch offices in EEA Member States. In this case, they cannot benefit from single license principle, therefore they have to get license from the host Member State where they wish to operate, after fulfilling all the establishment requirements of that Member State. Therefore, their transaction costs are likely to be higher than the costs of the EEA insurers benefiting from single market principles.

However, as can be seen from Graph 45, the premiums written by non-EEA branches to total written premiums in EEA in 2008 is 5,3%, which is higher than the share of the EEA branches which is 2,9%. Insurers from Switzerland, the USA and Japan dominate non-EEA branching in the European single insurance market. The share of the branches of the non-EEA life insurers is 4,8% (2,4% for EEA branches) and of the non-EEA non-life insurers is 6,1% (5,6% for EEA branches). However, while the share of non-EEA branches is higher than the share of EEA branches, they are not widespread throughout the EEA and are concentrated in some few Member States. Non-EEA branches in life business are mostly concentrated in the UK and Czech Republic while in non-life business they are mostly concentrated in Norway and the UK.



Graph 45: Share of Premiums Written by non-EEA Branches (in % of the country total) (2008)

Source: own Graph based on data from OECD (2010)
weighted EEA average represents 90% of the market in terms of premium production
2004 data for BE

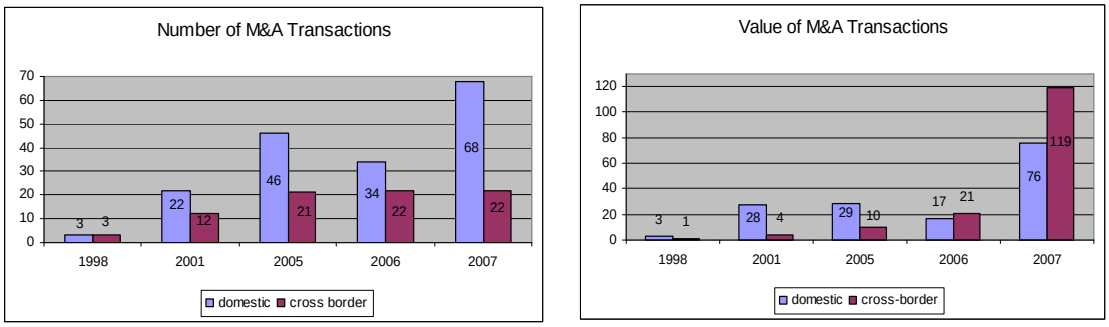
It can be concluded that, although the importance of non-EEA branching in non-life business is almost in line with EEA branching, in life business it is higher than EEA branching. However, the results should be read cautiously since non-EEA life branches

are concentrated in the UK which accounts for almost 40% of the EEA life market in 2008. When the UK is not included in the average, then the share of non-EEA branches in life business sharply decreases to 2,5%, which is in line with the share of life EEA branching. Therefore, at least one definitive conclusion would be that although the establishment of branches for EEA insurers benefiting from the single license principle is easier, less costly and does not require host country supervision, the share of non-EEA branches in the market is at least as much as (and even higher if the UK results are included) the share of EEA branches. It shows the lack of integration in the European single insurance market.

3.2.3.3.2.3. Mergers and Acquisitions

In the European single insurance market, the preferred method of foreign market entry is still physical establishment. However, this is usually done not through the establishment of a branch or agency by way of FOE but through M&A. It means that non-residents create a new domestic insurer (a subsidiary of the parent company) or acquire the whole or the majority shareholding or the minority shareholding of an existing domestic insurer in the host Member State. Therefore, they do not prefer to make use of single license principle in order to operate throughout the European single insurance market.

Since the second half of 1990s, there has been an increasing M&A activity in the European single insurance market both within and across Member States in terms of both number and value. Graph 46 shows that cross-border transactions make up a relatively small proportion of M&A activity in terms of the number of deals, while they make up relatively a large proportion in terms of the value of deals. Against 288 domestic transactions between 1998 and 2007 in the European single insurance market, there were only 118 cross-border transactions accounting for 29% of total number of transactions. However, the value of domestic transactions was USD 248 billion, while the value of cross-border transactions was USD 199 billion, accounting for 45% of the total value of transactions.

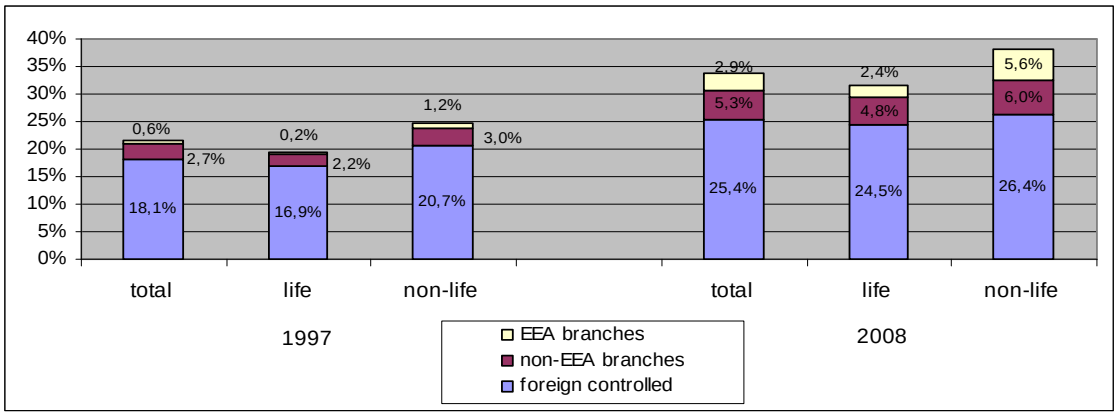


Graph 46: M&A Transactions in the EEA Insurance Market

Source: own Graph based on data from CRA International (2009)

Since the insurance business requires a high degree of consultancy, credibility and client confidence, local customers are likely to be suspicious of a foreign insurer which does not have a local office, thus physical establishment (branches or M&A) is often necessary to enter a market successfully (Hess and Trauth, 1998, p.95). Moreover, physical presence enables insurers to carry out more easily inspections of complex risks for underwriting purposes and for claims settlements (European Commission, 2007a, p.48). Nemeth (2001, p.64) states that foreign insurers normally lack the experience to cope with a different insurance contract law, lack the understanding of local market conditions and preferences and are faced with the cost of informing potential policyholders who come from a different social and cultural systems in order to convey them a sense of credibility. Therefore, a merger with or an acquisition of a domestic insurer has also the advantage of gaining the necessary know-how about the domestic market conditions and consumer preferences as well as the access to distribution channels to avoid high investment costs necessary to gain knowledge about the market and to set up their own distribution channels.

The increasing trend in the level of cross-border M&A activity among European insurers has resulted in an increasing penetration of the EU insurance markets by foreign insurers. Graph 47 illustrates the foreign presence in the European single insurance market. Foreign presence (including the share of insurers from the other EEA Member States) increased from 21,4% in 1997 to 33,6% in 2008. It increased faster in life market than in non-life market.

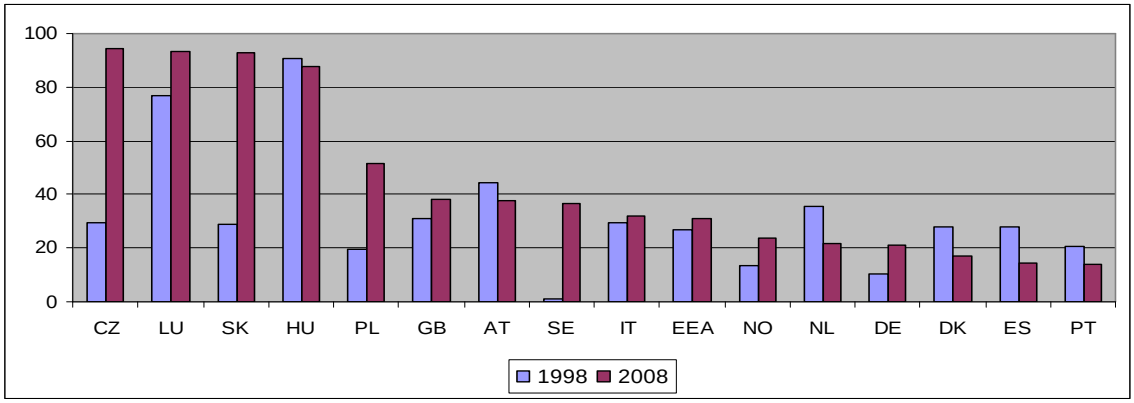


Graph 47: Total Foreign Presence in the EEA Insurance Market (in % of total premiums)

Source: own calculations based on data from OECD (2010), OECD (2009), CEIOPS (2009), CEA (2009a) the sample represents between 60%-90% of the market

The increase in foreign presence since 1997 is mainly related to the increase in the market share of foreign controlled insurers which consist of more than one quarter of the market in terms of premiums in both life and non-life business. Therefore, acquisitions of local insurers still seems to be the dominant strategy of the EEA insurers to access the other EEA insurance markets, rather than setting up new structures and new teams in those markets. This result can be attributed to the deregulation of the market rather than the establishment of a single insurance market.

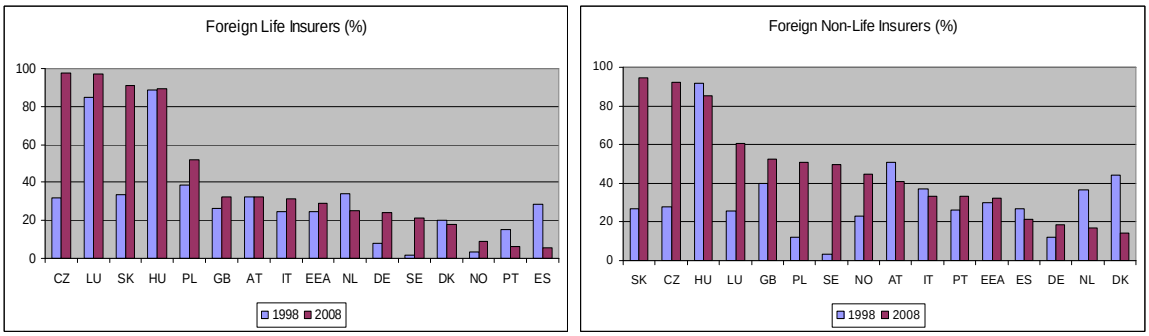
Graph 48 presents the market share of foreign insurers (domestic companies having more than 50% of the share capital and non-EEA branches) in the EEA Member States. The share of foreign companies has an increasing trend between 1998 and 2008 except in Austria, the Netherlands, Spain and Portugal. The share of premiums written by foreign companies in Slovakia and Czech Republic increased from around 30% in 1998 to 90% in 2008 and in Poland from 20% to 51% during the same period. Except the UK, countries with a greater market size in terms of total premiums are less open to foreign companies. Foreign insurers are very active in the UK which is one of the most important global financial centers. Together with some small Member States such as Luxembourg and Ireland, the UK is generally admitted as an ideal place to establish for third country insurers which wish to operate throughout the European single insurance market by benefiting from the single license principle (Labilloy, 2003, p.38).



Graph 48: Market Share of Foreign Insurers in the EEA Countries (in % of total premiums)

Source: own calculations based on data from OECD (2010) and OECD (2009)
foreign insurers include foreign controlled companies with at least 50% of foreign share in capital and non-EEA branches

While both life and non-life markets are internationally oriented in most of the EEA Member States, Graph 49 shows that the share of foreign presence in non-life market is clearly higher than in life market in the UK, Sweden, Norway and Austria. The UK, as a world leading financial center, has a foreign share of 32% in life market and 52% in non-life market. The share of foreign companies in the biggest CEEC, namely Czech Republic and Hungary is around 90% in both life and non-life business whereas in Poland their share is around 52%.



Graph 49: Life and Non-Life Market Share of Foreign Insurers in the EEA Countries (in % of total premiums)

Source: own Graph based on data from OECD (2010) and OECD (2009)

To sum up, these findings support the view that the preferred method of entry to the insurance market of another Member State is still the physical establishment in that State through M&A rather than the establishment of branches or agencies through FOE or direct cross-border selling through FOS.

As a consequence of M&A activities, the EU insurance market has become highly concentrated. In 1980, there were more than 7.000 insurers in the countries that now make up the European single insurance market, but this number reduced to around 5.000 in 2008. The result of this process is the emergence of big European insurance groups e.g. Allianz (DE), AXA (FR), Generali (IT), Aviva (UK) and ING (NL) which are operating throughout the world.

Table 6 lists the largest European insurance groups as of 2008 (including two insurance groups from Switzerland which is not an EEA Member State). Out of almost 5.000 companies, the biggest 20 European insurance groups produce more than half of the total premiums. Whereas they are internationally oriented, their cross-border activities are predominantly within Europe since 73% of their total premiums are written in Europe mostly through their subsidiaries. However, although they are pursuing European-wide strategies, they all still have a significantly stronger presence in their home markets than in Europe as a whole.

Table 6: Largest European Insurance Groups (2008)

No	Group	Country	Premium Income	Geographical Distribution			
				Europe	North America	Asia	Other
1	Allianz	DE	89.003	72.162	12.760	4.081	0
2	Axa	FR	86.857	48.794	13.755	4.627	19.681
3	Generali	IT	67.473	64.309	0	1.356	1.808
4	Zurich	CH	46.291	27.673	15.582	1.925	1.111
5	Aviva	UK	45.259	35.802	8.672	785	0
6	ING	NL	43.121	10.194	21.887	11.040	0
7	CNP	FR	28.323	26.795	0	0	1.528
8	Aegon	NL	22.409	13.642	8.244	523	0
9	Crédit Agricole	FR	21.999	21.558	0	88	353
10	Prudential	UK	20.999	9.713	6.973	4.313	0
11	Talanx	DE	19.700	13.453	3.682	2.565	0
12	Eureko	NL	19.306	19.059	0	0	247
13	Mapfre	ES	17.711	9.390	1.817	861	5.643
14	Standard Life	UK	17.334	14.563	2.477	294	0
15	Ergo	DE	16.578	15.763	0	0	815
16	BNP Paribas	FR	16.100	14.313	0	1.787	0
17	Old Mutual	UK	15.144	7.999	3.128	96	3.921
18	Groupama	FR	13.078	12.819	0	0	259
19	Covea	FR	12.070	12.070	0	0	0
20	Swisslife	CH	12.028	12.028	0	0	0
		Total	**630.783**	**462.099**	**98.977**	**34.341**	**35.366**

Source: CEA (2010a)

The result of the trend of Europeanization through M&A is twofold. First, it prevents the creation of a real European single insurance market. M&A in EEA insurance markets is mainly the result of globalization and deregulation process in world rather than the creation of the single market. Even without establishing a single insurance market, foreign insurers from all over the world may acquire a local insurer in Europe. Atalay (2004, p.71) concludes that the single market principles are not the prerequisites of the establishment of foreign subsidiaries which are subject to the supervision of the Member State in which they are established, thus the increase in European insurance groups is not purely the result of the creation of the European single insurance market. It is true that Europeanization of insurers increased with third insurance directives in 1994 and large European insurance groups emerged; but the insurance market integration in practice does not exist since the choice of foreign market entry is still M&A rather than the use of freedom of establishment or freedom of services. Since the European insurance groups are operating in the European single insurance market mainly through M&A, they do not benefit from the single license and home country control principles and are subject to the supervisory practices of the Member States in which they are established.

Second, this trend does not create most of the benefits that the financial integration provides since the range of products, their price and thus competition and consumer welfare are not always improved through M&A. However, through direct cross-border selling or establishment of branches, new and cheaper products would be introduced to the domestic markets which may increase competition, product choice and consumer welfare in these markets.

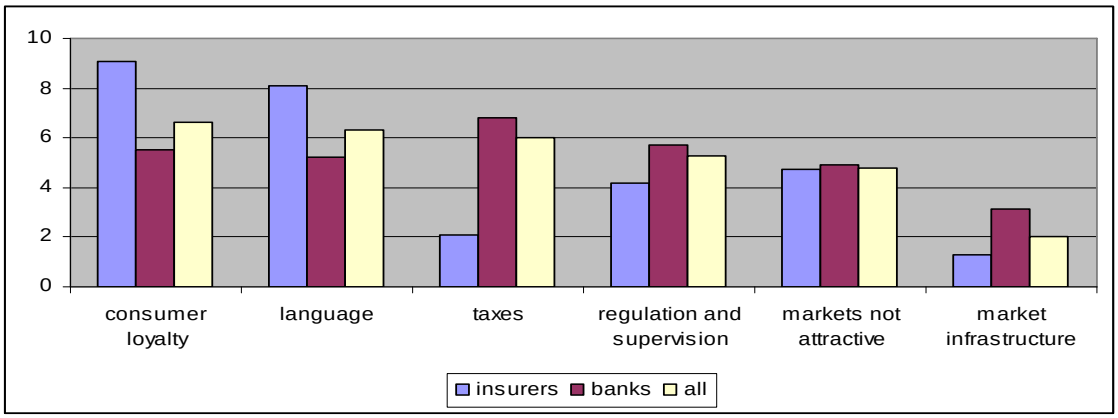
3.3. OBSTACLES FOR FURTHER INTEGRATION

Zimmerman (1999, p.213) points out that the governmental barriers are the most important barriers to world insurance business and he lists barriers to trade in insurance services as discriminatory financial, investment and license requirements as well as operational barriers such as discriminatory pricing, product, taxation and government procurement requirements. In line with these arguments, OECD (1999) reports the obstacles to foreign participation in domestic insurance markets in terms of deposits and financial guarantees, fiscal advantages, administrative and procedural aspects of

licensing, valuation and localization of assets and restrictions concerning the placing of contracts and work permits.

Assuming that the EU insurance legislation harmonizes to a large extent the supervisory regulations and the conditions of exercise of insurance by way of FOE and FOS and thus market entry restrains are disappeared, most of the barriers reported by Zimmerman (1999) and OECD (1999) for international insurance operations cannot be considered as valid arguments for the lack of further integration of the European single insurance market. However, Sterzynski (2003, p.47) claims that although the three generations of insurance directives built a regulatory framework for insurers, it could not establish an ideal insurance market where insurers would distribute their own goods without obstacles and where policyholders would freely choose the best and cheapest products.

The reason of the fact that most European insurers carry on European-wide insurance activities mainly through subsidiaries in host markets rather than by way of FOS can be attributed to several remaining obstacles for the well functioning of a single insurance market in Europe. Average relevance of obstacles in the EU retail financial markets documented by Heinemann and Jopp (2002, p.48) are shown in Graph 50. The results of their questionnaire, answered by leading European banks and insurers, indicate that insurers attach greater importance to natural obstacles such as consumer loyalty and language than other financial intermediaries.



Graph 50: Average Relevance of Obstacles in the EU Retail Financial Markets
Source: Heinemann and Jopp (2002, p.48)
10 means highly relevant and 1 means not relevant

The obstacles for further insurance market integration can be grouped into demand side and supply side obstacles. Demand side obstacles such as differences in consumer confidence and preferences, language, products and taxes are related to the choice of policyholders, while supply side obstacles such as differences in regulatory and supervisory rules, information costs and general good principle are related to the operation of insurance companies. These obstacles prevent to establish a real functioning European single insurance market mainly for retails consumers and not for big commercial and industrial consumers.

Both demand side and supply side obstacles can be divided into natural and regulatory obstacles. While natural obstacles are a consequence of preferences, technology and the inherent characteristics of a market and they cannot be directly addressed by the legislator, regulatory obstacles could in principle be addressed by local or EU legislators (Heinemann and Jopp, 2002, p.45). Lack of consumer confidence towards foreigners and consumer preferences are the examples of natural barriers which are very difficult to change. Different supervisory implementations, contract law, tax treatment and general good principle are the most obvious examples of regulatory obstacles. Natural obstacles seem the most important factors to prevent the single market in real life but while natural obstacles in both demand side and supply side would not disappear in short term, regulatory obstacles can be diminished by policy action in short and medium terms. Main obstacles that prevent the establishment of a functioning single insurance market in Europe are summarized in Table 7.

Table 7: Obstacles to the European Single Insurance Market

	Supply side obstacles	**Demand side obstacles**
Regulatory obstacles	• Regulatory and supervisory differences • Contract law • General good principle • Cross-border operation costs	• Tax treatment • Product differentiation
Natural obstacles	• Information costs (due to natural demand side obstacles) • Differences in distribution channels	• Policyholder confidence • Policyholder preferences • Language

Source: own Table

3.3.1. Demand Side Obstacles

CEA (2004a, p.14) claims that most Europeans are not aware of the different insurance offers to which they have access in the single market and as long as they have no real difficulties with their insurer, they do not attempt to change it, especially not with a foreign insurer, since looking for other products available in the single market would be a time and money consuming effort for them.

Pickering and Matthews (1997, p.22) argue that a single market in insurance would first of all require potential policyholders to display a willingness to engage in cross-border purchasing of products. However, assuming that European retail consumers has such a willingness to buy an insurance product from a foreign supplier, they are faced with regulatory barriers such as different tax treatment and definition and classification of products, as well as natural barriers such as policyholder confidence, preferences and language.

3.3.1.1. Tax Treatment

The responsibility for tax policy is mainly under the sovereignty of the Member States and not harmonized throughout the EU. However, taxation is crucial for good functioning of the internal market. This is why the EU Treaty prohibited the Member States to impose on the products of other Member States any internal taxation of any kind in excess of that imposed on similar domestic products.[34] Some important steps have been taken for harmonization of indirect taxation and approximation of direct taxation, taking into account the subsidiary principle (Oksay, Uyanık and Acar, 2005, p.44).

Before the Second Non-Life Directive, any indirect tax was due in the country where the insurance contract was concluded. But after this Directive, any tax was due in the country where the insurance risk was located. This principle was further clarified in the ECJ ruling of the Kvaerner Case in 2001.[35] Kvaerner, a Norwegian construction company, bought a professional indemnity insurance policy for its group companies, including its Dutch subsidiary. The policy was written in the UK and the insurance

[34] Article 110 of the Treaty on the Functioning of the European Union (ex Art 90 TEC)
[35] ECJ ruling of 14 June 2001 (C-191/99)

premium tax (IPT) on all the coverage was paid to the UK. The case is referred to the ECJ which decided that Dutch IPT was due on the Dutch subsidiary's element of the policy and should be paid to the Netherlands. In other words, IPT should be calculated and paid in accordance with the rules of the Member State where the risk is located.

Therefore, the Kvaerner case provided the customers to choose their insurer without any tax treatment differences because IPT rate will not be the rate of the Member State where the insurer has its head office, but it will be the rate of the Member State where the risk is located. For instance, when a German citizen buys home insurance policy from a German insurer for his summer home in Spain, the IPT part of his policy should be calculated in accordance with the Spanish IPT rate and should be paid to Spain. Thus, it can be claimed that Kvaerner case has accelerated the integration of the European single insurance market, since it has paved the way to overcome the differences in tax treatment between Member States.

At customer level, the paramount concern is to avoid being subject to double taxation on non-life premiums and to secure tax relief on life premiums (Expert Group on Insurance and Pensions, 2004, p.20). Some Member States permit the deduction of life premiums for tax purposes. However, the persisting limitations of deductions to contracts that are written with an insurer being authorized in another Member State pave the way to discrimination in taxation. If the premium is paid to an insurer from outside the taxing Member State, there is discrimination if tax relief is not available to the policyholder (Pickering and Matthew, 1997, p.25). Cross-border life insurance activities would be very limited if a national law prevented taxpayers from deducting premiums paid for life policies from their income tax unless they were paid to domestic insurers. Such kind of differences in national tax regimes should totally be abolished in the European single insurance market as they constitute a significant barrier to the integration.

On the other hand, although after the Kvaerner case, foreign insurers can now compete on an equal basis with domestic insurers in an environment where IPT is not yet harmonized, it made it difficult for companies to operate throughout the single market since insurance contracts covering risks in more than one Member State should be

divided on a proportional basis to ensure that each Member State where a part of the risk is located receives its share of the tax (Ennsfellner and Dorfman, 1998, p.46).

Thus, insurers have to comply with the differing indirect tax rules of each Member State. An insurer, who writes a policy covering a risk in for instance five Member States, would need to comply with the indirect tax rule in each of these five Member States. This can cause many difficulties and operational costs especially for large risks, written in several Member States because the tax rules and rates vary significantly between Member States.

In most of the Member States, insurance premiums are not subject to VAT. Instead, there is a system of premium taxes called Insurance Premium Tax (IPT). Member States have the right to charge their own IPT on the insurance of risks situated in their territory and to use their own means to collect the tax, regardless of whether the insurer covering the risk is situated in the same Member State or elsewhere (Pickering and Matthews, 1997, p.25).

As can be seen from Table 8, IPT rates vary significantly across Member States. While the standard IPT is 5% in the UK, it is 19% in Germany. IPT rate can also change from one line of business to another within the same Member State. For instance, in Italy while IPT rate in health insurance is 2,5%, it is 21,25% in fire insurance. The rates vary also in Germany from %3 to 19%. While life insurance is exempt from IPT in most of the Member States, IPT in MTPL insurance differs significantly between countries.

Table 8: IPT Rates in the EU Member States (2008)

	UK	IT	ES	FR	DE
Life	Exempt	Exempt	Exempt	Exempt	Exempt
Health	5%	2.5%	Exempt	7%	Exempt
Householder's all risks	5%	21.25%	6%	9%	18%
Accident	5%	2.5%	6%	18%	19%
MTPL	5%	12.5%	6%	18%	19%
Fire	5%	21.25%	6%	7%	14%
Transport	5%	7.5%	Exempt	Exempt	19%
Marine	Exempt	21.25%	Exempt	Exempt	3%
Reinsurance	Exempt	Exempt	Exempt	Exempt	Exempt

Source: own Table based on data from CEA (2009b)

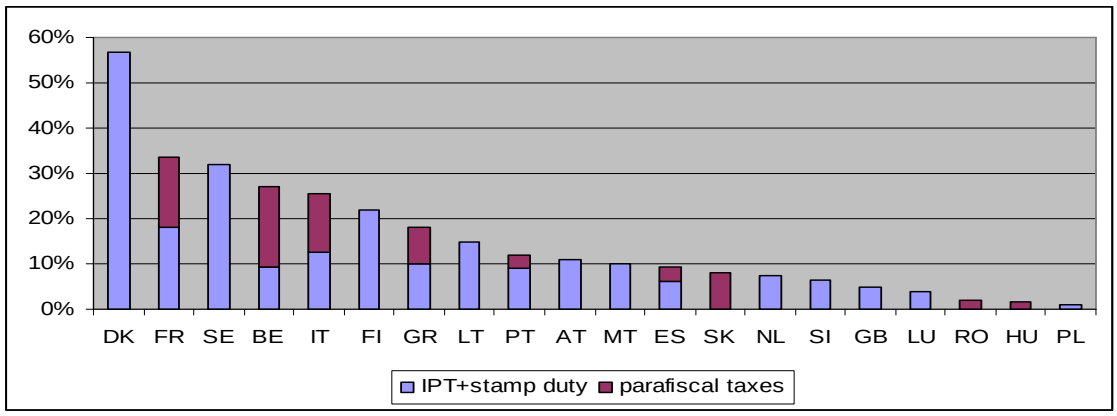
There is also fire brigade tax which is levied generally from fire insurance policies but it is also levied in some Member States from some other lines of business covering fire risks. Table 9 lists the Member States which apply fire brigade tax. Tax rates vary between Member States from 3% in Finland to 10% in Poland.

Table 9: Fire Brigade Tax in the EU Member States

Country	Fire brigade tax rate
AT	8%
DE	8% *
ES	5% **
FI	3%
GB	GBP 35 per GBP 1 million of the goods insured
HU	1.5%
LU	6%
PL	10%
PT	13%
SI	5%
SK	8%

Source: own Table based on data from CEA (2009b)
* 2% for buildings insurance and 1,6% for householder's all risks insurance
** 2,5% for householder's all risks insurance

As can be seen from Graph 51, taxation of compulsory MTPL insurance subject to IPT, stamp duty and/or parafiscal taxes, differ significantly between Member States. While several Member States such as Czech Republic and Norway do not impose any tax on MTPL premiums, the IPT rate is 42,9% and stamp duty is 14% which makes a tax burden of almost 57% in Denmark. In most of the Member States there are also parafiscal taxes at the expense of both insured and insurer for contribution to different bodies. For instance, in Portugal apart from 9% stamp duty, 2% of the premium is levied for National Institute of Medical Emergency and 2,71% for Motor Guarantee Fund at the insured expense while 0,242% of the premium is levied for Portuguese Insurance Supervisory Authority at the insurer expense. Total tax burden is then 13,9%.



Graph 51: Taxation of MTPL Insurance in the EU (2008)

Source: own Graph based on data from CEA (2009b)

Furthermore, related to direct taxation of companies, corporate income tax rate varies from 12,5% in Ireland to 34% in Belgium in 2009. There are also many different rules to the deductibility of insurance technical reserves. These differences would make insurers reluctant to physically establish in other Member States.

In conclusion, for the well functioning of the European single insurance market, Brittan (1990, p.421) argues that the fiscal regimes of the Member States should not be discriminatory in favor of their domestic markets, by disallowing deductibility of premiums relating to policies concluded outside of the home Member State or by imposing heavier taxation on the benefits from such policies. However, in the European single insurance market, the responsibility of tax treatment with respect to insurance still lies with individual Member States, diversities exist in terms of tax rates and tax systems.

3.3.1.2. Definition and Classification of Products

Differentiation in the definitions and classifications of the same insurance products in different Member States is another important barrier to the European single insurance market. Insurers from different Member States, while operating throughout the EU without prior approval of price and policy conditions, may offer their products under the same name but with different characteristics (Nemeth, 2001, p.70). The problem it creates to the well functioning of the European single insurance market from the policyholder point of view is the lack of transparency of products. Consumers have then difficulties to evaluate and choose the product which best suits their needs.

Resulting from different traditional approaches to insurance and different roles of various social security systems that have developed over time, especially the definition and classification of life and health insurance products diverge significantly. For instance, what is called a life insurance product in one Member State can be called as a pension product in another Member State. The cover of motor insurance policies, for instance, differs widely.

A possible solution to this problem may be the development of homogeneous products for the European market. Müller-Reichart (2005, p.292) argues that in addition to the cross-border sale of national products, new products that could be sold throughout the EU may be developed specifically for the European market. However, differences in taxation and lack of European framework for a harmonized contract law and civil law prevent European insurers designing and marketing a single product in all Member States (CEA, 2002, p.2).

To facilitate the marketing of pan-European products on an EU-wide scale, an alternative and optional regime, called 26th regime, applied to cross-border retail insurance products can be established. Insurers should be motivated to develop such kind of products which take into account the needs of the European market as a whole and which have a significant sales potential in Member States. Insurers should be able to design and price insurance products suited for European-wide distribution without having to change product terms to meet the local rules (CEA, 2004b, p.5). This so called 26th regime may also facilitate the harmonization of contract law in the EU. But Expert Group on Insurance and Pensions (2004, p.19) urges that a 26th regime approach need not result in a new, additional regulatory framework with new administrative burdens for the companies. In addition, in order to prevent the lack of transparency of products, sufficient level of pre-contractual information should be provided for consumers.

3.3.1.3. Policyholder Confidence

Insurance business is essentially based on confidence. Taking into account the intangible character of the insurance, a great deal of confidence is necessary from the policyholder while entering into a contractual relationship with an insurer. When the supplier is unknown and based in a foreign country, even more confidence is required.

Non-life insurance policies require after-sales services, in the form of claim handling. Thus, customer expectations of future service and satisfaction will be important considerations at the time of purchase (Expert Group on Insurance and Pensions, 2004, p.18). When a claim occurs, individual policyholders desire to be able to rely on a service provider who is immediately available and present to assist them (CEA, 2004a, p.15). On the other hand, life insurance policies also require a high degree of proximity between the consumer and the insurer since the consumer needs to feel comfortable with the company to which s/he pays a substantial amount of money for a long period of time. Keeping this proximity, thus the confidence, is even more difficult within a single market comprising 30 Member States.

Therefore, retail consumers are resistant to abandon their domestic insurers in favor of foreign players which are likely less well-known than the domestic insurers. Especially retail customers are not rational in their choice of product and company and they are therefore biased towards local insurance companies and intermediaries. Thus, taking into account the home bias towards domestic players, foreign insurers enter the foreign market through mergers and acquisitions instead of cross-border business by way of FOS. Moreover, once they acquire a domestic insurer and enter the market, they prefer to retain the locally trusted brand name of the acquired domestic insurer and rebrand it only gradually (Furstenberg and Junker, 2005, p.303).

Furthermore, since confidence is a natural barrier, it is difficult to deal with, taking into account its emotional and irrational aspects. However, it may be strengthened by better informing the policyholders, converging consumer protection rules and

establishing fast and effective out-of-court systems responsible for handling disputes between consumers and insurers such as the current SOLVIT and FIN-NET networks.[36]

3.3.1.4. Language

The insurance contract is a legal agreement which determines the rights and duties of the parties on the contract, namely the insurer and the insured. Therefore it is of outmost importance for the customer to read and understand the terms and conditions of the contractual relationship with the insurer. Therefore, the contract should be written in the mother language of the consumer. This is also a legal requirement in Member States. Different national languages in the EU, thus, create a major obstacle to cross-border insurance business, especially for retail insurance services. Consumers prefer domestic companies and intermediaries with whom they can speak their mother language during policy drafting and claims handling.

Having multiple-language copies of the policies and multi-lingual local and home office personnel can mitigate this problem, but in this case, foreign insurers should bear the additional costs that are not found in domestic companies (Ennsfellner and Dorfman 1998, p.47).

3.3.2. Supply Side Obstacles

EU-based insurance companies that wish to sell their products through FOE and FOS to foreign customers residing in other Member States are faced to explicit and implicit market entry barriers in the European single insurance market. On the supply side, regulatory and natural barriers faced by the insurers are the operational and

[36] SOLVIT is an on-line problem solving network to solve, without legal proceedings, problems caused by the misapplication of internal market law by public authorities. There is a SOLVIT centre in every EEA country that can help handling complaints from both citizens and businesses.
FIN-NET (Financial Dispute Resolution Network), launched by the European Commission, is a financial dispute resolution network of national out-of-court complaint schemes that are responsible for handling disputes between consumers and financial services providers. If a consumer in one country has a dispute with a financial services provider from another country, FIN-NET members will put the consumer in touch with the relevant out-of court complaint scheme and provide the necessary information about the issue.
SOLVIT is an on-line problem solving network to solve, without legal proceedings, problems caused by the misapplication of internal market law by public authorities. There is a SOLVIT centre in every EEA country that can help handling complaints from both citizens and businesses.

information costs due to the lack of convergence in regulation, supervision and distribution systems.

3.3.2.1. Contract Law

In the EU, insurance contract law which determines the policy conditions, thus the shape of the products, has not yet harmonized. Despite the harmonization initiatives taken at the EU level long time ago, rules on pre-contractual and contractual information as well as on cancellation of the contract still remain very different.

Whereas for large risks, law applicable to non-life insurance contracts can be chosen freely, for mass risks it is the law of Member State of location of the risk or law of the Member State of the policyholder's residence. For compulsory insurances, the applicable law is the law of the Member State imposing them. If the law of location of risk applies to the contract when a British consumer buys a home insurance policy for his summer home in Italy, she will be in difficulty because the contract law of the UK and that of Italy significantly differ from one another since the former traditionally followed Anglo Saxon model while the latter followed Continental model. On the other hand, law applicable to life insurance contracts is the law of the Member State of the commitment (country of residence of the policyholder) or law of the Member State of policyholder's nationality.

The main motivation behind applying the law of the country in which the consumer has his habitual residence is guaranteeing the protection of the consumer by the law which is most familiar to him (CEA, 2004a, p.15). This means that each product should meet the different specific legal requirements of each Member State. Given the significant differences of the contract law provisions in each Member State, preparing the contracts which should comply with the law of the policyholder's country would be complicated and expensive and thus would create a barrier for cross-border activities of the insurers.

Therefore, for the good functioning of the European single insurance market, contract law should be harmonized throughout the EU as far as possible in order to

standardize the policy conditions used by the insurers in different Member States. This is *sine qua non* not only for consumers but also for insurers in their cross-border activities.

3.3.2.2. Lack of Regulatory Convergence

At the legislative level, the convergence is advanced. However, the insurance *acquis* itself has sometimes deterrent effects on the European single insurance market. For instance, an insurer should notify its home insurance supervisory authority about its intention to be established in another Member State and then the supervisory authority communicates this intention to the host Member State supervisory authority. This is not a prior approval for the company but a long procedure to complete which may take up to five months before being established in another Member State.[37] Assume that an a company that wishes to sell its new innovative product in a foreign market by a branch office, while it has been waiting for the completion of the procedure, domestic companies may begin to commercialize a similar product and put the foreign company at a disadvantageous position against the domestic companies. Therefore, the envisaged deadlines between notification by the insurance company and authorization given by the supervisory authorities may have a deterrent effect on the single market.

Furthermore, current legislation is criticized to be too complex to implement. The legislative style of most of the directives is criticized by Nemeth (2001, p.7) to be somewhat unfortunate because it mainly consists of references to and amendments of other directives. Effective and uniform implementation and enforcement of legislation should be achieved through simplification and codification of the EU insurance legislation. For instance, consolidation of motor insurance directives in one Directive (2009/103/EC) and the taking-up and pursuit of life, non-life and reinsurance business in one single Directive (2009/138/EC) are one of the biggest steps towards the realization of this aim.

[37] When the required information has been notified by the insurance undertaking to the home Member State supervisory authority, it has then three months to communicate it to the host Member State which has two months to decide whether there are any general interest conditions. (see art 146 of the Directive 2009/138/EC)

Finally, timely and correct transposition as well as consistent implementation and enforcement of the insurance directives should be ensured for the well functioning of the European single insurance market. Therefore, to guarantee complete and correct transposition and implementation of the rules, European Commission should, as soon as possible, act against Member States which fail to transpose a directive or to comply adequately with its requirements. However, legislative process should not lead to overregulation which may cause administrative and compliance costs for the insurance industry. CEA (2002, p.3) claims that the EU insurance legislation should maintain the right balance between the costs it involves and the benefits it brings for consumers and companies.

3.3.2.3. Lack of Supervisory Convergence

Home country control principle prevents companies to face with several supervisory practices. However, there is not a single financial supervisory authority in the EU. Wymeersch (2007, p.255) states that the current EU financial supervisory system is based on twenty-seven supervisory systems, each acting within its own State and coordinating their action bilaterally and within the European networks. Lannoo (2002, p.7) argues that a single European financial supervisory authority would be difficult to reconcile with the basic principles of the single market where only essential rules are harmonized and the rest is left to Member States.

Current supervisory system requires convergence of some rules and cooperation and exchange of information between supervisors for the well functioning of the single market. This convergence is essential for the European single insurance market. Otherwise, taking into account the home country control principle, an insurer based in a Member State with a relatively liberal supervisory system may operate through FOS in another Member State that has a tighter supervisory system, thereby achieving a potential advantage over domestic companies (Ennsfellner and Dorfman, 1998, p.40).

The cooperation and convergence among financial supervisory authorities in the EU are implemented through “Lamfalussy Committees” which is a system based on the traditional institutional model envisaging the supervision of banks, insurers and securities

markets with their own distinct supervisory authorities. For insurance, reinsurance and occupational pensions business, Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has been established[38] to advise the European Commission regarding technical implementing issues and to contribute to the common and uniform day-to-day implementation of Community legislation and its consistent application by the supervisory authorities of the Member States.

However, Lamfalussy Committees are criticized for not being effective enough for further integration of financial markets since they do not have the legal power to take decisions and fail to keep a close cooperation between national supervisory authorities. Therefore, in order to strengthen European supervisory convergence and to establish a more efficient, integrated and sustainable European system of supervision, the system had to be reformed. From macro-prudential standpoint, European Systemic Risk Board (ESRB) is established to assess European macro prudential risks and to enhance early warning mechanisms.[39] From micro-prudential standpoint, European System of Financial Supervision (ESFS) based on three different European Supervisory Authorities for banking, insurance and securities is established to improve the effectiveness and cost efficiency of supervision, to balance home and host Member State supervisor interests and to ensure a level playing field for financial institutions operating in various Member States. As part of the ESFS that comprises three European Supervisory Authorities, the European Insurance and Occupational Pensions Authority (EIOPA) is established for the insurance and occupational pensions sector.[40] The main goals of EIOPA are better protection of consumers, ensuring a high, effective and consistent level of regulation and supervision taking into account of the varying interests of all Member States, greater harmonization and coherent application of rules across the EU and a coordinated EU supervisory response when necessary.

[38] CEIOPS is established by Commission Decision 2004/6/EC of 5 November 2003, OJL 003, 07.01.2004 which is then repealed by Commission Decision 2009/79/EC of 23.01.2009, OJL 25, 29.01.2009

[39] Regulation No 1092/2010 on European Union Macro-prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, OJL 331/1, 15.12.2010

[40] Regulation No 1094/2010 Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), Amending Decision No 716/2009/EC and Repealing Commission Decision 2009/79/EC, OJL 331/48, 15.12.2010

Müller-Reichart (2005, p.288) recognizes that a better coordination between supervisors is a basic prerequisite for more efficient supervision of individual companies, groups and financial conglomerates. But it is still too early to evaluate if the ESFS will be helpful to achieve a better coordination. Therefore, in order to achieve a real and functioning single insurance market in the EU, a common EU-wide supervisory authority which is binding on and responsible for every Member State may be required in near future.

3.3.2.4. General Good Principle

Member States may have recourse to the concept of general good to deny market access of an EU insurer that wishes to carry on business within its territory or to enforce this foreign insurer to comply with its own rules. General good principle allows Member States to refuse market entry of the new foreign insurers or to refuse the distribution of a new insurance product by claiming an infringement to the public interest (Sterzynski, 2003, p.47).

As a general rule, the Member State in which the risk is situated cannot prevent a policyholder from concluding a contract with an EEA insurer as long as that does not conflict with the legal provisions protecting the general good in that Member State. This concept of general good exists in the insurance *acquis* but it is still not clearly defined[41]. Therefore, its interpretation is limited to the description of the few ECJ rulings such as the 1986 ECJ insurance cases. In its several rulings, the ECJ has given the example of social protection, consumer protection, worker protection, prevention of fraud, fiscal consistency and road safety as a justification of general good (Labilloy, 2003, p.11).

Since the lack of definition still creates a lot of free interpretation possibility for Member States, the European Commission announced in an Interpretative Communication[42] that the measure of compliance with the rules of the host Member State can only be justified as being in the general good if (1) it is not already harmonized at the EU level, (2) it is not discriminatory and applies also to domestic insurers, (3) it is

[41] Article 180 of the Directive 2009/138/EC

[42] For more details see Interpretative Communication of the Commission Concerning the Freedom to Provide Services and the General Good of the Insurance Sector, OJ C 43 of 16.02.2000.

necessary to protect a general interest, (4) it does not duplicate the rules of the country of origin, in other words the checks required by the host Member State should not already be undertaken in the home Member State, (5) it is proportionate to the objective pursued and it must not be attainable by other less restrictive measures and (6) it pursues an objective of the general good. However, as the Communications have no legal binding effect, the result of this Communication depends on to what extent the Member States want to apply it.

To sum up, general good principle can still be used as an instrument of protectionism against foreign competition to the detriment of the single market. Member States may prevent the market entry of the companies under the pretext of consumer protection. Since consumer protection under the general good principle depends strongly on specific national traditions, the insurers have to adapt to the differing rules of different Member States (Beckmann, et al., 2002a, p.20). This may not only impose further compliance costs on insurers, but also limit the choice of products available to individual consumers. Therefore, general good principle should clearly be defined and its borders should be drawn by the European Commission or by the case law of the ECJ.

3.3.2.5. Differences in Distribution Channels

Intermediaries are vital for the insurance sector in the process of selling the products to customers. In all of the Member States, more than half of the premiums are collected by intermediaries both in life and non-life business. CEA (2010b) reports that non-life insurance products are mainly provided by traditional intermediaries, agents and brokers, whereas bancassurance is the main distribution channel for life insurance products in most of the Member States. However, distribution channels in both life and non-life business differ widely between Member States.

Although Insurance Mediation Directive 2002/92/EC provided single license principle for intermediaries, many *de facto* barriers prohibit insurance intermediaries from operating in different insurance markets of the EU, thus preventing insurers from using their home country's distribution channels to commercialize their products across

the EU (CEA, 2001, p.6). As a result, in order to penetrate into foreign markets, insurers should use the common distribution method of that Member State.

De Haan et al. (2009, p.288) claim that it is difficult to enter foreign markets where brokers and agents are predominant. Direct cross-border selling to the Member States where customers prefer agents and brokers to benefit from proximity at the time of the conclusion of the contract and in case of a claim is difficult. The use of FOE is expensive and time consuming since foreign insurers should establish their own agency network or work with already established local agents to sell their products. For instance, a Portuguese life insurance company offering his products in Portugal via bancassurance, in order to penetrate or survive in the German market where the dominant distribution strategy is the use of agents, it is forced to change its distribution strategy. In this case, the Portuguese insurer would be reluctant to enter the German market, taking into account that the use of different distribution strategies in each local market is an expensive and time consuming effort.

One potential response to this entry difficulty may be direct selling. Indeed, in many markets, retail non-life insurance products have increasingly been distributed by direct channels, especially through internet. Whereas the use of internet to sell insurance products is still negligible in Europe, around 40% of motor insurance is now sold online in the UK (CRA International, 2009, p.130).

3.3.2.6. Cross-Border Operation and Information Costs

Cross-border business is costly for insurance companies and intermediaries due to natural demand side obstacles such as language and consumer confidence. Foreign insurance companies should bear the cost of providing policies in the languages of the related Member State. They should also bear the cost of giving additional pre-contractual information to gain the policyholder confidence.

In addition, investment on local market knowledge, risk profiles and claims handling is essential. The use of the dominant distribution strategy of the host Member State is also necessary but costly. Finally, advertising costs to introduce to increase their awareness are also necessary for their operations in other Member States. Furthermore, it

is costly to deal with a plenty of differing tax and regulatory regimes. This is why cross-border activities in the European single insurance market are mostly pursued by big insurance groups which can bear all the transaction and information costs.

E-commerce offers a big chance to small and medium-size insurers to sell their products throughout the EU without bearing transaction and information costs. Beckmann, et al. (2002a, p.22) note that e-commerce offers a large possibility for further integration of the retail markets for insurance products. For that purpose, Electronic Commerce Directive 2000/31/EC[43] applies to all financial services and removes existing provisions that prohibit the offer of insurance products over the internet. However, the application of the Directive to insurance is incomplete because it provides for specific derogations relating to certain provisions in the Insurance Directives. Therefore, the necessary adaptations to the legal framework should be done to increase cross-border activities of retail insurance products via internet.

[43] Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market *(*OJ L 178, 17.7.2000)

4. TURKISH INSURANCE MARKET AND ITS INTEGRATION TO THE EUROPEAN SINGLE INSURANCE MARKET

4.1. TURKISH INSURANCE MARKET

4.1.1. History of the EU Membership Process of Turkey in the Field of Insurance

Formal relations between Turkey and the European Economic Community (EEC) were established with the Association Agreement, known as Ankara Agreement, which was signed in 1963 and entered into force in 1964.[44] The application was made on the legal basis of Article 238 of the Rome Treaty which regulates association relations of the EEC with non-members and not on the legal basis of Article 237 which regulates the accession of non-members to the EEC. However, Ankara Agreement has a full membership perspective as an ultimate aim.[45] Therefore, it can be seen as a preparatory stage to prepare Turkey for full membership. In accordance with this objective, it provides not only a progressive establishment of a customs union, but also envisages closer economic relations based on free movement of goods, services, workers and capital which were all adopted from the Treaty of Rome. Dartan (2002, p.281) considers the Ankara Agreement as an association for the purposes of development and as a pre-accession agreement which aims at the accession of the associate state to the Community.

Ankara Agreement covers three progressive stages, namely preparatory, transitional and final stage. The preparatory stage envisages preparing Turkish economy for performing its commitments in future stages (Seyidoğlu, 2007, p.264). Transitional stage which started in 1973 with the entry into force of the Additional Protocol aims to establish progressively a customs union between the two parties and to align the

[44] Agreement Establishing an Association between the European Economic Community and Turkey, (OJ L 182, 12.12.1963)

[45] Article 28 of the Ankara Agreement: As soon as the operation of this Agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community.

economic policies of Turkey with those of the Community.[46] The final stage started in 1996 on the completion of the Customs Union between the Community and Turkey.

Customs Union between the Community and Turkey took effect on 1 January 1996 with the Decision no 1/95 of the Association Council.[47] It eliminates all customs duties and charges having equivalent effect as well as the quantitative restrictions and measures having equivalent effect only on industrial and processed agricultural goods. Agricultural goods and services are out of the subject of the Customs Union. With the launch of the Customs Union, Turkey also aligned its customs tariff with the common customs tariff of the Community against third countries.

Ankara Agreement, in line with four freedom of movements of the Rome Treaty, envisages the progressive setting up of the free movement of services between the Community and Turkey.[48] However, since the EU-Turkey Association Council has not taken any decision necessary for the implementation of the free movement of services, it has not been established yet. In April 2000, the Association Council decided to open negotiations for the liberalization of services, including financial services, between the EU and Turkey.[49] Although Turkey had candidate status to the EU, the Draft Agreement presented by the European Commission was only based on the GATS commitments of the parties and thus was limited in scope and in ambition (Atalay, 2004, p.17). An updated Draft which ensures Turkey's incorporation in the Single Market for services was therefore presented. However, several rounds of negotiations for the extension of the Customs Union to services have ended up without success until today.

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[46] Additional Protocol and Financial Protocol signed on 23 November 1970, annexed to the Agreement establishing the Association between the European Economic Community and Turkey (OJ L 293, 29.12.1972)

[47] Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union (OJ L 35, 13.2.1996)

[48] Article 13 of the Ankara Agreement: The Contracting Parties agree to be guided by Articles 52 to 56 and Article 58 of the Treaty Establishing the Community for the purpose of abolishing restrictions on freedom of establishment between them.

Article 14 of the Ankara Agreement: The Contracting Parties agree to be guided by Articles 55, 56 and 58 to 65 of the Treaty Establishing the Community for the purpose of abolishing restrictions on freedom to provide services between them.

[49] Decision No 2/2000 of the EC-Turkey Association Council of 11 April 2000 on the opening of negotiations aimed at the liberalization of services and the mutual opening of procurement markets between the Community and Turkey.

After the fall of communism, a new and comprehensive enlargement process was launched in the 1990s. In Luxembourg European Council of December 1997, ten countries from Central and Eastern Europe together with Cyprus and Malta were determined as candidate countries for the EU membership on an equal footing. Turkey was excluded from this process since its candidacy status was denied while its eligibility for membership was reaffirmed. Turkey reacted to the conclusions of the Luxembourg Summit and political dialogue was broken off. Just two years after this Summit, the Helsinki European Council of December 1999 granted the status of candidate country to Turkey on the same footing with other candidates, but negotiations were not started until the decision of the European Council of December 2004 which confirmed that Turkey fulfils the Copenhagen political criteria which were a prerequisite for opening of the accession negotiations with candidate countries.

Finally, as agreed at the European Council of December 2004, accession negotiations were launched in October 2005 with screening process in which the differences between the EU legislation and the legislation of the candidate country are examined. Upon the completion of the screening process in October 2006, negotiations were started with the progressive opening of the negotiating chapters. However, negotiations are proceeding at a slow pace and out of the 35 negotiating chapters, 12 chapters are opened by the end of 2010 and only one of them is provisionally closed.

Negotiations in the field of insurance are going to be conducted under "Chapter 9: Financial Services". However, this chapter is one of the eight chapters that are blocked by the decision of the European Council of December 2006 until Turkey fully implements the 2005 Additional Protocol[50] which requires the opening of Turkish seaports and airports to all of the EU Member States, including Greek Cypriots.[51] Therefore, since the full implementation of the Additional Protocol is set as an opening

[50] Council Decision of 13 June 2005 on the signature of the Additional Protocol to the Agreement establishing an Association between the European Economic Community and Turkey following the enlargement of the European Union (2005/672/EC), OJ-L 264/57.

[51] The implementation of the 2005 Additional Protocol to all EU Member States was set as an opening benchmark to the following eight negotiation chapters which are considered as related to internal market: chapter 1 on free movement of goods, chapter 3 on right of establishment and freedom to provide services, chapter 9 on financial services, chapter 11 on agriculture and rural development, chapter 13 on fisheries, chapter 14 on transport policy, chapter 29 on customs union, chapter 30 on external relations.

benchmark of eight chapters including the chapter 9 on financial services, negotiations on insurance services have not yet started as Turkey does not fully agree with this European Council decision.

4.1.2. Legislation Governing the Turkish Insurance Market

4.1.2.1. Insurance Law

Taking up and pursuit of insurance and reinsurance business in Turkey is regulated by the Insurance Law no 5684 enacted in 2007.[52] The Law regulates the principles and procedures relating to the commencement of operations, management, organization and operations as well as the termination and supervision of the activities of the insurance and reinsurance companies and intermediaries, actuaries and loss adjusters operating in Turkey.

License requirements, withdrawal of license, winding up, merger, acquisition, portfolio transfer and bankruptcy procedures of the companies, insurance tariffs, compulsory insurances, technical reserves, financial reports and measures relating to financial structure as well as administrative and judicial penalties are regulated under this Law. Loss Adjusters Executive Committee, Insurance Agents Executive Committee, Insurance Arbitration Commission and Insurance Education Centre are the new bodies established by this Law. Moreover, Association of the Insurance and Reinsurance Companies of Turkey, Guarantee Account and Insurance Information Centre are also regulated under this Law.

4.1.2.2. Turkish Commercial Law

Insurance contract rules are regulated in the Turkish Commercial Law no 6762 which entered into force in 1957.[53] The new Turkish Commercial Law no 6102 which covers in its 6th book the definition, scope, time, commencement, termination and cancellation of the insurance contracts as well as the rules on the contracts of each type of

[52] Insurance Law no 5684, OJ 26552, 14.06.2007
[53] Turkish Commercial Law no 6762, OJ 9353, 09.07.1956

insurance will enter into force on 01.07.2012.[54] In order to safeguard the freedom of contract and enable the parties to formulate the content of the contract, the new Turkish Commercial Law has a certain degree of flexibility and contains rules which are not mandatory as much as possible.

The definition of the parties of an insurance contract and their contractual liabilities are now clearly defined. Furthermore, the new Law enforces a detailed set of rules on liability insurances which were not sufficiently regulated by the previous Law. It also envisages specific and comprehensive rules on life insurances, taking into account their investment component. Tontines which were not allowed by the previous Law become now possible. Moreover, upon the entry into force of the new Law, the contracts will be able to be concluded online by using electronic signature.

On the other hand, since the EU has not enforced any directives on insurance contract law, the new Turkish Commercial Law has not considered the EU *acquis* as a main source but is influenced by the German Code of Insurance Contracts (Deloitte Turkey, p.20). However, obligations to inform the insured and the establishment of tontines are regulated in the new Turkish Commercial Law in conformity with the EU *acquis* (Metezade, 2005, p.19). [55]

4.1.2.3. Agricultural Insurance Law

In order to provide coverage for the risks exposed by the agricultural sector, Agricultural Insurance Law no 5363 which envisaged an agricultural insurance mechanism based on public-private partnership was enforced in 2005.[56] The Government pays half of the premiums on behalf of the farmers. Premium contribution is determined by the Council of Ministers on an annual basis with respect to the crops, risk, region and premises scale.

[54] Turkish Commercial Law no 6102, OJ 27845, 14.02.2011
[55] Tontines are defined in the article 2 of the EU Directive 2002/83/EC Concerning Life Assurance as "the associations of subscribers are set up with a view to jointly capitalising their contributions and subsequently distributing the assets thus accumulated among the survivors or among the beneficiaries of the deceased".
[56] Agricultural Insurance Law no 5363, OJ 25852, 21.06.2005

The insurers conclude agricultural insurance contracts but all risks are transferred to the Agricultural Insurance Pool established by this Law. The Pool provides coverage for catastrophic risks such as drought or frost that cannot be covered by a single insurance company. In order to carry out the tasks of this Pool, a management entity called TARSIM is set up by the Law.

For all types of crops, loss of quantity arising from hail, storm, fire, tornado, landslide and earthquake is covered by this insurance. Moreover, the crops and technical equipment in greenhouses, dairy cattle registered in pedigree system, poultry within enclosed premises and fishes reared in sea cages are also under the scope of the agricultural insurance system established by Agricultural Insurance Law no 5363.

4.1.2.4. Decree Law on Compulsory Earthquake Insurance

Following the Marmara earthquake which took place in 1999, a compulsory earthquake insurance mechanism has been established by Decree Law no 587 relating to Compulsory Earthquake Insurance[57]. As of March 2001, earthquake insurance became compulsory for the dwellings that remain inside the boundaries of the municipalities. The dwellings that are built in villages, that belong to public institutions and that are entirely used for commercial and industrial purposes are outside the scope of this insurance.

Compulsory earthquake insurance covers up to a certain limit the material damages that are caused by earthquakes as well as fires, explosions and landslides as a result of earthquakes.[58] Loss of profit or income, all sorts of movable goods and furnishings, personal injuries and claims of damages for pain and suffering are excluded.

Insurance companies issue compulsory earthquake insurance contracts but all risks are transferred to the Turkish Catastrophe Insurance Pool (TCIP). The purpose of the Pool is to make claim payments in order to reinstate the insured property to the condition before the disaster. The government has no contribution to the compulsory earthquake insurance premiums or to the claim payments of the TCIP.

[57] Decree Law Relating to Compulsory Earthquake Insurance no 587, OJ 23919 bis, 27.12.1999
[58] Maximum cover of the compulsory earthquake insurance is TL 150.000 as of 01.01.2011.

4.1.2.5. Highway Traffic Law

According to Highway Traffic Law no 2918, motor vehicles registered in Turkey should have compulsory motor third party liability insurance (MTPL insurance) also called as traffic insurance, which indemnifies the liability of the driver against third parties in case of physical or material damages.[59] The Law is applicable to foreign visitors as well.

Motor vehicles which are not used in road transport nor designed to carry persons, animals or goods are exempted from the MTPL insurance. The Law applies in respect of liability for both personal injury and damage to property but moral claims are not covered by the Law. Traffic insurance does not cover any damages to the keepers/drivers of the motor vehicle. However, personal accident seat insurance covers bodily injuries of driver and driver's assistants. An insurer can reject a third party claim if damages are caused by stolen motor vehicles, by motor vehicles which are not being used in traffic or by motor vehicles participating in a car race. A claimant resident in a foreign country has a direct right of action against the Turkish Motor Insurance Bureau up to the MTPL limits in Turkey, provided that the vehicle which caused the damage has a valid Green Card.

4.1.2.6. Secondary Legislation on Insurance

Undersecretariat of Treasury which is responsible for the regulation of the insurance sector in Turkey issues the secondary legislation on insurance and reinsurance. The new Insurance Law enacted in 2007 and the harmonization process of the Turkish insurance sector with the European single insurance market made it necessary for a large number of secondary regulations. As a result, 27 regulations were enacted between the entry into force of the Insurance Law no 5684 in June 2007 and the end of 2010. Together with 12 regulations amending the existing regulations there are 39 regulations in total enacted in only 3.5 years. There are also 6 notices published in the Official Journal since 2007. Table 10 presents the regulations and notices published by the Undersecretariat of Treasury to regulate the insurance sector in Turkey.

[59] Highway Traffic Law no 2918, OJ 18195, 13.10.1983

Table 10: Regulations on Insurance in Turkey

Regulations	Date and Number of the Official Journal	Amending Regulations
Regulation on Motorway Transportation	11.06.2009 (27255)	25.12.2009 (27443)
Regulation on the Establishment and Operation Procedures and Principles of Insurance Loss Adjusters Executive Committee	01.03.2009 (27156)	
Regulation on the Implementation Principles of Insurances in Connection with Personal Loans	19.01.2009 (27113)	
Regulation on the Establishment and Operation Procedures of Insurance Agents Sector Council and Insurance Agents Executive Committee	10.09.2008 (26993)	
Insurance Information Center Regulation	09.08.2008 (26962)	19.06.2009 (27263)
Regulation on Independent Audit in Insurance, Reinsurance, Pension Comp.	12.07.2008 (26934)	01.03.2009 (27156) 26.02.2010 (27505)
Regulation on the Independent Audit Principles in Insurance Sector	12.07.2008 (26934)	
Regulation on Transfers from Associations, Foundations, Funds and Other Institutions to Private Pension System and Annuities	10.07.2008 (26941)	
Regulation on the Operation Procedures and Principles of the Association of the Insurance and Reinsurance Companies of Turkey	01.07.2008 (26923)	
Regulation on the Operation Procedures and Principles of Turkish Motor Insurance Bureau	28.06.2008 (26920)	09.06.2009 (27263)
Insurance Specialty Committees Regulation	22.06.2008 (26914)	
Insurance Loss Adjusters Regulation	22.06.2008 (26914)	09.05.2010 (27576)
Regulation on Internal Systems of Insurance, Reinsurance and Pension Comp.	21.06.2008 (26913)	
Insurance and Reinsurance Brokerage Regulation	21.06.2008 (26913)	
Insurance Education Center Regulation	01.06.2008 (26893)	
Insurance Agents Regulation	14.04.2008 (26847)	
Regulation on Measurement and Evaluation of Capital Requirements of Insurance, Reinsurance and Pension Companies	19.01.2008 (26761)	01.03.2009 (27156)
Regulation on Information Regarding Insurance Contracts	28.10.2007 (26684)	
Regulation on the Establishment and Operation Principles of Insurance and Reinsurance Companies	24.08.2007 (26623)	31.07.2009 (27305)
Regulation on Insurance Arbitration	17.08.2007 (26616)	
Regulation on Financial Structure of Insurance, Reinsurance, Pension Comp.	17.08.2007 (26616)	01.03.2009 (27156)
Actuary Regulation	15.08.2007 (26614)	
Regulation on Technical Reserves of Insurance, Reinsurance and Pension Companies and Assets in which These Reserves Shall Be Invested	07.08.2007 (26606)	28.07.2010 (27655)
Assurance Account Regulation	26.07.2007 (26594)	19.06.2009 (27263)
Life Assurances Regulation	18.07.2007 (26586)	13.01.2009 (27109)
Regulation on Tariff Implementation Principles of the Compulsory MTPL Insurance	14.07.2007 (26582)	06.02.2008 (26779) 19.06.2009 (27263)
Regulation on Financial Reporting of Insurance, Reinsurance, Pension Comp.	14.07.2007 (26582)	14.06.2008 (26906)
Regulation on Third Party Liability Insurance of Turkish and Foreign Civil Aircrafts Landing or Taking Off within the Borders of Turkey	15.11.2006 (26347)	
Regulation on the Operation Procedures and Principles of the Agricultural Insurances Pool	18.05.2006 (26172)	
Regulation on the Implementation of Agricultural Insurances	18.05.2006 (26172)	
Regulation on Third Party Liability Insurance to be Written by Turkish and Foreign Civil Aircrafts Flying Over Turkish Airspace	05.11.2005 (25994)	
Notices	**Date and Number of the Official Journal**	**Amending Regulations**
Notice on Insurance Arbitration Procedure and Insurance Arbitrators	21.01.2009 (27117)	
Notice on Foreign Assets in which Technical Reserves of Insurance, Reinsurance and Pension Companies Shall be Invested	21.01.2009 (27117)	
Notice on Preparation of Consolidated Financial Statements of Insurance, Reinsurance and Pension Companies	31.12.2008 (27097)	
Notice on Financial Statements	18.04.2008 (26851)	
Block Exemption Notice on Insurance Industry	01.02.2008 (26774)	
Notice on Insurance Branches	11.07.2007 (26579)	

Source: own table

Furthermore, secondary legislation includes also circulars and communications published by the Directorate General of Insurance of the Undersecretariat of Treasury not only to explain and clarify the implementation process of the laws and regulations but also to impose some new rules in order to effectuate the principle based rules of the regulations. Between 2007 and 2010, 73 circulars and 135 communications (208 in total) are published whereas the number of circulars and communications published during the previous four years (2003-2006) were only 64 in total. Thanks to a great number of comprehensive legislation enacted in a very short period of time, Turkish insurance legislation has been aligned with the EU insurance *acquis* to a great extent. However, it has equally brought many difficulties to the Turkish insurance sector in terms of human resources, capital and profitability.

4.1.3. Size of the Turkish Insurance Market

Turkish insurance market remains very small compared to developed countries and even to the world average. As of the end of 2008, total premium production in the world amounted to USD 4.26 trillion. USD 3.75 trillion of the total premium production was written in developed countries, while the remaining USD 512 billion was written in developing countries where insurance awareness is still not at the desired level.[60]

According to Swiss Re (2009), Turkish insurance sector constitutes only 0,21% of the world insurance market with its USD 8.9 billion premium production. While insurance penetration was 8,8% in developed countries and 8,3% in the EU in 2008, it remains at only 1,2% in Turkey. Premium production per capita in the world was USD 634 in 2008. This amount was USD 3.655 in developed countries and USD 3.061 in the EU whereas it was only USD 121 in Turkey. Out of 88 countries studied worldwide Swiss Re (2009), Turkey ranks 76th in insurance penetration and 65th in insurance density. Moreover, when compared to the EEA countries, Turkey is at the very bottom of the list in terms of insurance penetration and density.

It can be concluded from Table 11 which compares the size of the Turkish insurance market with the World insurance market that Turkish insurance market is

[60] See Swiss Re sigma no 3/2009 for the distribution of world premiums in 2008 and sigma no 2/2010 for the distribution of world premiums in 2009.

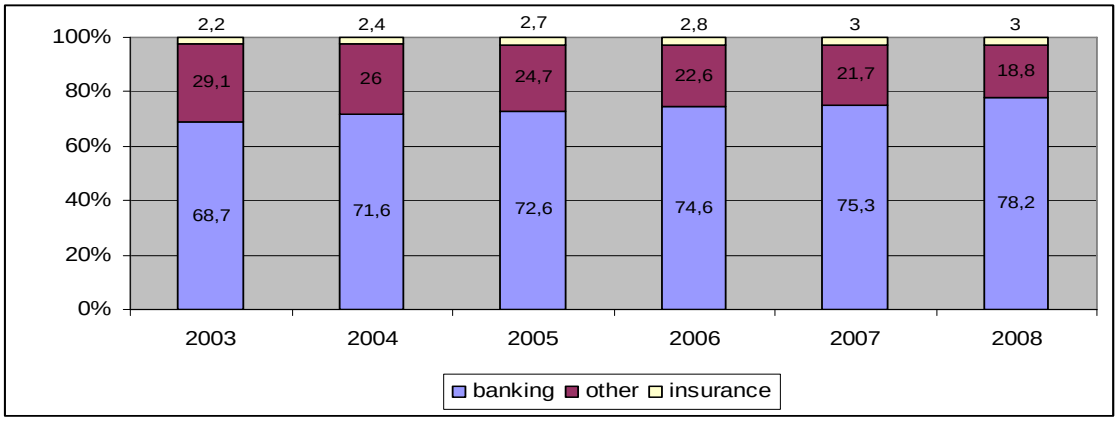
comparable not to the insurance markets of developed countries but to the insurance markets of developing countries. Compared to Turkey, even the EU Member States from Central and Eastern Europe are well advanced in terms of both insurance density and insurance penetration. However, Turkish insurance market has relatively a big growth potential and it is still in catch-up process with a higher premium production increase than the increases seen in developed countries.

Table 11: Turkish Insurance Market vs. World Insurance Market (2008)

	Premium production (USD million)	Share of world market (%)	Premiums as % of GDP	Premium production per capita (USD)
World	4.218.115	100	6,9	625
Developed countries	3.706.098	87,86	8,6	3.602
Developing countries	512.017	12,14	2,7	89
EU-27	1.571.115	37,25	8,0	2.958
UK	395.627	9,38	13,5	5.923
France	275.880	6,54	9,4	4.194
Poland	24.403	0,58	4,6	643
Hungary	5.018	0,12	3,3	500
Turkey	8.915	0,21	1,2	121

Source: own Table based on data from Swiss Re (2009)

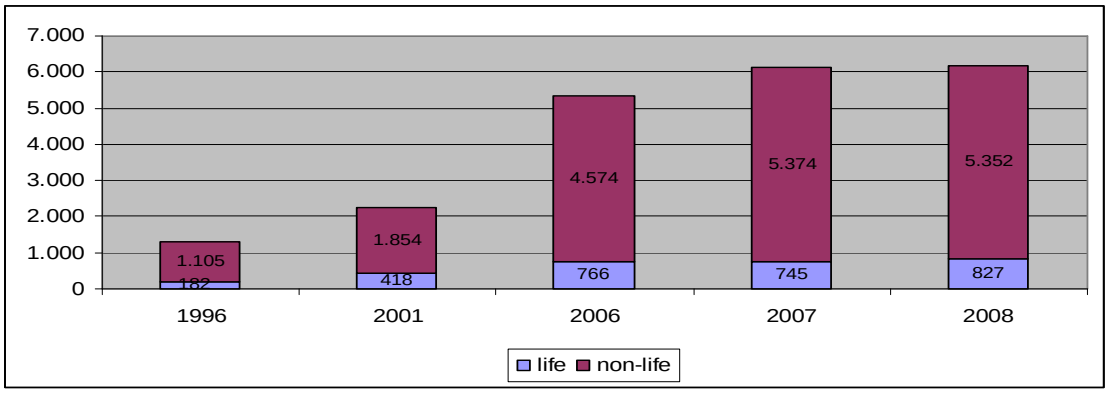
The share of Turkish insurance market in the financial sector remains also relatively small. Total assets of the Turkish financial sector reached to TL 937 billion as of the end of 2008. Graph 52 demonstrates that the structure of Turkish financial sector is predominantly banking which constitutes 78,2% (excluding Central Bank) of the financial sector assets. The share of the insurance, reinsurance and pension companies is much smaller. However, it has a continuous increasing trend and it increased from its level of 2,2% in 2003 to 3% in 2008.



Graph 52: Distribution of Turkish Financial Sector Asset Size (%)
Source: ISB (2009)

4.1.3.1. Premium Production

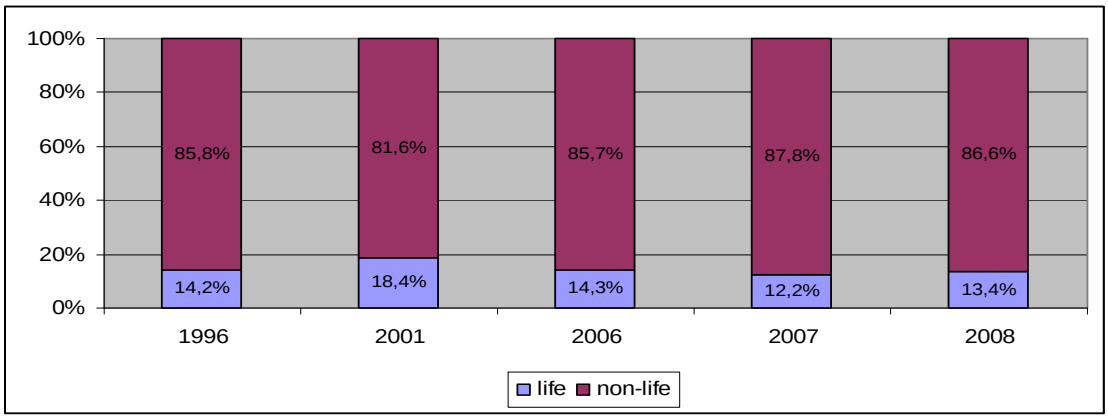
The share of premium production of the Turkish insurance market in the world is only 0,21% in 2008. However, it has an increasing trend especially since the end of 1990s. Graph 53 demonstrates that the total premium production increased from EUR 1.28 billion in 1996 to EUR 6.18 billion in 2008. The performance of non-life premiums was as good as life premiums between 1996 and 2008.



Graph 53: Total Premium Production in Turkey (EUR million)
Source: own Graph based on data from CEA (2009a)

Life premiums in Turkey have a share of 13% in total premium production whereas life business accounts for more than half of the total premium production in the EU. Graph 54 indicates that the share of life business in total premium production has a stable trend since 1996. While the ratio reached 18% in 2001, with the launch of the

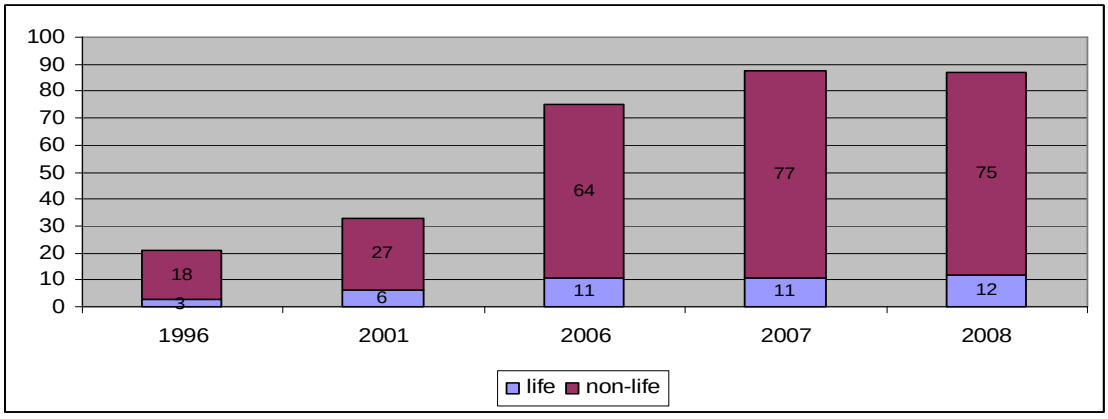
private pension system in 2003, the share of life business in total premium production decreased again to its level seen in 1990s.



Graph 54: Share of Life and Non-Life in Total Premium Income in Turkey
Source: own Graph based on data from CEA (2009a)

4.1.3.2. Insurance Density

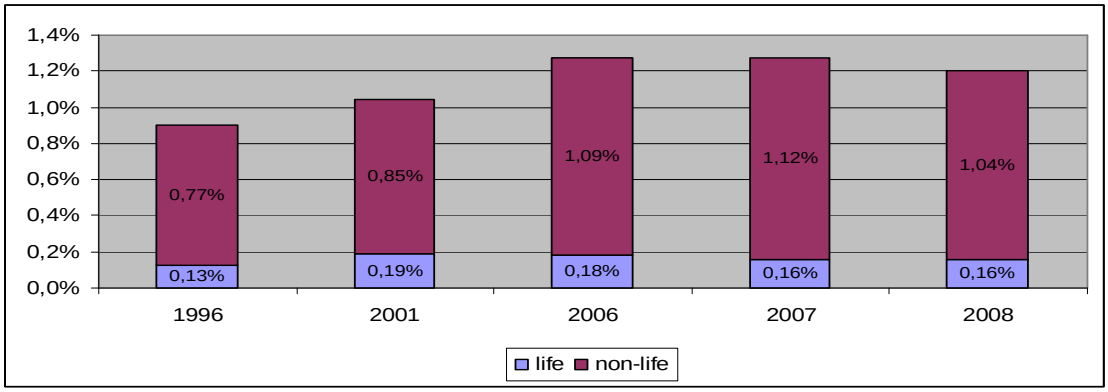
Graph 55 shows that following the rapid increase of the insurance premiums in Turkey, premium income per capita increased from EUR 21 in 1996 to EUR 87 in 2008. However, insurance density is almost five times smaller than the world average and it accounts for only 4% of the EU average. On the other hand, life insurance density in Turkey is six times smaller than non-life insurance density.



Graph 55: Insurance Density in Turkey (EUR)
Source: own Graph based on data from CEA (2009a)

4.1.3.3. Insurance Penetration

In Turkey, insurance penetration which shows the contribution of the insurance sector to economy is also much less than the world average. Graph 56 demonstrates that insurance penetration increased from 0,9% in 1996 to 1,2% in 2008. However, it is still much less than the EU average which is around 8%. In contrast to the EU, non-life insurance penetration rate in Turkey far surpasses the penetration rate of life insurance.

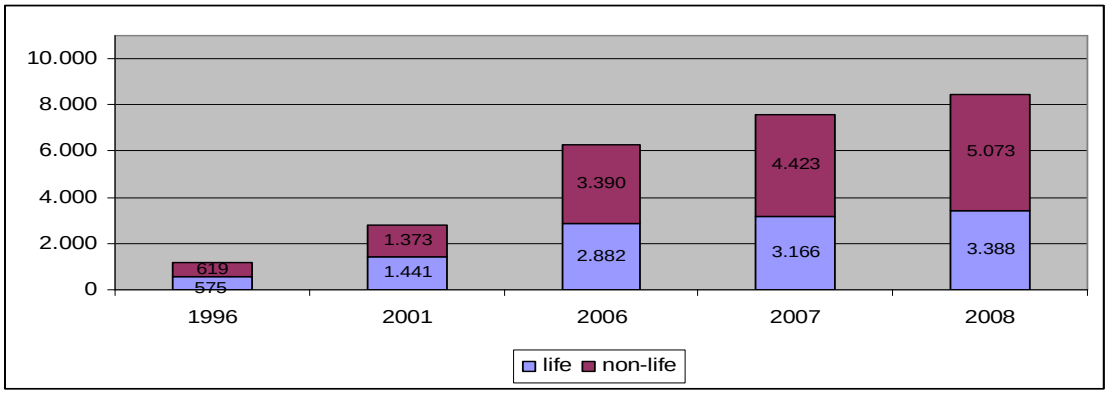


Graph 56: Insurance Penetration in Turkey

Source: own Graph based on data from CEA (2009a)

4.1.3.4. Insurance Investments

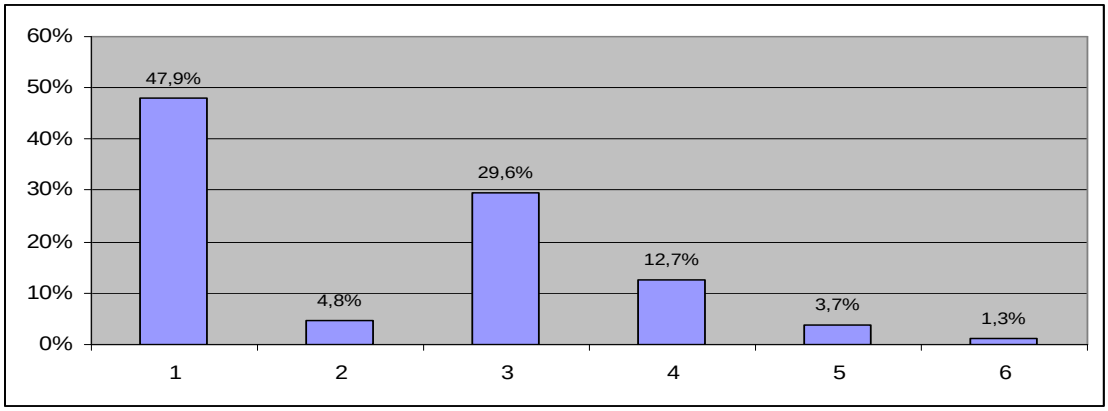
Graph 57 shows that investments of the insurance companies in Turkey increased from EUR 1.2 billion in 1996 to EUR 8.5 billion in 2008. It represents only 2% of the GDP whereas the average ratio in the EU is 51%. Although life business represents only 14% of the market, it constitutes 40% of the total investments of the sector.



Graph 57: Investments of the Insurers in Turkey (EUR million)

Source: own Graph based on data from CEA (2009a)

Furthermore, insurance investments are not very much diversified in Turkey. Graph 58 depicts the fact that the investment portfolio is very prudent and almost 80% of it is composed of fixed income securities and deposits with credit institutions. More risky variable-yield securities consist only less than 5% of the total portfolio.



Graph 58: Distribution of Investments of the Insurers in Turkey (2008)
Source: own Graph based on data from CEA (2009a)

(1) Debt securities and other fixed income securities; (2) Shares and other variable-yield securities and units in unit trusts; (3) Deposits with credit institutions; (4) Investments in affiliated enterprises and participating interests; (5) Lands and buildings; (6) Other investments

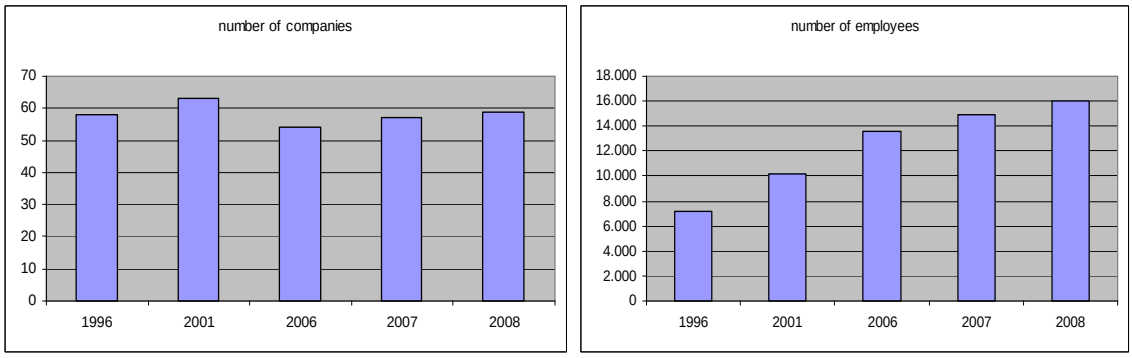
4.1.3.5. Insurance Market Operators

The number of companies carrying out insurance activities in Turkey has a stable trend since 1996. In Turkish insurance market mergers are not widespread whereas most of the Turkish insurance companies were acquired mostly by the EU insurance companies in the second half of 2000s.

Due to the economic crisis in Turkey in 2001, a significant amount of insurers has bankrupt or has lost their licenses. As can be seen from Graph 59, with some new market entries after the 2001 crisis, there are 61 insurers and reinsurers as of the end of 2008, 23 of them being life insurance companies, 36 of them being non-life insurance companies and 2 of them being reinsurance companies. 6 of them do not have the right to conclude new insurance and reinsurance contract actively.

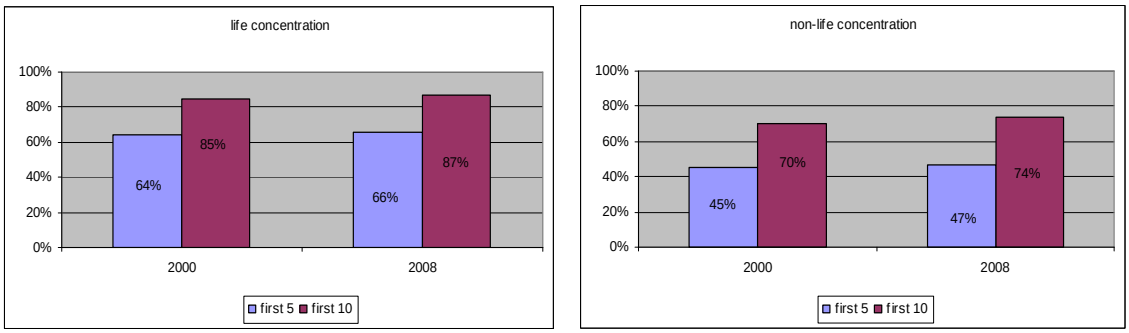
While the number of insurance companies has a stable trend, the number of people employed in the insurance sector increased since 1996. Graph 59 demonstrates

that the employment is more than doubled in Turkish insurance market since 1996 and reached almost 16.000 in 2008.



Graph 59: Number of Insurers and Employees Working in Insurers in Turkey
Source: own Graph based on data from CEA (2009a)

Furthermore, the concentration rate which represents the premiums written by the biggest companies as a percentage of total written premiums is high in Turkish insurance market and has a stable trend since 2000. Graph 60 shows that in life business, the concentration rate of the first 5 companies increased from 64% in 2000 to 66% in 2008 while in non-life business it increased from 45% to 47%. The first 10 companies represent 87% of the life market and 74% of the non-life market in 2008. Non-life business is more fragmented than life business.



Graph 60: Life and Non-Life Insurance Concentration in Turkey
Source: own Graph based on data from CEA (2010a)

4.2. INTEGRATION PROSPECT OF THE TURKISH INSURANCE MARKET WITH THE EUROPEAN SINGLE INSURANCE MARKET

Since Turkey is not a member of the EEA, Turkish insurance market is not part of the European single insurance market and there is no freedom of establishment or freedom of services between the EEA Member States and Turkey. This section aims to highlight the integration prospect of the Turkish insurance market with the European single insurance market if Turkey becomes member of the EU at the current stage of its harmonization process.

One way to analyze the integration prospect of the Turkish insurance market with the European single insurance market is to evaluate the existing regulatory and supervisory differences between these two markets. Higher level of legislative harmonization predicts higher potential for integration. However, while legislative harmonization is the prerequisite of integration, it is not solely enough. Therefore, a different, but complementary and necessary method to investigate the integration potential between the two markets will be the analysis of quantity based indicators.

4.2.1. Measurement at Legislative Level

This section aims to demonstrate that important parts of the EU insurance *acquis* have already been included in the Turkish insurance legislation and that the harmonization level is at an advanced stage especially after the entry into force of Insurance Law no 5684 in 2007.

Progress Reports that are published each year by the EU for each candidate country monitor and assess the achievements of the candidates. Progress Reports published for Turkey between 1998 and 2005 state that harmonization is well advanced in the field of financial services except insurance services. The lack of harmonization in insurance sector was also reflected at that time in the Accession Partnership Documents prepared by the EU to indicate the short-term and mid-term priority areas for the membership preparations of the candidate country.

After Turkey was nominated as a candidate country to the EU in 1999, the first Accession Partnership Document for Turkey was published in 2001[61]. The emphasis related to financial services was on the completion of the financial sector reform in Turkey and there was no specific target for the insurance sector. However, the second Accession Partnership Document for Turkey which was published in 2003[62] requires the alignment with the EU insurance legislation and the establishment of an independent insurance supervisory authority in Turkey. The third Accession Partnership Document which was published in 2006[63] brings nothing new for the insurance sector and making substantial progress towards the alignment of the legislation with the EU insurance *acquis* was again stated as the priority of the sector.

In response to the Accession Partnership Documents of the EU, Turkey's National Programme for the Adoption of the Acquis (NPAA) determines the necessary steps and a timetable for the alignment of Turkish legislation with the EU *acquis*. The very first NPAA which was published in 2001[64], after pointing out that the main principles of the EU legislation on insurance have already been reflected in Turkish insurance legislation, lists the Directives that should be adopted into Turkish legislation. In 2003, the updated NPAA[65] states that for further alignment a new Draft Insurance Law has been prepared in line with the EU insurance *acquis*.

Under these circumstances, Turkey 2005 Progress Report[66] states that the overall alignment with the *acquis* remains limited in the insurance sector where public awareness is still very limited and the number of insured persons and insurance premiums per capita are accordingly low. The ex-ante tariff controls, pre-approval procedures for licensing and the pool system for the non-life reinsurance based on compulsory cessions to a single operator (reinsurance monopoly) are criticized. Also, the General Directorate of Insurance and the Insurance Supervision Board are categorized as non-autonomous

[61] Accession Partnership Document of 2001, Council Decision 2001/235/EC (OJ L85/13, 24.03.2001).
[62] Accession Partnership Document of 2001, Council Decision 2003/398/EC (OJ L 145/40, 12.06.2003).
[63] Accession Partnership Document of 2006, Council Decision 2006/35/EC (OJ L22/34, 26.01.2006).
[64] National Programme for the Adoption of the Acquis 2001, Decision of the Council of Ministers 2001/2129 (OJ 24352 bis, 24.03.2001)
[65] National Programme for the Adoption of the Acquis 2003, Decision of the Council of Ministers 2003/5930 (OJ 25178 bis, 23.07.2003)
[66] Turkey 2005 Progress Report, European Commission, COM (2005) 561 final, Brussels, 9.11.2005

institutions, on the ground that the important decisions require the approval and signature of the Undersecretary of Treasury and the relevant minister. Non-existence of the sector-specific block exemption regulations on insurance services is also criticized for the first time in this Progress Report.

Turkey 2006 Progress Report[67] welcomes the new solvency regime but the outdated Insurance Supervision Law and the independence of the General Directorate of Insurance and the Insurance Supervision Board are continued to be criticized. 2006 Progress Report reminds also that Turkey has no specific legislation on the supervision of insurance groups, consolidated insurance accounting, reinsurance, co-insurance, credit insurance, legal expense insurance and tourist assistance. As a result, the overall alignment of the insurance legislation with the *acquis* is again considered limited.

In 2007, the new Insurance Law which regulates the taking up and pursuit of the insurance and reinsurance business and which is to a great extent in conformity with the EU insurance *acquis* was finally enacted and thus the harmonization process was accelerated with a package of secondary legislation governing technical reserves, financial reporting, solvency regime and policyholder protection. Therefore, Turkey 2007 Progress Report[68] states that good progress has been made in the insurance sector. New legislation as regards the compulsory MTPL insurance which to a limited extent liberalizes the tariffs, the extension of the scope of the insurance guarantee scheme to all types of compulsory insurances and the introduction of out-of-court settlement body for policyholder protection are especially considered as welcome developments. However, Turkish legislation is assessed as partly in line with the EU insurance *acquis* on the ground that certain basic principles of the *acquis* such as the freedom of tariffs for all types of insurances and the abolishment of general conditions are not fully respected.

However, compared to the previous Regular Reports stating that the overall alignment of Turkish insurance legislation with the EU insurance *acquis* is "limited", in the 2007 Regular Report, it is stated for the first time that the alignment with the *acquis* is

[67] Turkey 2006 Progress Report, European Commission, COM (2006) 649 final, Brussels, 8.11.2006
[68] Turkey 2007 Progress Report, European Commission, COM (2007) 663 final, Brussels, 6.11.2007

"partial". The wording shows the improvement in the harmonization level of the Turkish insurance sector.

The 2008 Progress Report[69] finds significant progress in the area of insurance on the ground that the Undersecretariat of Treasury has set new rules on license applications, mergers and acquisitions and public disclosure of the insurers and that the Competition Authority has adopted a block exemption communiqué covering the insurance sector in line with the EU *acquis*. It also reports that new rules on insurance intermediaries which improve consumer protection have been established but the level of professional indemnity insurance coverage is criticized to be markedly below the EU standards.

Regulation to ease the domestic asset-holding requirements applicable to the technical reserves of insurance companies, rules on consolidated financial statements and the inclusion of the insurance cover for ships and yachts registered in Turkey to the insurances that can be purchased from foreign insurance companies established abroad are just some of the harmonization efforts stated in 2009 Progress Report[70].

Therefore, Turkish insurance sector has made big steps towards alignment with the EU insurance *acquis* in a very short period of time. Most of the necessary legislation in the harmonization process is adopted during the course of 2007-2010 and it has now been successfully implementing by insurance market players. Consequently, the most recent NPAA which was published in 2008[71] gives a detailed timetable of the final amendments in order to fully harmonize the Turkish insurance market with the European single insurance market. In this context, the necessary amendments ensuring freedom of services and freedom of establishment in the insurance services are going to be entered into force on the accession date of Turkey to the EU.

In order to determine the level of harmonization of the Turkish insurance market with the European single insurance market, the rules on the establishment of insurance and reinsurance companies and intermediaries, the operation of foreign insurers, tariffs,

[69] Turkey 2008 Progress Report, European Commission, COM (2008) 674 final, Brussels, 5.11.2008
[70] Turkey 2009 Progress Report, European Commission, COM (2009) 533 final, Brussels, 14.10.2009
[71] National Programme for the Adoption of the Acquis 2008, Decision of the Council of Ministers 2008/14481 (OJ 27097, 31.12.2008)

general conditions, classification of insurance branches, technical reserves, financial reporting, capital requirements, supervision and policyholder protection in both markets are compared.

4.2.1.1. Type of Companies

Insurance and reinsurance companies which are going to operate in Turkey have to be established as a joint stock or a cooperative.[72] Mutual companies are permitted in the Insurance Law no 5684. Insurance and reinsurance companies can only perform insurance transactions which are directly related to insurance operations and they cannot be engaged in other businesses.

Both in Turkey and the EU, life and non-life insurance groups are managed separately. Since 1998, the establishment of composite insurers is not allowed in Turkey. But, when the establishment of new composite insurers was forbidden in the EU, the existing composite insurers were allowed to continue to operate. However, in Turkey, the existing composite insurers had to separate their life and non-life business upon the decision of the prohibition of the establishment of composite companies and thus there are no composite insurers operating in the Turkish insurance market.

4.2.1.2. Conditions for Authorization

In the EU, taking-up of insurance or reinsurance business is subject to prior authorization from the supervisory authorities. In Turkey, a permit from the Ministry in charge with the Undersecretariat of Treasury as a prerequisite for the establishment of insurance and reinsurance companies is no more required. The establishment of an insurance or reinsurance company is not subject to prior permission of the Minister but a license obtained from the Undersecretariat of Treasury for each branch in which the insurer intends to operate is necessary. However, while the license received from the supervisory authority of the home Member State is valid for the entire Community and not Turkey, the license received from the Undersecretariat of Treasury is valid for Turkey and not for the EU. In order to operate in Turkey, foreign insurance and reinsurance

[72] Article 3(1) of Insurance Law no 5684.

companies should get license from the Undersecretariat of Treasury, but they are subject to the same authorization conditions with Turkish companies.

Insurance and reinsurance companies that ask a license from the supervisory authorities should limit their objects to the business of insurance or reinsurance, submit a scheme of operations and show evidence that they will be in a position to comply with the system of governance and to hold adequate own funds.

Founders and managers of the insurance and reinsurance companies are subject to fit and proper criteria.[73] Persons who effectively run the insurance and reinsurance companies should possess adequate professional qualification, knowledge and experience to enable sound and prudent management (fit) and should be of good repute and integrity (proper). For insurance and reinsurance companies to be established as a joint stock in Turkey, the founders or shareholders should not be bankrupt, should have the necessary financial power, good repute and good judicial records. The members of the board of directors, general managers, deputy general managers and auditors are also subject to good repute, experience and education criteria.

In conformity with the EU *acquis,* scheme of operations should include the information on the nature of the risks or commitments which the company concerned proposes to cover, the guiding principles as to reinsurance, the financial resources, estimates of the financial resources intended to cover technical provisions and capital requirements for the first three financial years.

Taking-up capital is set to EUR 2.3 million in the non-life business and EUR 3.5 million in the life and reinsurance business in the EU. Non-life insurance companies operating in any of the liability, credit or suretyship branches should also have a capital of EUR 3.5 million. In Turkey, taking-up capital is determined according to the insurance branches in which the company is operating but it should not be less than TL 5 million.[74] If the company receives license for each of the non-life branches, the taking-up capital is then TL 11.6 million (almost EUR 5.5 million) which surpasses the minimum capital requirement of the EU. If the company receives license for each of the life branches, the

[73] Article 3(2) and 4 of Insurance Law no 5684.
[74] Article 5(3) of Insurance Law no 5684.

taking-up capital is then TL 10.7 million (almost EUR 5 million) which again surpasses the minimum capital requirement of the EU.[75]

The conditions under which the authorization may be withdrawn are also in conformity with the EU *acquis*. The Treasury may withdraw an authorization granted to an insurance or reinsurance company if the company does not make use of the authorization within 12 months or it ceases to pursue business for more than 6 months or it no longer fulfils the conditions for authorization or it seriously fails in its obligations under the legislation to which it is subject or it does not comply with the minimum capital requirement or it seriously fails to comply with the objectives of its scheme of operations.[76]

4.2.1.3. Membership to Professional Organizations

Within one month after getting their licenses, all insurance and reinsurance companies are obliged to become members of the Association of the Insurance and Reinsurance Companies of Turkey which is a professional organization established by Law. However, the obligation of being member of a professional organization is found against the free market principles by the European Commission. Thus, this obligation should be abolished in Turkey as well and membership to the Association of the Insurance and Reinsurance Companies of Turkey should become voluntary rather than compulsory for all insurance and reinsurance companies. The Council of Ministers is authorized to abolish this obligation.[77]

4.2.1.4. General Conditions and Tariffs

In the EU, prior approval or systematic notification of general and special policy conditions, scales of premiums and technical bases used in particular for calculating scales of premiums and technical provisions cannot be required.

However, in Turkey, general conditions of the insurance contracts are approved by the Undersecretariat of Treasury and are to be applied by all insurance companies in a

[75] Circular no 2007/4, 12.07.2007.
[76] Article 7 of Insurance Law no 5684.
[77] Article 24(1) of Insurance Law no 5684.

similar way.[78] Insurance companies can freely determine special conditions. General conditions that are determined and approved by supervisory authorities are used to exist in the countries that follow Continental Model rather than Anglo-Saxon Model which is chosen by the EU. Therefore, in order to comply with the EU *acquis*, the approval of the general conditions should be abolished.

On the other hand, the liberalization of the tariff system in Turkey was applied to non-life insurance in 1990, excluding the compulsory non-life insurance branches. Except for annuity products which are considered as high risk products for the protection of policyholders, the obligation of approval of tariffs in life insurances was abolished with Life Insurance Regulation published in 2007. Insurance tariffs, except those of compulsory insurances and annuities, are thus determined freely by the companies.

In compulsory earthquake insurance and compulsory medical malpractice insurance for doctors, both the minimum coverage and premiums are set by the Treasury. In other compulsory insurances, minimum coverage is pre-determined by the Treasury but companies are free to set the premiums. In compulsory motor third party liability insurance, tariffs are set twice a year but may be amended by the companies within pre-determined intervals. Although as a general rule the Treasury does not approve these tariffs, it has the right to ask the company to change it taking into consideration the financial structure of the company.

Complete liberalization of tariffs should be implemented in order to comply with the EU insurance *acquis*. It will also allow insurers to shape their portfolios based on their own actuarial information and to price the policies they sell more rationally.

4.2.1.5. Classification of Insurance Branches

Classification of insurance branches in life and non-life business is totally harmonized with the EU insurance *acquis*. There are 18 classes of insurance for non-life

[78] Article 12(1) of Insurance Law no 5684.

and 7 classes of insurance for life business.[79] However, some of these branches and their sub-branches are not frequently used in the Turkish insurance market.

While the legislation is harmonized, product diversity is limited and innovative products are not widespread. There are also compulsory insurance products in both the European and Turkish insurance markets. Mostly, liability insurances are compulsory. Motor third party liability insurance is compulsory both in the EU and Turkey. In Turkey, the Council of Ministers is authorized to introduce compulsory insurances.

4.2.1.6. Technical Reserves

For their obligations arising from the contracts, insurance and reinsurance companies should allocate technical reserves. Turkish legislation on the calculation of technical reserves and the rules on the assets covering these reserves are in line with the EU *acquis*. Companies allocate six different types of technical reserves namely unearned premiums reserve, unexpired risks reserve, outstanding claims reserve, equalization reserve, mathematical reserve and bonus and rebate reserve.[80]

Unearned premiums reserve is calculated for the premiums of each contract which extend to the next fiscal periods. In addition, a liability test should be implemented in all insurance branches and if the unearned premiums reserve is found to be inadequate compared to the risks undertaken by the company and to its level of expected cost, then, unexpired risks reserve is allocated.

Outstanding claims reserve is allocated for the claims that are reported but not yet paid, for the claims that are incurred but not enough reported (IBNER), for the claims that are incurred but not reported (IBNR) and for the expenses arising from such claims. Whereas IBNR is calculated according to statistical and actuarial methods in the EU and Turkey, insurance companies operating in Turkey should calculate it in all non-life insurance branches according to one of the five actuarial chain ladder methods determined by the Undersecretariat of Treasury. In life insurance, IBNR is not calculated

[79] Communication no 2007/1 (OJ 26579, 11.07.2007).
[80] Article 16 of Insurance Law no 5684 and Regulation on Technical Reserves of Insurance, Reinsurance and Pension Companies and the Assets Covering These Reserves (OJ26606, 07.08.2007).

based on actuarial chain ladder methods but based on the average amount of coverage of the company.

In conformity with the EU *acquis*, companies allocate 12% of the credit insurance premiums as equalization reserve. The EU *acquis* also permits the Member States to allocate equalization reserves in other branches. In Turkey, 12% of the insurance products' premiums taken for earthquake coverage (including term assurance products) are allocated as equalization reserve.

If the insurance company gives bonuses or applies rebates for the insured or beneficiaries, bonus and rebate reserve is calculated. Finally, for insurance products with periods longer than a year (especially life insurance products), mathematical reserves are calculated.

Furthermore, the rules on the assets covering these reserves are in line with the EU *acquis*. Prudence in asset allocation is the rationale behind the rules. Foreign assets are accepted as the assets covering the technical reserves on the condition that these are the assets of the OECD countries.[81] Therefore, the assets of the EU countries which are not OECD members are not accepted as assets covering technical reserves. It does not mean that investing to the assets of non OECD Member States is forbidden, but to be prudent, these assets are not accepted as assets covering technical reserves.

4.2.1.7. Financial Reporting

A major reform in insurance accounting was done at the end of 2004. A new insurance accounting system which aims at improving the information gathering and reporting standards in line with Directive 1991/674/EEC was put in place by 1.1.2005.[82] Insurance accounting plan and the layout, presentation and publication of solo and consolidated financial statements of the insurance and reinsurance companies are

[81] Communication on Foreign Assets Covering the Technical Reserves of Insurance, Reinsurance and Pension Companies (OJ 27117, 21.01.2009)
[82] Communication on Insurance Accounting Plan (OJ 25686, 30.12.2004)

reasonably in line with the EU *acquis*. Financial statements should also be audited by independent audit firms.[83]

Whereas only listed insurance and reinsurance companies have to implement International Financial Reporting Standards (IFRS) in the EU, all insurance and reinsurance companies operating in Turkey, listed or not, should prepare their financial reports according to the Turkish Financial Reporting Standards (except for IFRS 4 for insurance contracts) which are in conformity with IFRS.[84]

4.2.1.8. Capital Requirements

Insurance and reinsurance companies should calculate their capital requirement every six months and hold sufficient own funds. They calculate the capital requirements with two different methods and the highest result of these methods is recognized as the required capital.[85] The calculation of the first method is in conformity with Solvency I and the second method which is a risk based calculation is inspired by the ongoing Solvency II framework. Risk based capital calculation takes into consideration the asset risk, underwriting risk, reinsurance risk, outstanding claims risk, currency risk and excessive premium growth risk.

On the other hand, with the entry into force of Solvency II in the EU by the end of 2012, comprehensive amendments will be necessary in the Turkish legislation as well. Preparations have already begun and Solvency II Specialty Committee has been established to coordinate the preparations. 17 companies have implemented QIS 4 study in 2010 and all insurance and reinsurance companies will implement QIS 5 study in 2011 on the demand of the Undersecretariat of Treasury.

In conformity with the EU *acquis*, the deposit system is abolished for non-life insurance companies and the Turkish legislation now requires non-life companies to establish a minimum guarantee fund which is equal to one third of their required capital

[83] Article 18 of Insurance Law no 5684.
[84] Regulation on Financial Reporting of Insurance, Reinsurance and Pension Companies (OJ 26582, 14.07.2007).
[85] Regulation on Measurement and Evaluation of Capital Requirements of Insurance, Reinsurance and Pension Companies (OJ 26761, 19.01.2008).

and cannot be less than the taking-up capital. However, the custody of assets (deposit system) covering the allocated mathematical reserves is still obligatory for life insurance companies.[86] While the rationale behind the deposit system is the protection of policyholders, it is not in conformity with the EU requirements.

4.2.1.9. Supervision

The Undersecretariat of Treasury is responsible for the regulation and supervision of the insurance sector. While Insurance Supervision Board is responsible for on-site supervision of insurance and reinsurance companies, insurance intermediaries and other persons operating in the Turkish insurance market, General Directorate of Insurance is responsible for preparing and monitoring the implementation of the regulations.[87]

In line with the EU requirements, on-site supervision is now a risk based supervision and not a compliance based supervision. It means that instead of carrying out supervision over all of the activities of the company, the supervision is focused only on areas of highest risk for the company.

The criteria of financial weakness and the necessary measures to strengthen the financial structure are in conformity with the EU *acquis*. There is a ladder approach in supervisory intervention.[88] For the strengthening of the financial structure of the company, the Minister to which the Undersecretariat of Treasury is attached may first require the company to present a recovery plan, to reduce its risks, to increase its capital or to dispose its assets. If the financial structure still continues to deteriorate, the Minister may limit the insurance portfolio of the company or transfer it to another company, may replace the members of the Board or may finally withdraw its licenses in some or all of the branches.

However, when the financial structure of the insurer is weakened to endanger the rights and benefits of the insured, it is not an autonomous insurance supervisory body

[86] Article 17 of Insurance Law no 5684.
[87] Law no 4059 on the Organization and Duties of the Undersecretariat of Treasury and Undersecretariat of Foreign Trade (OJ 22147, 20.12.1994).
[88] Article 20 of Insurance Law no 5684.

but it is the Minister who is responsible to take these measures for the strengthening of the financial structure of the company. While the criteria of financial weakness and the necessary gradual measures are in line with the EU *acquis*, adopting these measures by the Minister who is a political figure is not in line with the EU requirements.

Furthermore, the structure of regulatory and supervisory bodies is at the focus of the EU. In each Progress Reports, it is stated that further alignment is required towards establishing an independent regulatory and supervisory authority in the insurance and occupational pension sector. Turkish insurance market is regulated and supervised under the authority of the Undersecretariat of Treasury which is attached to the Minister of State for Economic Affairs. The Directorate General of Insurance and Insurance Supervisory Board are affiliated to the Undersecretariat of Treasury. This is why these bodies are not considered as being independent by the EU. The Accession Partnership Document 2008[89] requires the strengthening of prudential and supervisory standards in insurance sector and establishing an independent regulatory and supervisory authority. As in case of several EU Member States, final solution would be the establishment of an independent Financial Supervisory Authority covering the regulation and supervision of banks, insurers and capital markets.

However, Directorate General of Insurance and Insurance Supervisory Board are affiliated to and operate under Undersecretariat of Treasury in order to provide maximum harmonization between regulation and supervision. In order to provide more autonomy to the Insurance Supervisory Board, its chairman directly reports to the Undersecretary. Supervisors are independent on their supervision since they are appointed upon joint decision and any authority cannot give them instructions concerning supervision (NPAA 2008, p. 93).

4.2.1.10. Policyholder Protection

In line with the EU principle of effective policyholder protection, all information concerning the insurance contract should be provided to the policyholder in writing. Obligation of the insurers to give information begins before the conclusion of the contract

[89] Accession Partnership Document of 2008, Council Decision 2008/157/EC (OJ L51/4, 26.02.2008)

and continues during the contractual period.[90] During the negotiation stage, the insurer should provide a sheet of information covering information related to the name and contact information of the insurer and the intermediary, the coverage of the contract, special conditions, indemnity payments and the arrangements for handling complaints of the policyholders. Moreover, web sites of the insurers should include their shareholding structure, equity, annual reports, interim and year-end financial reports, contact information, electronic forms for complaint applications as well as information related to its insurance products, indemnity payment methods, taxes and statistics.

Furthermore, with the aim of better policyholder protection, Assurance Account and Insurance Arbitration Commission are established.[91] For all types of compulsory insurances, Assurance Account is established to cover personal injuries from which anyone suffers in case of non identification of the insured or non-possession of the compulsory insurance policy by the party at default. Limited to the compulsory insurances falling within the scope of the Assurance Account, it is also responsible of damages to property and personal injuries in case of the withdrawal of the licenses of the insurer.

On the other hand, Insurance Arbitration Commission is established for an easy and quick out of court settlement of disputes between the policyholder or beneficiaries of the insurance contract on the one hand and the insurer assuming the risk on the other hand. Insurance arbitration system is based on voluntary participation of the insurance companies and as of the end of 2010 it has 47 members. The disputes are settled by independent arbitrators in 4 months. The decisions of the Commission up to TL 40.000 cannot be appealed.

4.2.1.11. Motor Insurance

Alignment with Directive 2009/103/EC relating to insurance against civil liability in respect of the use of motor vehicles, known as Motor Insurance Directive which is the consolidated version of the previous five motor insurance directives enacted between 1972 and 2005, is one of the most difficult problems of the Turkish insurance

[90] Regulation on Information Regarding Insurance Contracts (OJ 26684, 28.10.2007).
[91] Articles 14 and 30 of Insurance Law no 5684.

market. In order to align Turkish motor insurance regulations with Directive 2009/103/EC, several crucial steps should be taken in the long run.

First of all, tariffs that are already liberalized to a great extent should be further liberalized and minimum limits of coverage should be increased seriously. Table 12 indicates that in the field of MTPL insurance, the minimum amounts of cover are considerably low in Turkey compared to the EU. NPAA (2008) reminds that the increase of minimum limits of coverage for motor insurance should be gradual during the accession period since the difference between the minimum limits of coverage foreseen by Directive 2009/103/EC and the limits in the Turkish insurance sector is not at a negligible level. Therefore, Turkey may demand transitional periods on this subject during the accession negotiations.

Table 12: Minimum Amounts Covered by MTPL Insurance in the EU and Turkey (EUR)*

	In Case of Damage to Property		In Case of Personal Injury	
	Per vehicle	**Per accident**	**Per victim**	**Per accident**
Turkey	10.000	20.000	100.000	500.000 – 3.100.000
EU	1.120.000		1.120.000	5.600.000

Source: own Table (Directive 2009/103/EC and Notice 2010/C 332/01)
* exchange rate is taken as EUR 1 = TL 2

Systematic checks within Turkey's borders concerning MTPL insurance should also be removed. However, NPAA (2008) reminds that MTPL insurance provides coverage for travelling across Member States and thus without membership to the EU, in other words without falling under the coverage of this insurance, removing systematic checks at the border may result in uninsured entrances to Turkey.

Furthermore, Assurance Account is applicable for non-residents as well but it covers only losses of bodily injuries up to the limits, if the vehicle which caused the damage does not have a valid MTPL insurance or the damage is caused by a stolen vehicle or by a vehicle with an unknown registration plate. In order to comply with the EU *acquis*, it should also cover damages to property in such cases. However, since covering the damage to property may cause not allocating adequate funds for personal

injuries which is the main objective of the Assurance Account, it should also be equipped with new resources which would bring additional financial burden on both the insurers and policyholders.

4.2.1.12. Insurance Mediation

In line with the EU Insurance Mediation Directive 2002/92/EC, Turkish legislation envisages strict professional requirements for the intermediaries in relation to their competence, good repute, professional indemnity cover and financial capacity.[92]

Intermediaries include brokers and agents. They should be registered in the register maintained by the Union of Chambers and Commodity Exchanges of Turkey. Banks may also act as insurance agents but they should not register. Registration requirement is also valid for actuaries and loss adjusters.

Insurance agents may be real or legal persons. Their technical staff has professional and educational requirements and should obtain a certificate from the Undersecretariat of Treasury confirming their qualifications. Legal person agencies should have a minimum paid-in capital of TL 25.000. However, Directive 2002/92/EC requires insurance intermediaries to have a financial capacity amounting to 4% of the sum of annual premiums received, subject to a minimum of EUR 15.000. Insurance intermediaries in Turkey should also hold professional liability insurance with a minimum of TL 100.000 coverage. However, in the EU, professional indemnity insurance against liability arising from professional negligence should be at least EUR 1 million applying to each claim and in aggregate EUR 1.5 million per year for all claims. Therefore, alignment with those criteria would bring unbearable financial burden for small and medium size insurance intermediaries in Turkey.

4.2.1.13. Operation of Foreign Insurance Market Players in Turkey

All insurance and reinsurance companies, regardless of whether they are foreign or domestic, are subject to the Insurance Law no 5684 and to the related secondary legislation adopted by the Undersecretariat of Treasury. There is no limitation for foreign

[92] Article 23 of Insurance Law no 5684.

insurers wishing to buy a domestic insurance company or its majority shareholding. Foreign insurers may open branch offices in Turkey or may act as a separate entity under the requirements of the Turkish Commercial Law and Insurance Law and after getting license from the Treasury on an equal footing with domestic insurers. There is no discrimination between domestic and foreign insurance companies related to their taking up and pursuit of insurance and reinsurance business.

Operations of the branches of foreign insurance and reinsurance companies are also subject to the rules required for the insurance and reinsurance companies established in Turkey.[93] They should get license from the Treasury but after opening the first branch, opening of the following branches is not subject to license. They should not be forbidden from engaging in insurance business in their home country. The taking-up capital allocated to this branch should not be less than the amount required for the insurance and reinsurance companies established in Turkey.

Foreign agents operating in Turkey are also subject to the same rules required for insurance agents established in Turkey. A foreign real person insurance agent may operate in Turkey provided that she is a resident in Turkey. Foreign insurance agents that are legal entities should open a branch in order to operate in Turkey. Both real person and legal person agents may only operate on behalf and account of insurance companies operating in Turkey.

Foreign loss adjusters operating in Turkey are subject to the rules required for Turkish loss adjusters. However, the operation of loss adjusters in Turkey is subject to reciprocity between the relevant country and Turkey.

Furthermore, there is no reinsurance monopoly in Turkey. An exclusive right was granted to Milli Re to administer and manage the system of reinsurance pool, which required insurance companies to cede their cessions to Milli Re which was the reinsurance monopoly in Turkey. However, the reinsurance monopoly of Milli Re ceased in 2001 and the compulsory cessions to the reinsurance pool administered by Milli Re totally ceased by the end of 2006.

[93] Resolution of the Council of Ministers on the International Activities in Turkish Insurance Sector (OJ 26602, 03.08.2007)

On the other hand, if they are located in Turkey, insurable interests of the residents of Turkey have to be insured in Turkey by the insurance companies operating in Turkey except for (a) transport insurance for goods which are subject to export and import, (b) hull insurance to be provided for ships registered in Turkey, (c) liability insurances arising from the operation of ships, (d) liability insurance for compulsory clinical medicine research, (e) life insurance and (f) personal accident, health and motor insurances taken out by Turkish residents limited to the time they are abroad.[94] All types of liability insurances can be included to this list by the Undersecretariat of Treasury. Otherwise, the list can only be amended by the Council of Ministers. Permission of buying insurance products from the insurers established in the EU Member States without any restrictions will only be possible with the membership of Turkey to the EU.

By the accession date of Turkey to the EU, FOS and FOE for the EEA insurers and insurance intermediaries should be adopted and cross-border sales of all types of insurance policies by the EEA insurers should be allowed. The necessary legislative amendments can be made easily on that date without any need of further amendments in the Insurance Law because the Law gives to the Council of Ministers the authority to determine the rules and regulations on the operation of foreign insurance and reinsurance companies in Turkey (article 3 of Insurance Law no 5684) and to broaden the scope of the insurances that can be concluded abroad (article 15 of the Insurance Law no 5684).

4.2.1.14. Results of the Comparative Analysis on Insurance Legislation

From the legislative point of view, Turkish insurance market is largely ready for the integration to the European single insurance market.

Separation of life and non-life business and licensing requirements including the criteria for founders and managers, corporate governance standards, financial strength and taking-up capital are in line with the EU insurance *acquis*. There is no discrimination between domestic and foreign insurers related to their taking up and pursuit of insurance and reinsurance business. Foreign insurers can open branch offices in Turkey. There is no

[94] Article 15 of Insurance Law no 5684.

reinsurance monopoly. Registration and professional and financial requirements for insurance intermediaries are also in line with the EU rules.

Criteria of financial weakness and conditions under which the license may be withdrawn are also aligned with the EU requirements. However, the responsibility of sanctions as well as the decision of license withdrawal lies with the minister responsible for the economy. Therefore, the decisions of the minister who is a political figure can be criticized by not being objective. In addition, regulatory and supervisory authorities in insurance are under the responsibility of the Undersecretariat of Treasury which is again attached to the minister responsible for the economy. Therefore, these institutions can be criticized by not being independent.

Tariff liberalization is at an advanced stage except the tariffs in compulsory insurances. Tariffs in MTPL insurance are liberalized to a great extent but minimum limits of coverage should still be further increased.

Classification of insurance branches and the rules on technical reserves, financial reporting and capital requirements are aligned with the EU requirements. However, deposit system in life insurance should be abolished.

In line with the EU principle of effective policyholder protection, policyholders are well informed both before and during the contractual period. Necessary institutions for better policyholder protection such as Assurance Account and Arbitration Commission are established. However, insurance arbitration system is based on voluntary participation of the insurance companies and Assurance Account is liable only for personal injuries. The scope of the Account should be broadened to cover damages to property.

To sum up, the comparative analysis reveals the fact that the Turkish insurance legislation is harmonized with the EU insurance *acquis* to a great extent whereas further alignment efforts such as the liberalization of tariff system in compulsory insurances, removal of the approval of general conditions, removal of the deposit system in life insurance, amendment on the scope and limits of MTPL insurance coverage and adoption of specific legislation on reinsurance and supervision of insurance groups are required.

4.2.2. Measurement by Quantity Based Indicators

To replace price based indicators which are not applicable in insurance business and to complement the findings at legislative level, quantity based indicators of integration is used to track the integration level of the Turkish insurance market with the European single insurance market.

First of all, the convergence of insurance markets and market players between the EEA countries and Turkey is investigated. For that purpose, insurance market indicators of both markets such as insurance density, penetration, types of products, type and size of market players as well as their efficiency, investments, assets and capital level are analyzed.

Market share of the EEA insurers operating in Turkey in terms of number, premium production and asset size are used as a sign of integration. Since freedom of services and freedom of establishment do not exist between the EEA and Turkey, neither direct cross border sales without physical establishment nor the physical establishment without having the license from the domestic supervisory authority is possible. Therefore, foreign presence through merger with and acquisition of domestic insurers is investigated.

Main data sources are the dataset of the CEA European Insurance in Figures 2009 that contains data for the period 1996-2008 for the EEA countries and Turkey and OECD Insurance Statistics Yearbook 2010 that contains data for the period 1999-2008. The dataset for Turkey is partly augmented by the 2008 Report of the Turkish Insurance Supervisory Board (ISB) about insurance and private pension activities in Turkey and 2008 Annual Report of the Insurance and Reinsurance Companies of Turkey (TSRSB).

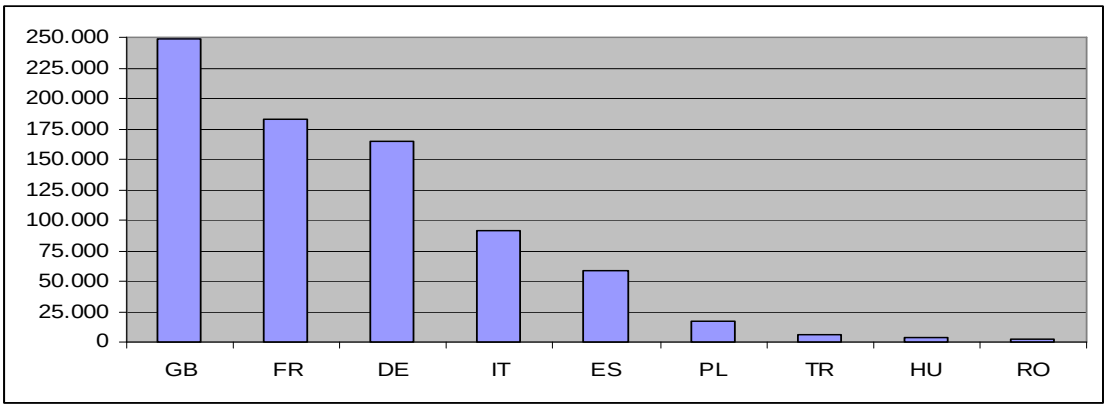
4.2.2.1. Convergence of Insurance Markets

Integration of the Turkish insurance market to the European single insurance market would depend on market convergence between the EU Member States and Turkey rather than just the establishment of a single insurance market between the two. As far as data is available, market indicators of the Turkish insurance market are

compared to the indicators of the EEA average as well as the UK, France, Germany, Italy and Spain being the biggest insurance markets of the EEA. In addition, the comparison is also made with Poland, Hungary, Czech Republic and Romania which represent the developing EU Member States which are similar to Turkey in terms of economic development.

4.2.2.1.1. Insurance Density

Size of the insurance markets varies considerably between Turkey and the EEA. Graph 61 indicates that the premium production in Turkey deviates greatly from the UK, France and Germany. The size of the Turkish insurance market in terms of premium production is much more similar to the size of the insurance markets of the CEEC.

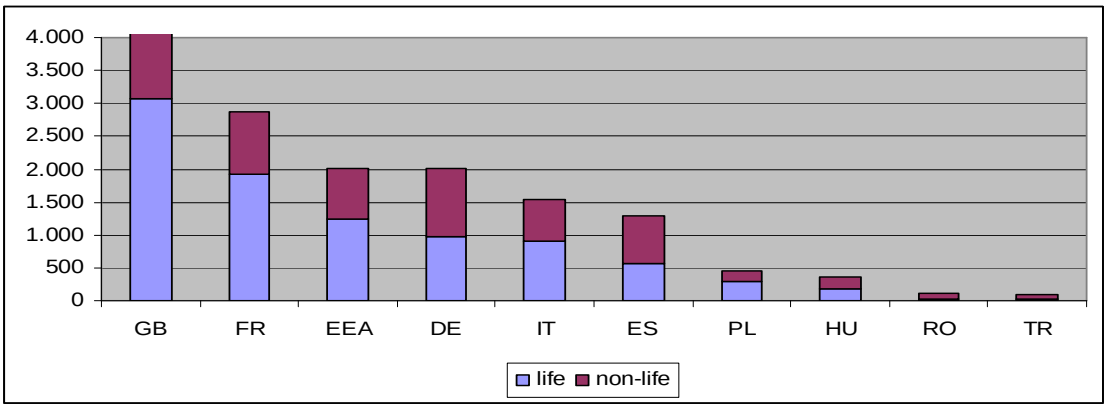


Graph 61: Total Premium Production in the EEA and Turkey (2008) (EUR million)

Source: own Graph based on data from CEA (2009a)

Furthermore, the average premium production per capita which eliminates the country-size effect also shows that Turkey with its insurance density of EUR 87 in 2008 deviates largely from the EEA average of EUR 2.022. Despite the fact that over the course of the 1990s and 2000s this indicator grew steadily in Turkey, Graph 62 shows that Turkey still ranks at the very bottom of the list and premium income per capita represents only 4% of the EEA average in 2008. In addition, in contrast to high density countries, policyholder expenditure in Turkey is higher in non-life insurance products. On the other hand, there is a high potential for growth in the Turkish insurance market

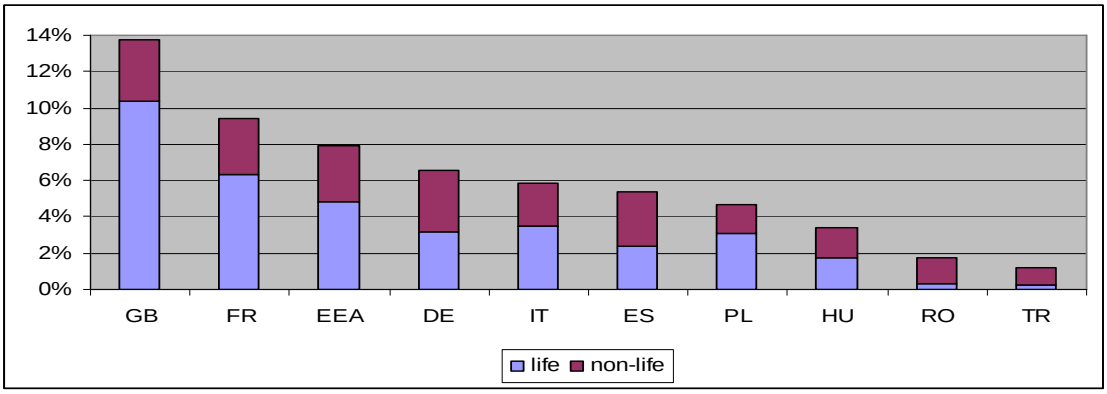
whereas the European single insurance market has almost reached its potential especially in life insurance market.



Graph 62: Insurance Density in the EEA and Turkey (2008) (EUR)
Source: own Graph based on data from CEA (2009a)

4.2.2.1.2. Insurance Penetration

The penetration rates shown in Graph 63 demonstrate the importance of the insurance sector in the national economies of the EEA Member States and Turkey. While insurance penetration rate in the EEA is 8% in 2008 and it ranges from 1,7% in Lithuania to 13,8% in the UK, it remains at only 1,2% in Turkey.

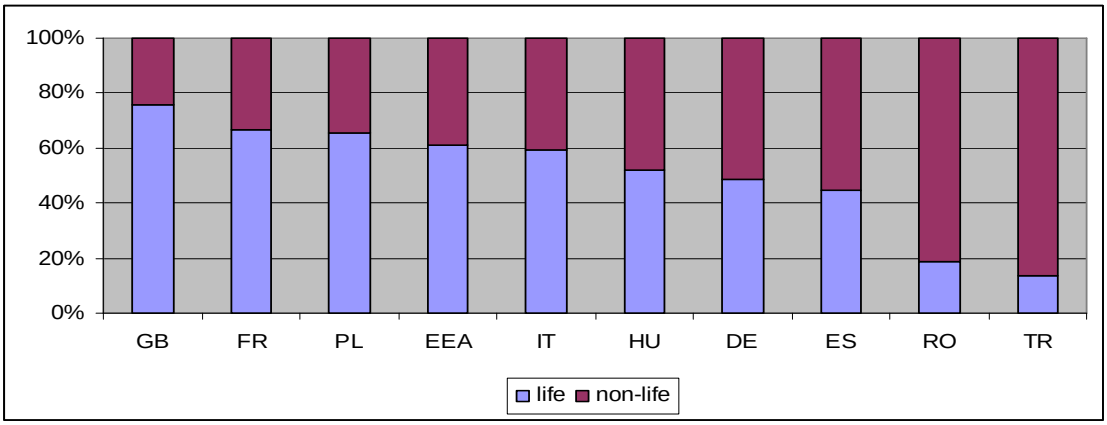


Graph 63: Insurance Penetration in the EEA and Turkey (2008)
Source: own Graph based on data from CEA (2009a)

4.2.2.1.3. Insurance Products

European single insurance market is dominated by life insurance products whereas the Turkish insurance market is largely dominated by non-life insurance

products. Graph 64 illustrates the share of life and non-life insurance business in the EEA and Turkey. The share of life business in Turkey is 13% of the total insurance business in 2008, while it is around 60% in the EEA. Even in the few Member States where non-life products prevail, the share of life business varies between 20% and 40%. Furthermore, most of the life insurance products which are widespread in the EEA insurance markets such as the unit linked life insurance products which are widespread in the UK and France do not exist in the Turkish insurance market. Instead, credit linked life insurance products dominate the Turkish life insurance market. This is why the Turkish life insurance market does not comove with most of the already fragmented EEA life insurance markets.



Graph 64: Share of Life and Non-Life Insurance in the EEA and Turkey (2008)
Source: own Graph based on data from CEA (2009a)

In non-life insurance lines of business, Turkey differentiates from the EEA average. Traditional insurance products dominate the Turkish non-life insurance market. Table 13 shows the share of non-life insurance branches in total insurance production in the EU and Turkey. Motor insurance products represent 48% of the Turkish non-life insurance market while they cover 30% of the European single insurance market. Liability insurances as well as credit insurance, legal expense and financial losses insurance products are still not widespread in the Turkish insurance market. In addition, mortgage related insurances are new and not commonly used.

Table 13: Share of Branches in Non-Life Insurance in the EU and Turkey (2008)

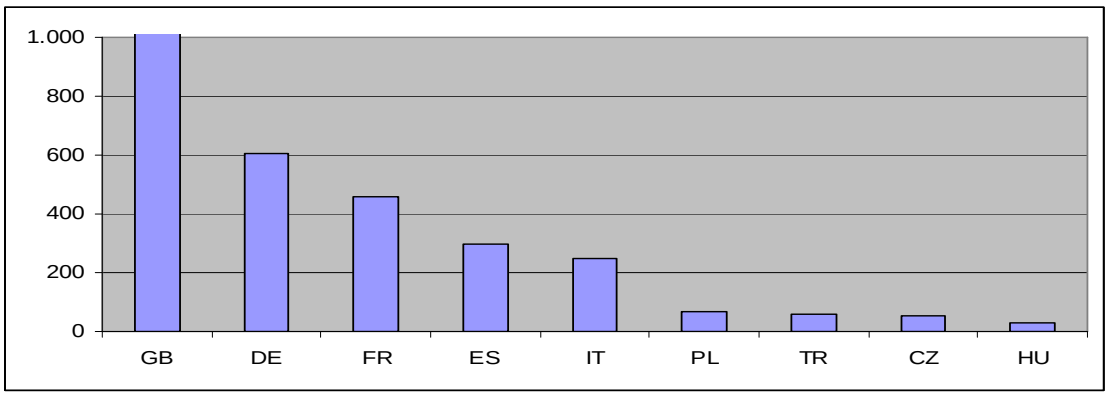
	EU-27	Turkey
Motor	30,5%	48,2%
Accident&health	31,0%	17,6%
Liability	7,9%	2,9%
Legal expense	1,8%	0,3%
Property	19,1%	16,8%
MAT	3,7%	4,7%
Other	6,0%	9,5%

Source: own Table based on data from CEA (2009a)

4.2.2.1.4. Type and Size of Insurers

Insurance companies are established as joint-stock companies in Turkey. However, mutual insurers which are widespread in France and Germany do not exist in Turkey. Moreover, while the establishment of composite insurers is forbidden in the EU since the introduction of the third insurance directives in 1994, the already established composite insurers of that time which represent 10% of the total number of the EEA insurers today continue to operate. However, there are no composite insurers in Turkey.

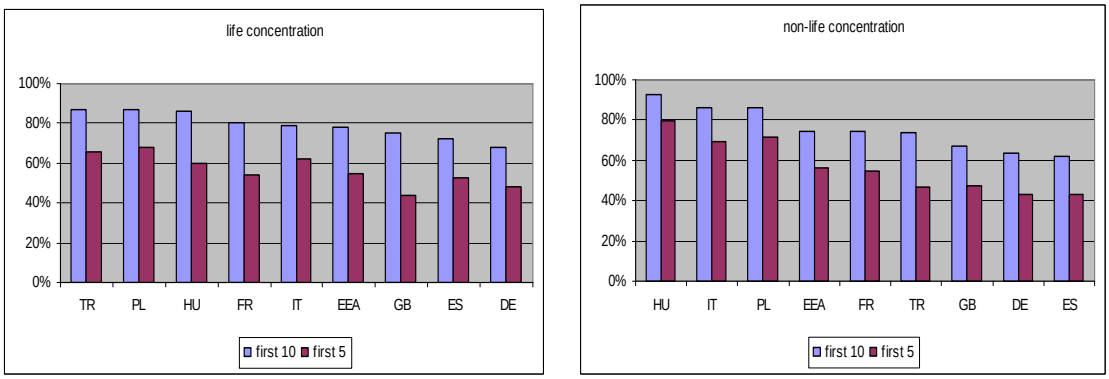
It can be concluded from Graph 65 that the number of insurance companies in Turkey is far below the number of insurers in the EU-15 but similar to the number of insurers in the new EU Member States. However, taking into account the size of the Turkish insurance market, 54 actively operating companies in the market by the end of 2010 can be considered too many.



Graph 65: Number of Insurers in the EEA and Turkey (2008)

Source: own Graph based on data from CEA (2009a)

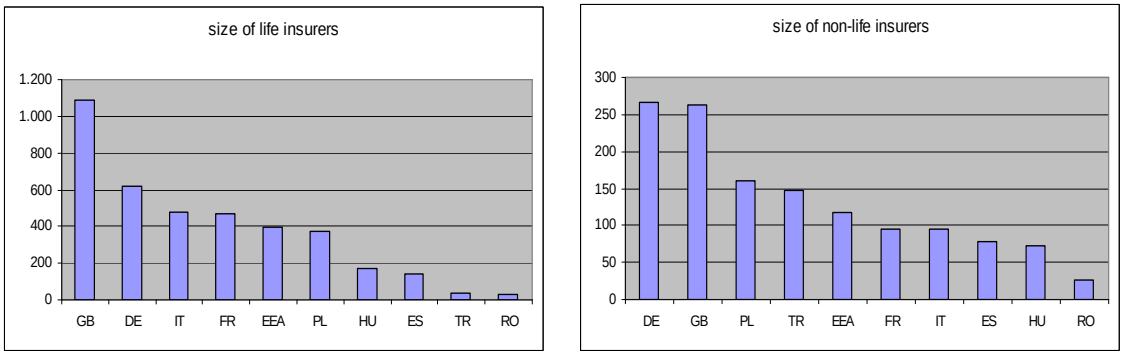
It can be seen from Graph 66 that the concentration ratio is very high in the EEA Member States and Turkey in both life and non-life market. Concentration ratio for both the EEA average and Turkey accounts to around 80%. The sector is relatively more fragmented in bigger Member States, which is not the case in Turkish insurance market.



Graph 66: Life and Non-Life Concentration in the EEA and Turkey (2008)
Source: own Graph based on data from CEA (2010a)

Size of the insurers established in Turkey is smaller than the European insurance groups. The EEA average premium production per company accounts to EUR 235 million, but it is only EUR 104 million in the Turkish insurance market. Moreover, while worldwide premium production of Allianz and Axa was EUR 89 and EUR 87 billion in 2008, premium production of Anadolu Group which is the biggest pure domestic insurance group in Turkey was only EUR 0.7 billion. This puts Turkish insurers into a disadvantageous position to compete with the insurance groups established in the EEA.

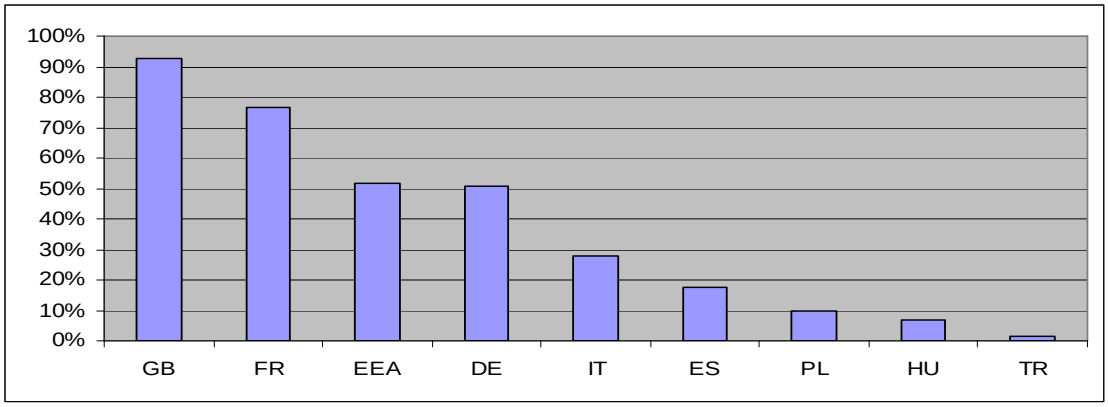
Graph 67 shows that in life business, the average size of life insurers in Turkey (EUR 36 million) is well behind the EEA average (EUR3 96 million). However, due to high number of non-life insurers operating in the EEA (including monoliners operating in one specific branch), the average size of non-life insurers operating in the Turkish insurance market (EUR 148 million) is above the EEA average (EUR 118 million).



Graph 67: Size of Insurers in the EEA and Turkey (2008) (EUR million)
Source: own calculations based on data from CEIOPS (2009) and TSRSB (2008)
data excludes composite companies

4.2.2.1.5. Investments of Insurers

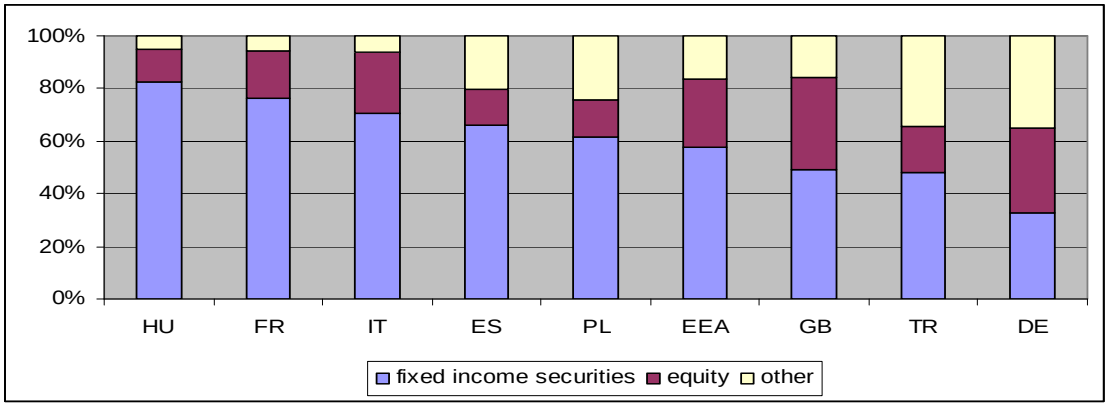
The ratio of investments to GDP which provides an indicator of the relative importance of insurance to the economy shows great disparities between Turkey and the EEA. Graph 68 shows that the average investment of insurers to GDP in the EEA is 51% in 2008, while the ratio exceeds 90% in the UK. Turkey ranks among Baltic States with less than 2%.



Graph 68: Investments of Insurers to GDP in the EEA and Turkey (2008)
Source: own Graph based on data from CEA (2009a)

Graph 69 depicts the fact that the allocation of insurers' investments between EEA Member States and Turkey differ. With some few exceptions such as Germany, Austria and the UK, relatively more risky investments such as equities are not widespread in both the European and Turkish insurance markets. While the share of fixed income securities is biggest in the EEA average and Turkey, it accounts for more than

half of the total investments in most of the Member States (EEA average is 58%) whereas it accounts 47% in Turkey in 2008. On the other hand, the biggest difference between the allocation of investments in Turkish and European insurance markets is the deposits with credit institutions which accounts almost 30% of total investments of the Turkish insurance market against the EEA average of 3%. Therefore, with almost 80% of investments allocated to fixed-income securities and deposits, Turkish insurance market is more secure and stable than the insurance markets of most of the EEA Member States, including the new EU Member States.



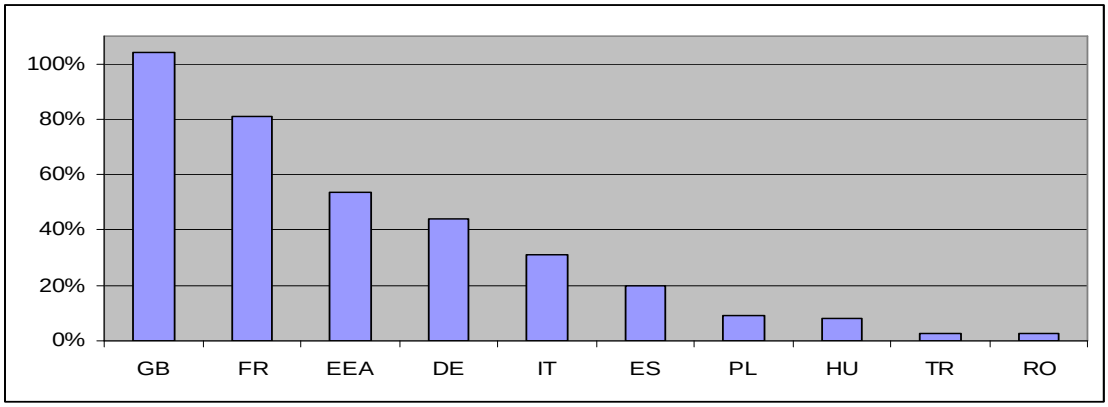
Graph 69: Allocation of Insurers' Investments in the EEA and Turkey (2008)

Source: own calculations based on data from CEIOPS (2009) and CEA (2010a)

Fixed income includes debt securities and other fixed income securities; equity includes shares and other variable-yield securities, and investments in affiliated enterprises and participating interests; other includes lands and buildings, loans, deposits with credit institutions and other investments.

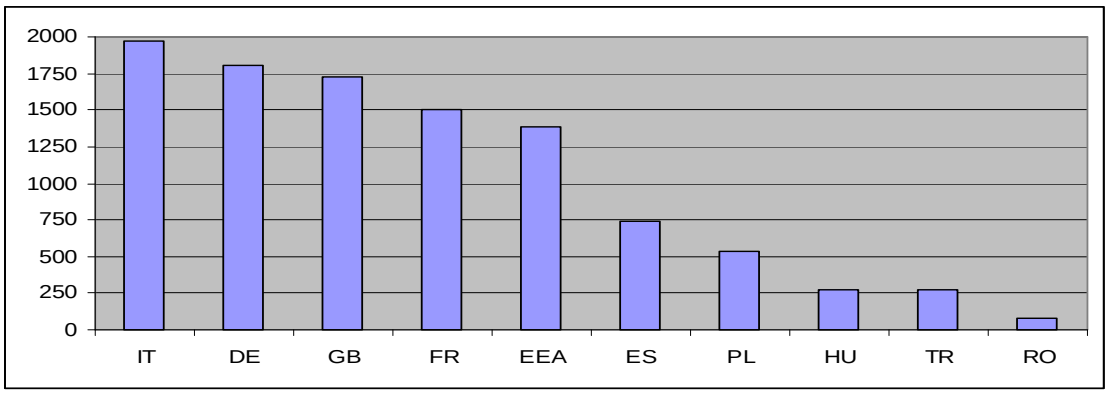
4.2.2.1.6. Competitiveness of Insurers

Assets of insurers operating in Turkey are much smaller compared to the assets of big European insurance groups. Graph 70 demonstrating the ratio of total assets to GDP in 2008 makes it clear that while the average EEA ratio is 54%, it is less than 10% in most of the new EU Member States and is only 2,9% in Turkey which ranks among Baltic States, Bulgaria and Romania.



Graph 70: Insurers' Assets to GDP in the EEA and Turkey (2008)
Source: own calculations based on data from CEIOPS (2009) and ISB (2009)

Therefore, the competitive power of Turkish insurers (except foreign insurers operating in Turkey which can benefit from the financial power of their parent undertakings under certain conditions) is relatively smaller than their European counterparts. Graph 71 indicates that in terms of assets, average size of companies is EUR 1.4 billion in the EEA. While it is EUR 2 billion in Italy, EUR 1.8 billion in Germany and EUR 0.5 billion in Poland, it is only EUR 0.27 billion in Turkey.



Graph 71: Amount of Assets per Insurer in the EEA and Turkey (2008) (EUR million)
Source: own calculations based on data from CEIOPS (2009) and ISB (2009)

Furthermore, Table 14 demonstrates that Turkish insurance groups are very small compared to the world's leading European insurance groups. Total assets of Allianz Group account to EUR 955 billion and total assets of Axa Group account to EUR 673 billion in 2008. However, total assets of Anadolu Insurance and Anadolu Life Insurance account to EUR 2.6 billion. Out of 60 insurers operating in Turkey, 41 insurers have

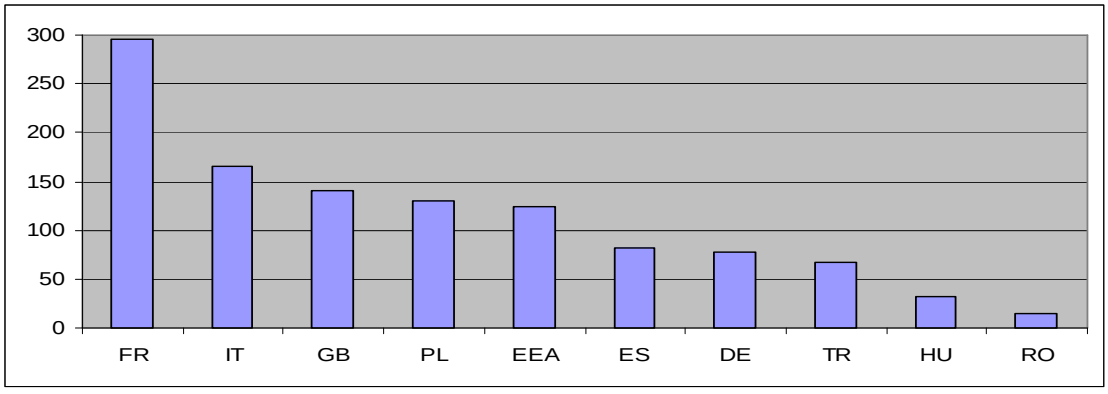
direct or indirect foreign partners. Therefore, as subsidiaries of the biggest insurance groups operating worldwide, these companies benefit from the competitive power of their parent companies.

Table 14: Insurance Groups in Europe and Turkey (2008)

Company	Worldwide Premiums	Technical Provisions	Total Assets
Allianz	89	411	955
Axa	87	488	673
Generali	67	296	384
Aviva	45	312	446
ING	43	235	312
Anadolu (Life+Non-Life)	0.7	1.3	2.6
Yapı Kredi (Life+Non-Life)	0.3	0.5	1.3
Total of Turkish Insurance Market	6.2	6.2	14.6

Source: own Table based on data from 2008 Annual Reports of the companies

On the other hand, while total capital (own funds) of the insurers in the UK and France is EUR 153 billion and EUR 136 billion respectively, it accounts to EUR 3.7 billion in Turkey. Graph 72 shows that the average amount of capital of the EEA insurers (including cooperatives) is EUR 124 million, while the average in Turkey is only EUR 67 million. Furthermore, the EEA average includes cooperatives having small amount of capital and thus excluding them, the EEA average would be much higher. The amount of capital of some of the biggest European insurance groups is even bigger than the total amount of capital of all insurers operating in Turkey.

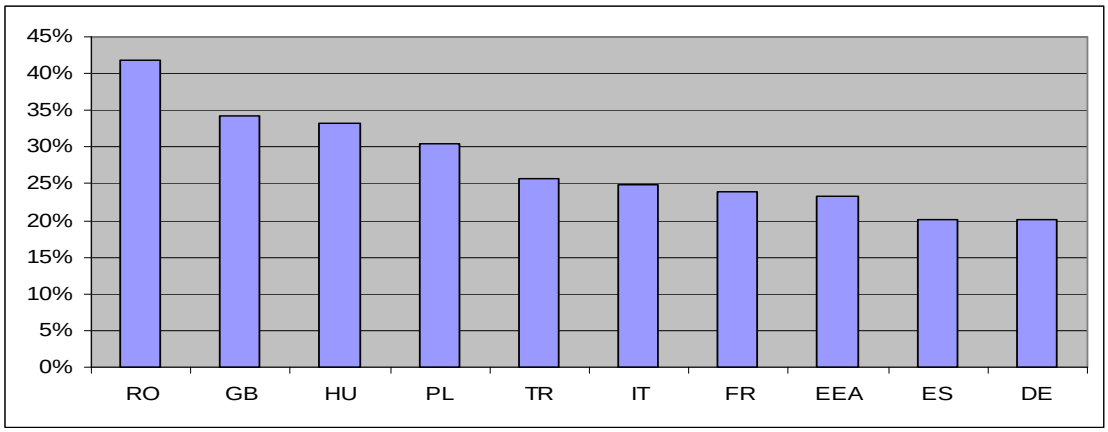


Graph 72: Amount of Capital per Insurer in the EEA and Turkey (2008) (EUR million)

Source: own calculations based on data from CEIOPS (2009) and ISB (2009)

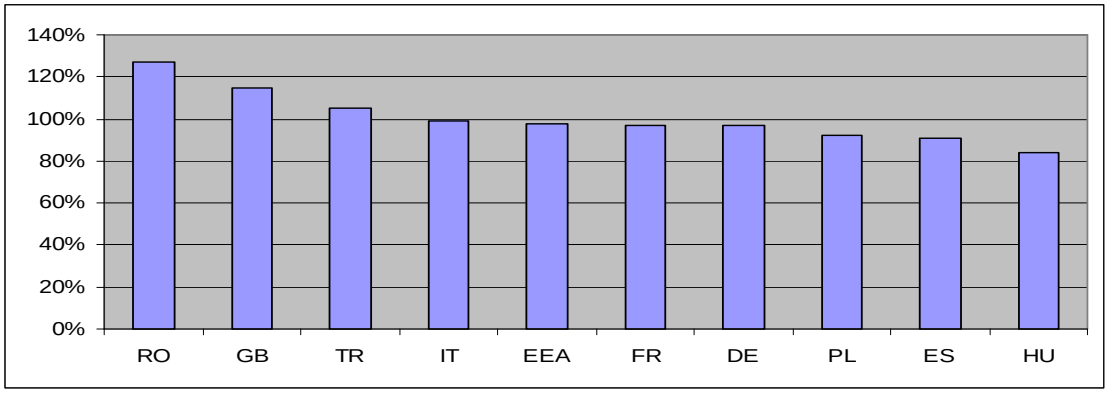
4.2.2.1.7. Efficiency of Insurers

Cost ratio in non-life business showing the ratio of net operating expenses to net premiums earned do not differ between Turkey and EEA average. Graph 73 shows that the weighted average of the cost ratio is 23% in the EEA non-life business and 25% in Turkish non-life business in 2008, whereas for every EUR 100 of earned premium, insurers in Romania have to spend EUR 42. It means that insurers in Turkey are more efficient than the insurers operating in Romania.



Graph 73: Cost Ratio in Non-Life Business in the EEA and Turkey (2008)
Source: own calculations based on data from CEIOPS (2009) and ISB (2009)

Whereas the cost ratio in Turkey is in line with the EEA average, the combined ratio which gives an idea about the profitability of the insurers is worst than the EEA average. Divergent combined ratios suggest the existence of divergences in efficiency. Graph 74 shows net combined ratio in non-life business defined as net claims and net operating expenses divided by net premiums earned. The ratio in the EEA was 98% in 2008 whereas it was 105% in Turkey which means that claims and expenses were higher than earned premiums in Turkish non-life business. In contrast to Turkey, although cost ratio in Poland and Hungary was higher than the EEA average, their combined ratio is below the EEA average mainly due to low level of claims incurred.



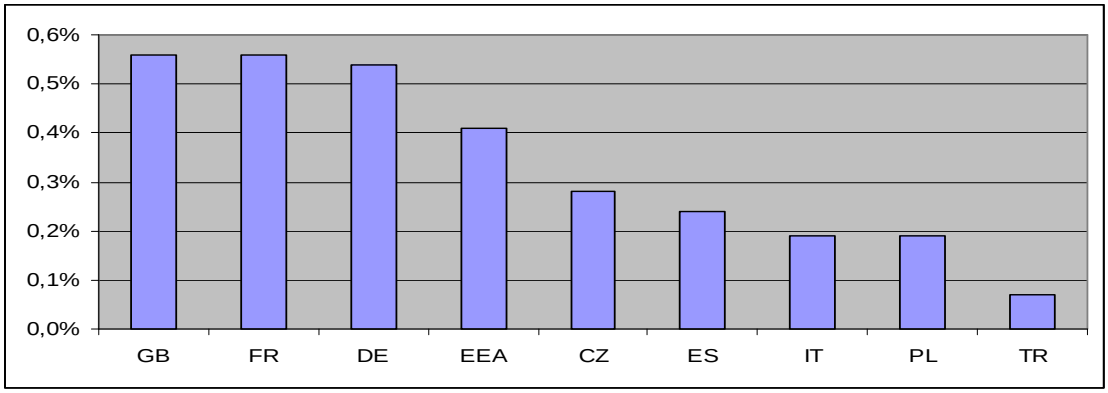
Graph 74: Net Combined Ratio in Non-Life Business in the EEA and Turkey (2008)
Source: own calculations based on data from CEIOPS (2009)

4.2.2.1.8. Productivity of Insurers

In Turkey, there are 16.000 people working in insurance and reinsurance companies in 2008 whereas total number of people employed in the EEA insurance and reinsurance companies is 926.000. CEA (2009a) reports that Germany is the leader in the EEA with 216.000 employees while the UK has 175.000, France 144.000 and Poland 29.000 employees working in their insurance and reinsurance companies.

In the EEA, there are 185 persons employed per insurer while insurers in Turkey have an average of 295 employees. The average in Turkey is higher than the EEA average due to the fact that in Turkey there are no mutuals where the level of employment is considerably low.

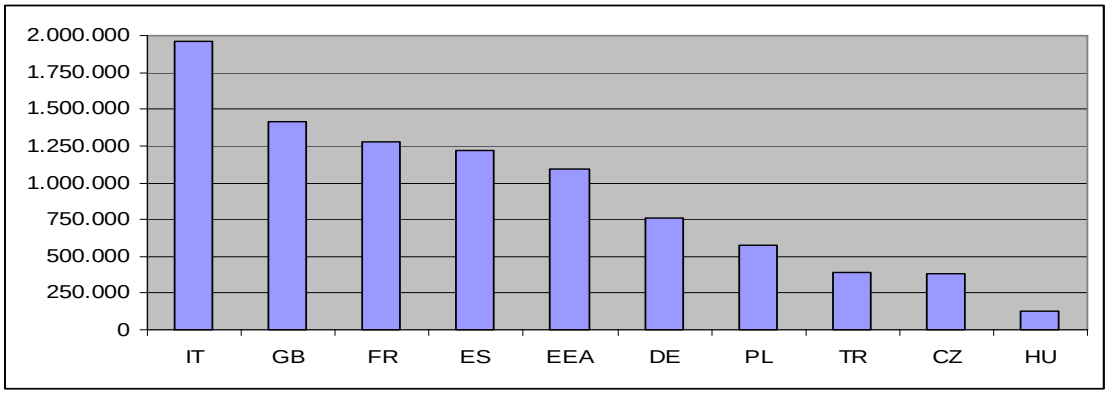
Graph 75 shows the share of employees working in insurance and reinsurance companies to total employment of the country. While the average share in the EEA is 0,41%, it remains at 0,07% in Turkey. Taking into account that 0,56% of total employees in the UK and France work in insurance companies, the share in Turkey is only one-eighth of these countries.



Graph 75: Employment in Insurers to Total Employment in the EEA and Turkey (2008)

Source: own calculations based on data from CEA (2009a)

Labor productivity in the insurance business calculated by total premium production (as the output) to total number of persons employed (as the input) varies greatly between the EEA and Turkey. Graph 76 demonstrates that productivity is highest in Italy with almost EUR 2 million premium production per employer in 2008. While the average in the EEA is EUR 1.1 million, it remains at EUR 0.38 million in Turkey.



Graph 76: Labor Productivity in the EEA and Turkish Insurance Market (2008)

Source: own calculations based on data from CEA (2009a)

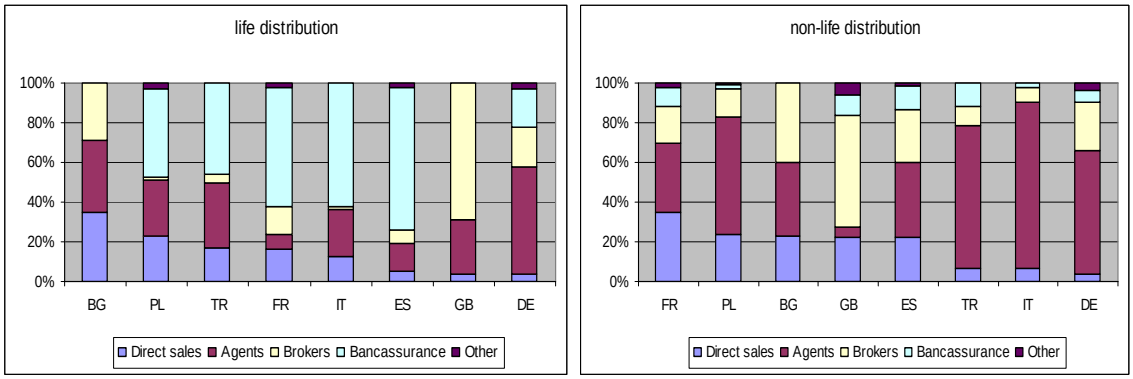
4.2.2.1.9. Insurance Distribution Channels

Insurance intermediaries in the EEA and Turkey consist of agents, brokers and banks. Graph 77 demonstrates that distribution channels in both life and non-life business differ widely between countries. Brokers lead the life insurance market in the UK while bancassurance is commonly used in Spain, Italy and France, and agents are particularly

widespread in Germany. In Turkish life insurance markets, bancassurance and agents dominate the market while direct selling is also more important than the EU-15 countries.

In the distribution of non-life insurance products, agents and brokers are the largest suppliers. Non-life insurance products in Turkey, Italy and Germany are widely sold through agents, while brokers are dominant in the UK and Ireland. Contrary to life business, the share of bancassurance is smaller in most of the countries.

On the other hand, direct selling through company employees, internet or telephone, which also facilitates the selling of insurance products abroad, is used to some extent in life insurance market in Bulgaria and non-life insurance market in France while it is negligible in both life and non-life markets in Turkey.



Graph 77: Insurance Distribution Channels in the EEA and Turkey (2008)
Source: own Graph based on data from CEA (2009a)
2007 data for ES
In GB, bancassurance in life business is included in other channels and its market share is around 14%.

4.2.2.1.10. Results of the Comparative Analysis on Market Convergence

From the convergence point of view, Turkish insurance market is not ready for the integration to the European single insurance market since market indicators between Turkey and the EEA Member States differ to a great extent.

Life and non-life insurance density and penetration in Turkey deviate largely from the EEA average. Contrary to the European single insurance market, the Turkish insurance market is largely dominated by traditional non-life insurance products. Premium production of the insurers established in Turkey is smaller than the European

insurance groups. Their competitive power and efficiency are found to be considerably smaller than the EEA insurers. The ratio of investments of the insurers to GDP shows also large disparities between the EEA and Turkey. Whereas the Turkish insurance market ranks among the developing insurance markets of the EU-10 countries from Central and Eastern Europe, there are still large disparities between them.

To sum up, life and non-life insurance density, insurance penetration, insurance products, allocation of investments and the level of competitiveness, efficiency and productivity of insures greatly differ between the EEA average and Turkey. Therefore, Turkish life and non-life insurance markets do not comove with the already fragmented EEA insurance markets. Lack of convergence in market indicators reduces the integration potential.

4.2.2.2. Foreign Presence in the Turkish Insurance Market

Since Turkey is not part of the European single insurance market, there is no freedom of establishment or freedom of services between the EEA Member States and Turkey. However, low penetration rate and robust growth in the insurance and pension markets in recent years increased foreign investors' attention to the Turkish insurance market (ISB, 2009, p.13). There has been a substantial increase in the entrance of foreign capital especially since 2005.

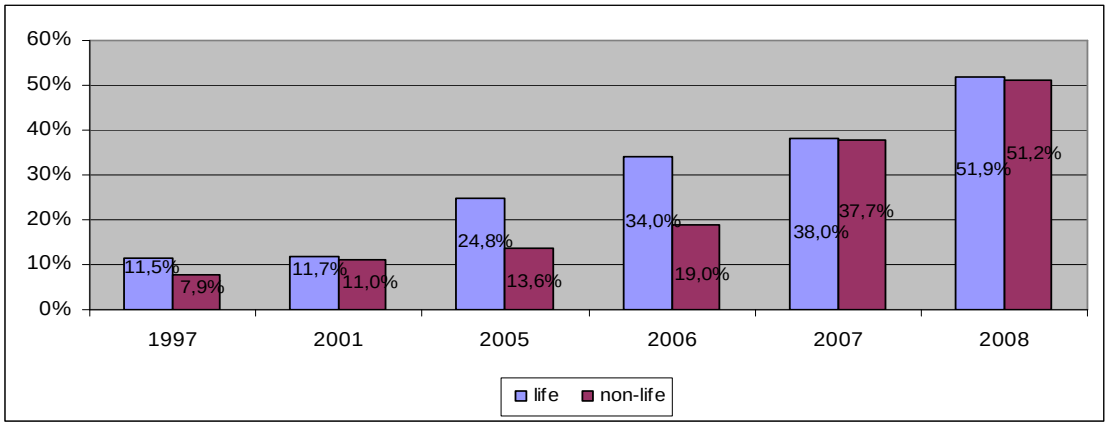
Table 15 shows the number of foreign insurers in Turkey. While there were only 17 foreign shared insurance companies in Turkey in 2000, this number increased to 43 in 2009. Total number of companies did not increase during the same period since foreigners prefer to penetrate to the Turkish insurance market mostly by way of M&A instead of establishing new branches or subsidiaries. 24 of 37 non-life companies and 19 of 24 life companies have direct or indirect foreign shares as of the end of 2009. 35 companies are foreign controlled companies which have more than 50% of the capital that belongs to foreigners. Moreover, out of 43 insurers which have foreign shares, 32 insurers have their headquarters in the EEA Member States. It means that most of the foreign players in the Turkish insurance market are the EEA based insurers.

Table 15: Number of Insurers in Turkey with Foreign Partners

Year	Total Number of Company	Number of Companies with Foreign Partners	Foreign Partner's Share	
			>%50	<%50
2000	62	17	6	11
2001	59	16	8	8
2002	58	15	8	7
2003	57	11	6	5
2004	58	16	7	9
2005	55	20	9	11
2006	55	24	15	9
2007	61	32	22	10
2008	62	41	34	7
2009	62	43	35	8

Source: own Table based on data from ISB (2009)

As a result of the increase in foreign investments in the Turkish insurance market, the share of foreign players has been increasing not only in terms of number but also in terms of capital and premium production. Graph 78 shows that the share of foreign paid-in capital to total paid-in capital of the Turkish insurance market reached 51% in life and non-life business in 2008. Life insurance market was more open than non-life market until 2006. Due to intense mergers and acquisitions in non-life market in 2007 and 2008, non-life market is now as open as life market. Moreover, in 2008, only 7% of the total capital belongs to non-EEA insurers while EEA insurers hold 47% of the total capital of the Turkish insurance market.

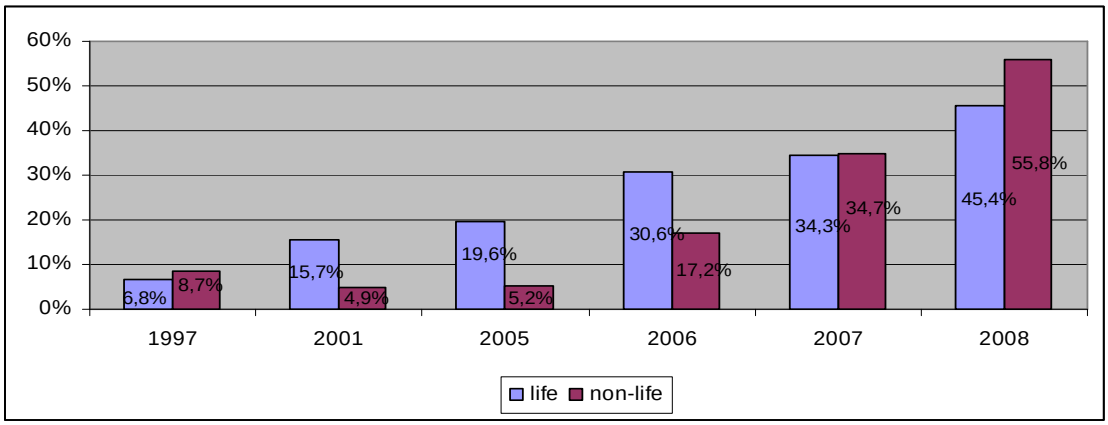


Graph 78: Share of Foreign Insurers in Turkey (in terms of capital)

Source: own Graph based on data from Annual Reports of the ISB
share of foreign paid-in capital to total paid-in capital of the Turkish insurance market

Graph 79 represents the share of the premium production of the foreign insurers that hold the majority (more than 50%) of the paid-in capital of the company to total premium production of the Turkish insurance market.

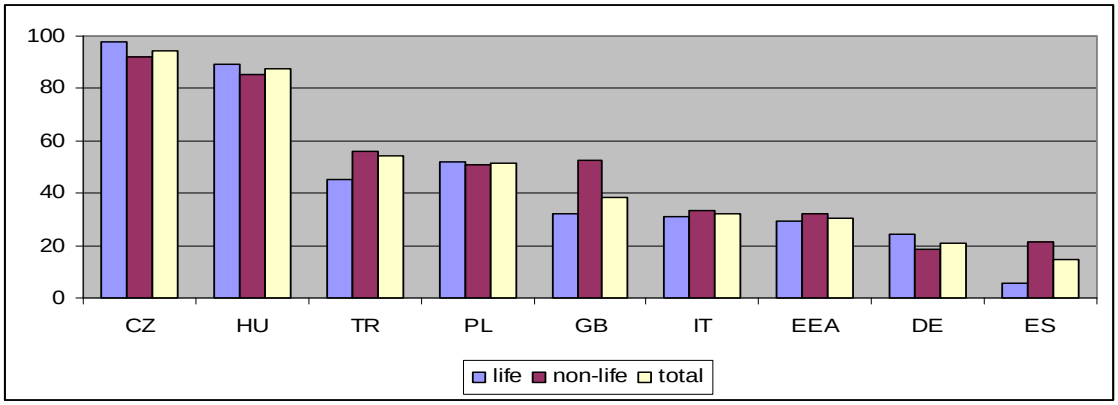
In line with the increasing penetration of foreign insurers into the Turkish insurance market, the share of foreigners in the premium production has also increased in both life and non-life businesses especially since 2005. The openness of non-life business is higher than life business. Almost 56% of non-life premiums and 45% of life premiums were written by foreign insurers in 2008.



Graph 79: Share of Foreign Insurers in Turkey (in terms of premiums)

Source: own Graph based on data from Annual Reports of TSRSB
share of premium production of the insurers which hold more than 50% of the paid-in capital of the company to total premium production of the Turkish insurance market

Overall, countries with a greater market size in terms of total premiums are less open to foreign companies. Graph 80 indicates that foreign share in the Turkish insurance market is much higher than the EEA average, Germany and Spain. The share of foreigners in both life and non-life insurance markets of Turkey is less than the shares in Czech Republic and Hungary but similar to the shares in Poland.



Graph 80: Share of Foreign Insurers in the EEA and Turkey (in terms of premium production)

Source: own Graph based on data from OECD (2010)
Excluding the share of EEA branches

In conclusion, foreign insurers widely operate in Turkish life and non-life insurance markets through M&A as in the case of the European single insurance market. Foreign insurers, especially the EU insurers, have been penetrating into the Turkish insurance market since the acceleration of the flow of foreign direct capital (FDI) to Turkish financial market in 2005. Whereas opening of the EU membership negotiations in 2005 has an effect on the acceleration of foreign penetration into the Turkish insurance market, at micro-level growth potential and profitability opportunities and at macro-level young population, macro-economic results and political stability are the main motivations behind this acceleration. The growing involvement of foreign insurers in the Turkish insurance market can be seen as the result of this broader picture.

Moreover, discourse analysis also supports the arguments of this study. Managers or founders of the EU insurers which acquire Turkish insurers in their speeches in media just after the acquisition process mostly use the words “growth”, “stability” or “insurance penetration” rather than the words “EU”, “harmonization” or “alignment”. A survey carried out by the European Commission on the insurers that had entered the market of another EU Member State concluded also that the main drivers of the EU insurers to enter another market are purely commercial such as potential for growth or profitability (European Commission, 2007a, p.48).

Furthermore, increasing involvement of foreign insurers in Turkish insurance market since 2005 did not result in higher product differentiation and more effective risk management in the sector. In contrast, it did result in excessive price competition and thus profitability of the companies has been considerably deteriorated. In addition, foreigners did not bring a significant additional capital to the sector. Equity capital is not improved in terms of quality and quantity. While the ratio of the equity capital of the sector to total premium production was 68% in 2005, it fell down to 65% in 2008.

4.3. SURVEY ON PERCEPTIONS AND EXPECTATIONS ABOUT THE INTEGRATION OF THE TURKISH INSURANCE MARKET WITH THE EUROPEAN SINGLE INSURANCE MARKET

Since Turkey is not a member of the EU, the insurers operating in Turkey are not benefiting from FOS or FOE. However, foreign penetration into the Turkish insurance market is high and most of the foreign players in the Turkish insurance market are EU insurers. It reflects the fact that the EU insurers are widely operating in the Turkish insurance market without feeling the need to wait for the membership of Turkey to the EU. Therefore, the EU membership of Turkey would not have a considerable effect on the decision of the EU insurers to operate in the Turkish insurance market and *vice versa*. However, the level of integration between the Turkish insurance market and European single insurance market when Turkey becomes a member of the EU cannot already be quantified since there has not yet been FOS or FOE between the two markets.

Therefore, expectations of the managers in the Turkish insurance sector on the level of integration as well as their perceptions and expectations on the arguments and claims presented in this study are investigated by a survey.

4.3.1. Aim

The main aim of the survey is to explore the perceptions and expectations of the managers in the Turkish insurance sector about the integration of the Turkish insurance market to the European single insurance market. Perceptions and expectations on the current harmonization level of the Turkish insurance market with the European single insurance market, on the benefits and costs of the EU membership of Turkey in Turkish

insurance market and on the integration level between the two markets when Turkey becomes member of the EU are investigated in the survey.

The following questions are investigated by three different scales which measure the belief in the level of harmonization, in the benefits of the EU membership of Turkey and in the level of integration as a result of the membership of Turkey to the EU:

1. Perceptions on the level of harmonization of the Turkish insurance legislation with the EU insurance *acquis*
    - Perceptions on the existence of harmonization in different areas of legislation related to insurance
    - Perceptions on behavioral changes of insurers and consumers during the harmonization process
2. Expectations on the benefits of the membership of Turkey to the EU in the Turkish insurance market
    - Expectations on the likelihood of different types of benefits and costs occurring in the Turkish insurance market when Turkey becomes member of the EU
3. Expectations on the level of integration between the Turkish insurance market and European single insurance market when Turkey becomes member of the EU
    - Expectations on the market entry strategies of the EU insurers to operate in Turkey and Turkish insurers to operate in the EU when Turkey becomes member of the EU
    - Expectations on the likelihood of different insurance branches in which the EU insurers would intend to operate in Turkey when Turkey becomes member of the EU
    - Expectations on types of consumers who would buy insurance products from the insurers established in the EU when Turkey becomes member of the EU

The questions above are investigated by a descriptive approach. In addition to that, the questions are tested to see whether there is a significant relationship between foreign and domestic insurers and between life and non-life insurers. The existence of a

significant difference between foreign and domestic insurers and between life and non-life insurers in their belief in the level of harmonization of the Turkish insurance market with the European single insurance market, in their belief in the benefits of the integration of Turkish insurance market with the European single insurance market when Turkey becomes member of the EU and in their belief in the level of integration between Turkish insurance market and European single insurance market when Turkey becomes member of the EU are investigated.

4.3.2. Methodology

4.3.2.1. Participants

There are almost 300 top managers, including general managers, deputy general managers and legal advisors, working in 57 insurance and reinsurance companies actively operating in Turkey as of the end of 2010. This survey covered 52 managers from 33 different companies. This corresponds around 17% of all top managers and 58% of all companies in the market.

The distribution of the participants is shown in Table 16. Companies having more than 50% of their equity acquired by foreigners are classified as foreign companies. 22 participants from domestic companies and 30 participants from foreign companies operating in Turkey participated in the survey. 18 participants are from life insurance companies (7 of them being from domestic companies and the remaining 11 being from foreign companies), 29 participants are from non-life insurance companies (10 of them being from domestic companies and the remaining 19 being from foreign companies), 3 participants are from reinsurance companies and 2 participants are from insurance professional organizations.

Table 16: Number of Participants

	domestic	**foreign**	**total**
life	7	11	**18**
non-life	10	19	**29**
other	5	-	**5**
total	**22**	**30**	**52**

As of the end of 2009, 46% of the employees in the insurance and reinsurance companies operating in Turkish insurance market are male and 54% of them are female. However, only 20% of general managers and deputy general managers are female. 40 males and 12 females participated in this survey. 23% of the participants are thus female and this reflects the current situation of the Turkish insurance sector.

Age of the participants ranges from 30 to 64. The seniority is not based on age or total work experience but based on the experience in the insurance sector. Participants having more than 10 years of experience in the insurance sector are considered as senior. As a result, for the purpose of this study, 36 participants are labeled as senior and 16 participants are labeled as junior in terms of experience in the insurance sector.

The first 10 non-life companies writing 73% of the total non-life premium production and the first 5 life companies writing 67% of the total life premium production are considered as big companies. As a result, for the purpose of this study, 30 participants are from the companies labeled as big companies and 20 participants are from the companies labeled as small companies.

4.3.2.2. Instruments

The scale used in this survey to measure the belief in the level of harmonization consists of 19 items covering relevant areas of insurance legislation and participants are asked to indicate the degree to which they believe that the harmonization exists. They give their responses on a 5-point Likert scale ranging from 1 *(strongly disagree)* to 5 *(strongly agree)* with higher scores indicating greater belief in the existence of harmonization. Items affirming the lack of harmonization are reverse scored.

The scale used to measure the belief in the benefits in Turkish insurance market when Turkey becomes member of the EU covers 21 items containing different types of benefits and costs. The participants are asked to indicate the degree to which they expect that there will be benefits for the Turkish insurance market when Turkey becomes member of the EU. They give their responses on a 5-point Likert scale ranging from 1 *(strongly disagree)* to 5 *(strongly agree)* with higher scores indicating greater belief in the benefits of membership. Items affirming the costs of membership are reverse scored.

The scale used to measure the belief in the level of integration when Turkey becomes member of the EU consists of 12 items covering different types of foreign market entry strategies. The participants are asked to indicate their degree of expectations related to the foreign market entry strategies of the EU and Turkish insurers when Turkey becomes member of the EU. They give their responses on a 5-point Likert scale ranging from 1 *(strongly disagree)* to 5 *(strongly agree)* with higher scores indicating greater belief in the materialization of integration. Items affirming foreign market entry strategies without need for integration are reverse scored.

In addition, participants are asked to give the name of the company they work for so that they can be categorized in terms of type and nationality of company. All of the respondents surveyed are guaranteed complete anonymity when the results are evaluated and published.

Reliability is checked for all scales. It is measured with Cronbach's alpha. The reliabilities of the scales used to measure dependent variables are reported in Table 17. An alpha between .6 and .8 indicates acceptable reliability and an alpha of .8 or higher indicates good reliability. Therefore, Cronbach's alphas turned out to be acceptable for all scales of the survey.

Table 17: Results of Reliability Test

variable	number of items	Cronbach's alpha
harmonization	19	.61
benefits	21	.78
integration	12	.75

Source: own Table based on the results of reliability test run in SPSS

Exploratory Data Analysis (EDA) is performed to reveal possible errors in the data, to test for normality and homogeneity and then to determine whether parametric or non-parametric tests should be used.

First, normality tests are performed to investigate if variables are normally distributed for each level of the independent variable. In order to determine normality, graphical and numerical methods are used. The distribution of all variables is graphically

compared to a standard normal distribution by using Q-Q plots. In each graph, the points in the Q-Q plot lie approximately in a straight line. Therefore, the data is from normally distributed population.

As a numerical method of assessing normality, Shapiro-Wilk Test which is appropriate for small samples which are less than 2000 participants is performed. The results of Shapiro-Wilk Test are presented in Table 18. The null hypothesis that the data comes from a normally distributed population cannot be rejected for none of the variables since $p > .005$ in each case. Therefore, for domestic and foreign companies and for life and non-life companies, dependent variables are normally distributed.

Table 18: Results of Shapiro-Wilk Test of Normality

dependent variable	independent variable	statistic	Sig.
harmonization	**domestic**	.90	.06
	foreign	.96	.32
	life	.97	.80
	non-life	.93	.09
benefits	**domestic**	.95	.32
	foreign	.97	.61
	life	.93	.24
	non-life	.96	.36
integration	**domestic**	.96	.53
	foreign	.96	.51
	life	.93	.20
	non-life	.96	.37

Source: own Table based on the results of Shapiro-Wilk Tests run in SPSS

Second, homogeneity of the variances is tested to see whether the variances of the observations in the individual groups are equal. Levene's Test of Equality of Error Variances is performed to check the homogeneity of variance. The results of Levene's Test are shown in Table 19. The null hypothesis that the population variances are equal cannot be rejected for none of the variables since $p > .005$ in each case. Therefore, the error variance of each dependent variable is equal across groups.

Table 19: Results of Levene's Test of Homogeneity

dependent variable	independent variable	F	Sig.
harmonization	**domestic/foreign**	.13	.71
	life/non-life	.72	.54
benefits	**domestic/foreign**	3.41	.07
	life/non-life	3.11	.06
integration	**domestic/foreign**	1.948	.16
	life/non-life	1.277	.29

Source: own Table based on the results of Levene's Tests run in SPSS

4.3.3. Results and Discussion

Descriptive statistics on all variables are reported in Table 20. The perception of the respondents on the harmonization level is that Turkish insurance legislation is harmonized with the EU insurance *acquis* (*M* = 3.65; *SD* = .27). The perception of the sector is in conformity with the finding of the comparative analysis made in this study on insurance legislation of Turkey and the EU that although there are still areas to be further harmonized, Turkish insurance legislation is harmonized with the EU insurance *acquis* to a great extent.

Respondents expect that the membership of Turkey to the EU would be beneficial for the Turkish insurance market (*M* = 3.48; *SD* = .35). Interestingly enough, both big and small insurers expect that the benefits of being member of the EU will be higher than its costs. It can be concluded that they would not abstain from further harmonization with the EU insurance *acquis*.

Furthermore, related to the level of integration between the insurance markets of the current EU Member States and Turkey as a result of the membership of Turkey to the EU, the expectation of the respondents is not as strong as the previous two tendencies (*M* = 2.99; *SD* = .47). The sector does not seem strongly optimistic about the realization of the integration. Furthermore, standard deviation is relatively high. It can be concluded that the expectations on the realization of integration differ within the sector.

Table 20: Descriptive Statistics of Variables

variables	Total Sample	Sample of Domestic Insurers	Sample of Foreign Insurers	Sample of Life Insurers	Sample of Non-life Insurers	Sample of Big Insurers	Sample of Small Insurers
	Mean (SD)	Mean (SD)	Mean (SD)	Mean (SD)	Mean (SD)	Mean (SD)	Mean (SD)
harmonization	3.65 (.27)	3.63 (.31)	3.66 (.24)	3.64 (.23)	3.65 (.31)	3.62 (.27)	3.67 (.28)
benefit	3.48 (.35)	3.37 (.37)	3.57 (.31)	3.46 (.20)	3.57 (.37)	3.50 (.38)	3.50 (.29)
integration	2.99 (.47)	2.80 (.35)	3.18 (.49)	2.92 (.56)	3.11 (.44)	2.97 (.48)	3.09 (.49)

Source: own Table based on the results of the survey

Since reliability of the scales used in the survey is acceptable, data is normally distributed and variances are identical, the assumptions to run analysis of variance (ANOVA), a parametric test, are validated. Therefore, the existence of a significant difference between foreign and domestic insurers and between life and non-life insurers in their belief in the level of harmonization, in the benefits of the integration and in the level of integration is tested by one-way ANOVA. The results of ANOVA for all variables are reported in Table 21.

Table 21: Results of ANOVA

dependent variable	independent variable	F	Sig.
harmonization	**domestic/foreign**	.08	.77
	life/non-life	.43	.72
benefits	**domestic/foreign**	7.15	.01
	life/non-life	4.09	.01
integration	**domestic/foreign**	9.45	.00
	life/non-life	.70	.55

Source: own Table based on the results of ANOVA run in SPSS

In order to test whether there is a significant difference between domestic and foreign insurers and between life and non-life insurers in their belief in the level of harmonization of the Turkish insurance market with the European single insurance market, one-way ANOVA is carried out to compare the groups of domestic and foreign insurers and the groups of life and non-life insurers. There is not a significant difference in the belief in the level of harmonization of the Turkish insurance market with the European single insurance market between domestic insurers (M = 3.63; SD = .31) and foreign insurers (M = 3.66; SD = .24), F (1, 50) = .77, ns and also between life insurers

(M = 3.64; SD = .23) and non-life insurers (M = 3.65; SD = .31), F (1, 45) = .72, ns. The fact that the survey reveals that being from life or non-life insurer does not matter in the belief in harmonization may be attributed to the findings of this study which indicate that the level of harmonization does not differ between life and non-life insurance markets.

In order to test whether there is a significant difference between domestic and foreign insurers and between life and non-life insurers in their belief in the benefits of the integration of Turkish insurance market with the European single insurance market when Turkey becomes member of the EU, one-way ANOVA is carried out to compare the groups of domestic and foreign insurers and the groups of life and non-life insurers. There is a significant difference between domestic and foreign insurers in their belief in the benefits of the integration of Turkish insurance market with the European single insurance market. Foreign insurers (M = 3.57; SD = .31) turn out to have a stronger belief in the benefits of the integration more than domestic insurers do (M = 3.37; SD = .37), F (1, 50) = 7.15, $p < .01$. It can thus be concluded that Turkish insurance sector supposes that the membership of Turkey to the EU would be more beneficial to foreign insurers operating in Turkey than domestic insurers.

There also exists a significant difference between life and non-life insurers in their belief in the benefits of the integration of Turkish insurance market with the European single insurance market. Non-life insurers (M = 3.57; SD = .37) turn out to have a stronger belief in the benefits of the integration more than life insurers do (M = 3.46; SD = .20), F (1, 45) = 4.09, $p < .01$. It can thus be concluded that Turkish insurance sector supposes that the membership of Turkey to the EU would be more beneficial to non-life market than life market.

In order to test whether there is a significant difference between domestic and foreign insurers and between life and non-life insurers in their belief in the realization of the integration between the Turkish insurance market and the European single insurance market when Turkey becomes a member of the EU, one-way ANOVA is carried out to compare the groups of domestic and foreign insurers and the groups of life and non-life insurers. There is a significant difference between domestic and foreign insurers in their belief in the realization of the integration between the Turkish insurance market and the

European single insurance market when Turkey becomes a member of the EU. Foreign insurers (M = 3.18; SD = .49) turn out to have a stronger belief in the realization of the integration more than domestic insurers do (M = 2.80; SD = .35), F (1, 50) = 9.45, $p < .01$.

However, there is not a significant difference in the belief in the realization of the integration between life insurers (M = 2.92; SD = .56) and non-life insurers (M = 3.11; SD = .44), F (1, 45) = .55, ns. This study concludes that there is not a considerable difference between life and non-life markets in the EEA in terms of the level of integration and that it is negligible in both markets. This conclusion is predicted to be valid also for the Turkish insurance market.

Furthermore, for none of the variables, were there any significant difference between the participants labeled as senior and junior and between the participants from the companies labeled as big and small ($p > .01$ for all tests).

Furthermore, descriptive analyses give more detailed results about the perceptions on the harmonization process, expectations on the likelihood of different types of benefits and costs of the integration and expectations on the market entry strategies of the EU and Turkish insurers.

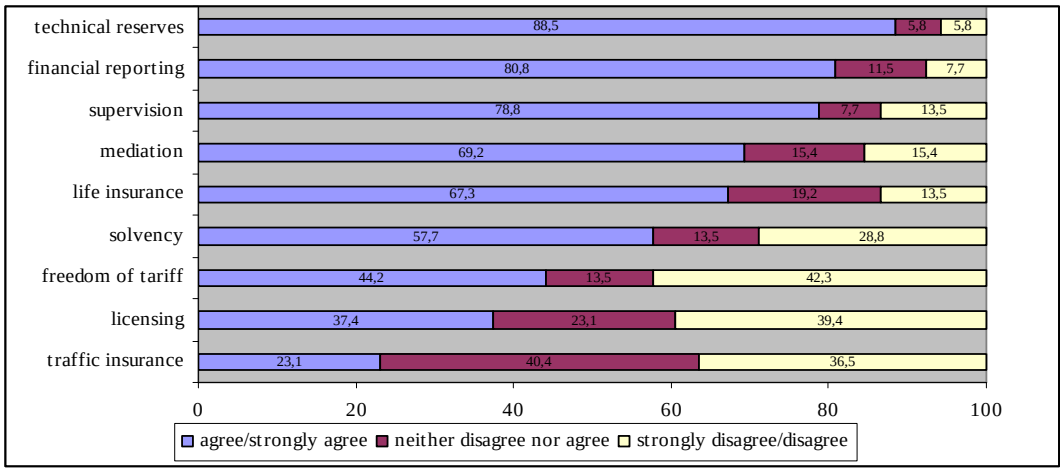
Perceptions of the Turkish insurance sector on the harmonization level of different areas of insurance legislation with the EU *acquis* are reported in Graph 81. Managers in the Turkish insurance sector believe that supervisory requirements (78%) as well as the rules on technical reserves (88%), financial reporting (80%), insurance intermediaries (69%), life insurance (67%) and solvency requirements (58%) are harmonized with the EU rules to a great extent. These perceptions are in line with the findings of the comparative analysis made in this study on insurance legislation of Turkey and the EU that although there are still areas to be further harmonized, Turkish insurance legislation is harmonized with the EU insurance *acquis* to a great extent.

The abstention in the perception of the level of harmonization in MTPL insurance is high mainly due to non-responsive participants from life insurers. Those who responded are mostly of the opinion that MTPL insurance is not harmonized with the EU

rules. The perceptions are in line with the findings of this study that most of the requirements of Directive 2009/103/EC on motor insurance such as minimum cover limits, cover of material damages of uninsured vehicles should be gradually aligned with the EU *acquis*.

Mixed conclusions can be drawn as to the perceptions about the level of harmonization of tariffs and licensing rules. Although the Turkish insurance market which was traditionally a highly regulated market has made big steps towards tariff liberalization, 42% of the respondents suppose that tariffs are not as liberalized as they are in the EU. The perceptions are again in line with the findings of this study that tariffs in compulsory insurances and in life insurance should be further liberalized in order to comply with the EU requirements.

37% of the respondents think that the licensing requirements are aligned with the EU rules and 39% of them think the opposite. The perception that licensing requirements are not harmonized with the EU rules is not in conformity with the findings of this study that licensing rules such as fit and proper requirements for founders and managers, scheme of operation to be submitted to authorities and taking-up capital per line of business are harmonized with the EU *acquis*. Since it is theoretically demonstrated in this study that licensing requirements are harmonized to a great extent, those who perceive a lack of harmonization in this area of legislation may just give their opinion taking into account the considerable amount of work and time to be spent in order to establish an insurer in Turkey. However, it does not mean that the rules are not harmonized. While the length of the establishment process may differ from one country to another or even from one company to another within a country, it does not mean that the establishment rules and procedures differ between countries.



Graph 81: Perceptions on the Harmonization of the Turkish Insurance Legislation with the EU Insurance Legislation (%)

Source: own Graph based on the results of the survey

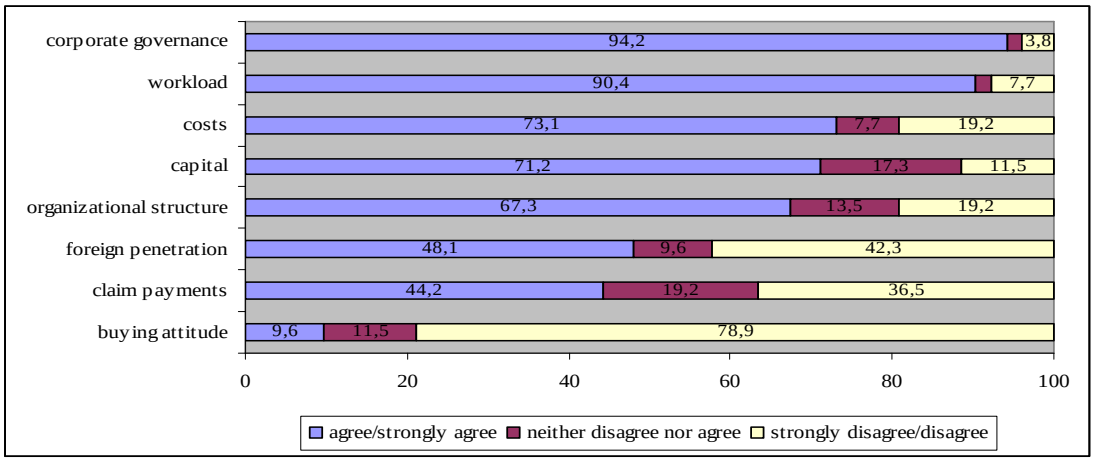
Perceptions of the Turkish insurance sector on the changes in the behavior of insurers and policyholders during the harmonization process with the EU are illustrated in Graph 82. 94% of the respondents think that corporate governance has become more important for the companies. 67% of the respondents think that organizational structure of the insurers has been restructured. This reflects the fact that 90% believe that workload has been considerably increased during the harmonization process. Moreover, 73% of the respondents also believe that the harmonization process is considerably costly for the entire sector.

71% of the managers surveyed arrive at the opinion that insurers had to increase equity capital due to the harmonization process. Only 44% of them believe that claim payments have been accelerated during the harmonization process whereas 36% of them do not perceive any acceleration.

A great majority of the participants believe that the buying attitude of the policyholders has not been changed during the harmonization process. This result is in line with the general assumption that policyholders in Turkey still take into account the price of insurance products rather than their coverage in their buying decisions.

As to the perception about the reasons of the penetration of foreign insurers into the Turkish insurance market, there is not a widespread assumption in the sector that the

harmonization process engenders foreign penetration. 48% of the participants think that one of the motivations of the penetration of the EU insurers into the Turkish insurance market is the alignment of the market with the EU requirements while 42% of them attach the EU insurers' penetration into the Turkish insurance market to other reasons than the harmonization process itself. The views of the participants are largely in line with the conclusions of this study that whereas the harmonization process affects the decisions of the EU insurers to enter the Turkish insurance market, political stability, macroeconomic results and growth potential of the sector are the main motivations behind the market entry decision of the EU insurers.



Graph 82: Perceptions on the Changes in Turkish Insurance Market in its Harmonization Process with the EU (%)

Source: own Graph based on the results of the survey

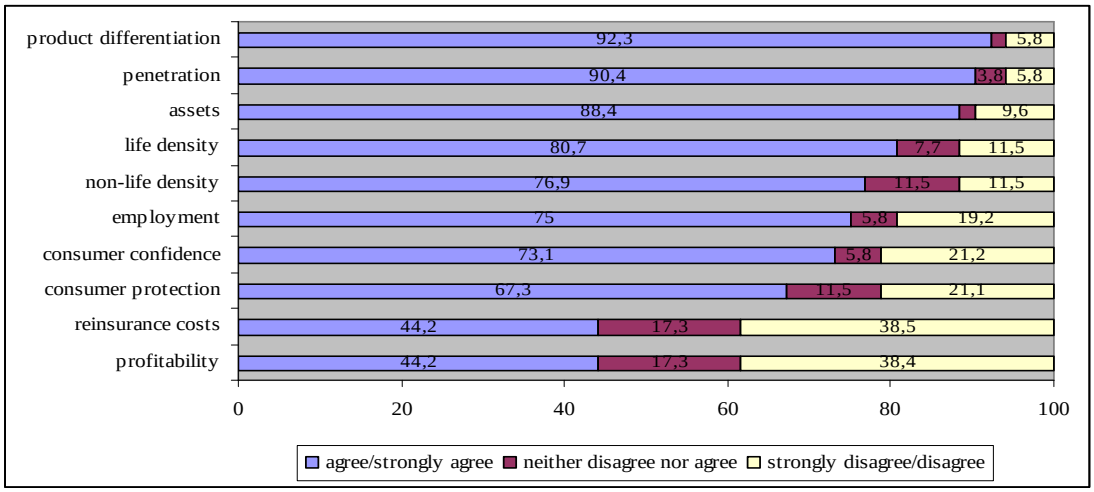
The respondents predict both positive and negative consequences for Turkish insurance market when Turkey becomes member of the EU. However, expected benefits seem to dominate expected costs. Graph 83 demonstrates the expectations on the benefits of the EU membership of Turkey for the Turkish insurance market. Participants are predominantly positive about the benefits of the membership of Turkey to the EU.

A great majority foresee an increase in life insurance density (80%), in non-life insurance density (77%) and in insurance penetration (90%). As a result of the expected increase in the volume of premiums, they also predict an increase in the assets of the companies (88%) and in employment (75%).

Although an increase in premium production is foreseen by the majority of the respondents, the increase in profitability is expected only by 44% of the respondents. The results can be interpreted as excessive price competition is expected to continue. Moreover, the decrease in reinsurance costs is not an expected result of the membership. Thus, increase in profitability is not foreseen by the majority of the respondents. The predictions on profitability are in line with the expectations of the EU insurers that were surveyed before the establishment of the single insurance market in 1994. The survey carried out by the Institute of Insurance Studies at Cologne University in conjunction with the Geneva Association in 1994 to investigate the expectations of the EU insurers on the European single insurance market revealed that 56% of the insurers anticipate decreasing profits in their countries of origin as a result of the increase in competition (Weidenfeld, 1996, p.88).

A clear majority of the respondents expect an increase in product differentiation in the sector (92%) as a result of the membership of Turkey to the EU. Further liberalization as well as alignment with Solvency 2 requirements would enable the insurers to provide innovative products. In addition, new market entries in Turkish insurance market as a result of the EU membership of Turkey would also lead to product differentiation.

Furthermore, after membership of Turkey to the EU, in other words after full alignment of Turkish insurance market with the EU insurance *acquis*, the sector anticipates higher consumer protection (67%) and higher consumer confidence (73%). Higher consumer protection will naturally give rise to higher consumer confidence. However, since supervision of the insurers is considered to be harmonized with the EU rules, the reasons of the expected increase in consumer protection should be further analyzed. One reason may be the upcoming of the new solvency requirements which consist of risk-based capital requirement calculations and new rules on corporate governance and market discipline. Another reason may be the predicted increases in the assets and shareholders' equity of the companies that would make their financial structure stronger.

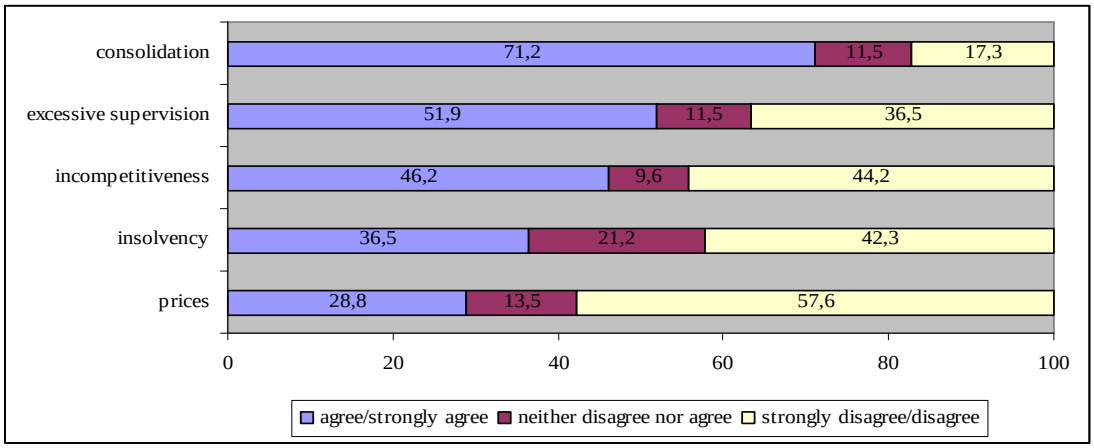


Graph 83: Expectations on the Benefits of the EU Membership of Turkey for the Turkish Insurance Market (%)

Source: own Graph based on the results of the survey

Graph 84 demonstrates the expectations on the costs of the EU membership of Turkey for the Turkish insurance market. Consolidation is the most important concern of the sector (71%). In contradiction to this concern, only 46% of the respondents think that the Turkish insurance market will be faced with competition problems. Therefore, an important number of respondents attribute the reason of consolidation to other reasons than competition problems. Only 36% of the respondents anticipate insolvency problems in Turkish insurance market as a result of the EU membership of Turkey. Therefore, liquidation in the sector is not predicted by the majority of the respondents. However, EEA insurers were anticipating liquidation in the European insurance market as a result of third insurance directives, and thus higher level of concentration in the market (Weidenfeld, 1996, p.88).

On the other hand, the majority of the respondents do not suppose any decrease in the price of insurance products (58%) to the benefit of the consumers. They do not expect any reduction in prices since they largely believe that the prices are already considerably low due to excessive competition between the insurers.



Graph 84: Expectations on the Costs of the EU Membership of Turkey for the Turkish Insurance Market (%)

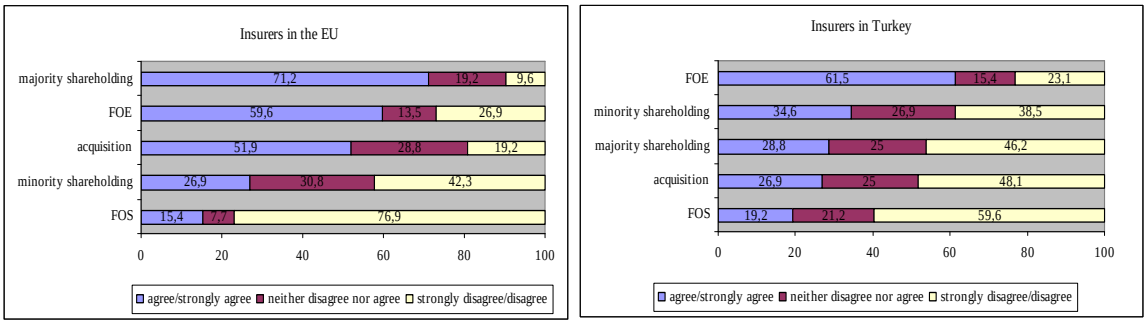
Source: own Graph based on the results of the survey

Graph 85 illustrates the expected market entry strategies of the EU insurers to the Turkish insurance market and of the Turkish insurers to the insurance markets of the EU Member States after the membership of Turkey to the EU. When Turkey becomes member of the EU, freedom of services is not expected to be used neither by the insurers in Turkey (60%) nor by the EU insurers (77%).

However, the respondents are optimistic about the use of FOE both by the insurers established in Turkey (62%) and in the EU (60%). The prospect for the success of FOE is thus estimated as considerably higher than the prospect for the success of FOS. These results are in line with the expectations of the EU insurers surveyed before the establishment of the single insurance market in 1994. Weidenfeld (1996, p. 85) reports that 52% of the EU insurers was expecting an increase in the number of the EEA branches operating in their countries of origin as a result of third insurance directives and concludes that the internal insurance market would be effective not so much throughout Europe but rather between neighboring countries.

Majority of the respondents predict that Turkish insurers would be acquired by the EU insurers while partnership through acquisition of minority shareholding is not a predicted result. However, M&A in Turkish insurance market, especially by the EU insurers, is already a given fact since 2006. Therefore, the process of M&A in Turkish insurance market is not directly related to the EU membership of Turkey.

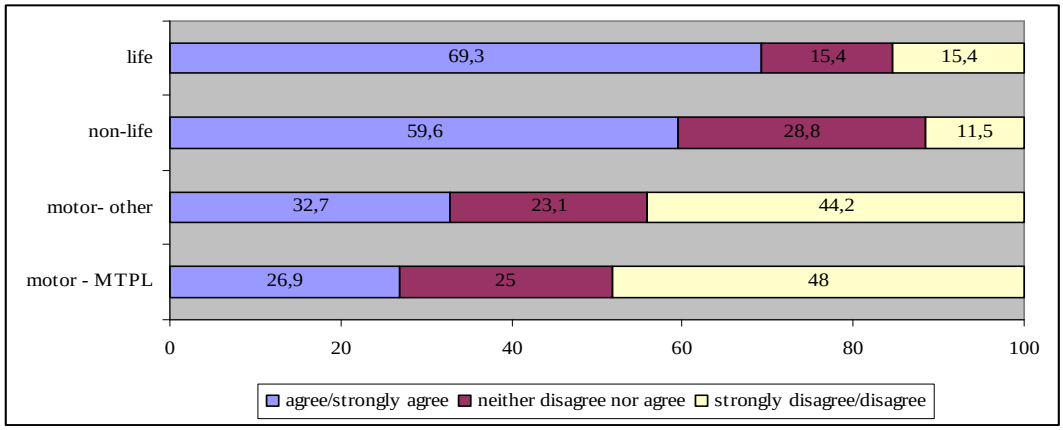
On the other hand, the participants are also surveyed about their expectations on the acquisition of the EU insurers by the insurers in Turkey. Acquisition of the majority shareholding or minority shareholding of the EU insurers is not an anticipated result of the EU membership of Turkey. Taking into account the size of the insurers in Turkey, this is not a surprising anticipation.



Graph 85: Expectations on Market Entry Strategies of the Insurers (%)
Source: own Graph based on the results of the survey

Expectations on the likelihood of different lines of business in which the EU insurers would intend to operate in Turkey are reported in Graph 86. Respondents believe that the EU insurers would operate mostly in life insurance market in Turkey (69%). The underlying assumption behind this expectation would be that life insurance market in Turkey has a big growth potential and thus would attract foreign players from the EU.

Respondents from life insurers mostly preferred not to give any predictions on non-life insurance market. Those who gave a response suppose that the EU insurers would also penetrate into non-life insurance market in Turkey. However, interestingly enough, the majority of the respondents do not suppose a penetration into motor insurance market (neither MTPL nor casco) which is the biggest insurance market in Turkey. Motor insurance market is not profitable and due to high price competition, insurers bear large losses in this line of business. Therefore, foreign entries are expected in more profitable lines of business since growth potential and profitability are the main motivations behind foreign entries. Non-traditional non-life branches such as liability (other than MTPL), financial losses and legal protection would thus be more attractive to the EU insurers.

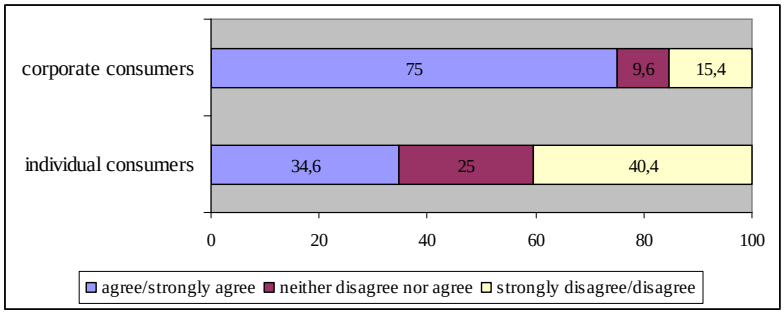


Graph 86: Expectations on Lines of Business in which the EU Insurers Would Operate in Turkey (%)

Source: own Graph based on the results of the survey

Graph 87 demonstrates the expectations on type of consumers who would buy insurance products directly from the insurers established in the EU. It is not expected that individual consumers in Turkey would buy insurance products from the insurers that are not established in Turkey. Therefore, it would not be meaningful to expect that the EU insurers would be able to directly sell their products to Turkish consumers through FOS.

However, the majority of the respondents (75%) predict that corporate consumers would prefer to benefit from FOS when Turkish insurance market becomes part of the European single insurance market. The predictions are in line with the current situation in the EU where cross-border business through FOS in wholesale insurance market is higher compared to retail insurance market.



Graph 87: Expectations on Type of Consumers Benefiting From FOS (%)

Source: own Graph based on the results of the survey

5. CONCLUSION

The legislative framework for the creation of a single insurance market in Europe is gradually achieved by three generations of life and non-life insurance directives. The first set of EU insurance directives in 1970s ensured FOE but the supervision of foreign branches remained in the hands of the authorities of the host Member States. Second generation directives in 1980s ensured FOS for large commercial and industrial risks in non-life market and for policyholders who took the first step to buy the policy in life market. However, neither mass risks of private consumers in non-life market nor the consumers who did not take the first step in buying the policy in life market were subject to FOS. Finally, third generation directives in 1994 established FOS for all types of risk. In line with the Anglo Saxon model, third generation directives totally liberalized the insurance market and established minimum harmonization and mutual recognition of the rules, home country control and single license principle with the aim of creating a single market in insurance services.

Therefore, the creation of the European single insurance market that is now made up of 30 countries of the EEA and that is the biggest insurance market in the world was completed in 1994 with third generation of insurance directives. Consumers and re/insurers situated in any one of the Member States are now completely free to operate throughout the EU, either through FOE or through FOS under the same conditions with local companies and consumers.

This thesis analyzes the level of integration of the European single insurance market. However, assessing the integration level of the single market is a more difficult task than assessing the integration level of the other financial markets due to specific features of the insurance. In this thesis, the main method used to determine the level of integration is the analysis of the extent of the use of FOS and FOE in the European single insurance market.

Regarding the legislative harmonization which is the prerequisite of the integration, it is found that while late and/or wrong transposition and wrong

implementation of directives persist, the EU insurance legislation is almost completed in creating FOS and FOE through three generation of insurance directives. Since there is no more discrimination between foreign and domestic market players, it is generally accepted that from the legislative point of view, the EU insurance markets, together with those of Liechtenstein, Norway and Iceland, became a single insurance market since the entry into force of the third generation of life and non-life insurance directives in 1994. However, while the aim of the insurance regulation at the EU level has been to create a framework for an integrated insurance market, deregulation has not led to considerable expansion in cross-border insurance trade but has rather led to an unprecedented wave of M&As.

While legislative harmonization is the prerequisite of the integration, it does not prove the (non)existence of the integration in practice. Therefore, this study further analyzes price-based and quantity-based measures to determine the level of integration of the European insurance markets.

Price-based measurement of integration is generally accepted as the best method for assessing the integration of financial markets. Integration theory explains that financial markets are integrated when the law of one price holds. The law of one price can only be analyzed when products are homogeneous and comprehensive and high quality price data exist. In this context, the law of one price is not applicable to insurance products mainly for two reasons. First, it is difficult to find identical insurance products in order to compare their prices since insurance is a complex and multi-product business. The products bearing the same name may provide very different covers. Since these products are not identical in practice, their price would differ. Second, although identical insurance products may be found, their prices are not expected to be the same even in totally integrated markets. Price disparities in insurance business are not affected by the level of integration but by country and consumer-specific diversities. For instance, country and consumer-specific diversities such as drivers experience, road safety, traffic conditions, vehicle repair and medical care prices and fraud levels affect claims frequency and average claim cost which are the two key determinants of the prices in traffic insurance policies.

Therefore, since simple price comparison is not meaningful and is not a useful guide to the degree of the integration of insurance markets, quantity-based indicators are examined to track the integration level of the European single insurance market. First of all, convergence of market indicators is analyzed. Literature reveals that the creation of a single insurance market where there are no market entry barriers may significantly improve the desirability of the markets with less concentration, high profitability, high insurance density and high insurance penetration as host country markets for foreign insurers. Therefore, the integration of the insurance markets would depend on the market indicators of the Member States rather than the establishment of the single insurance market itself. This thesis examines the convergence of insurance density, insurance penetration, lines of business, distribution channels, as well as size, investments, competitive power, efficiency and productivity of the insurers in the European single insurance market. It concludes that the insurance markets of the EU Member States do not converge.

Size of the insurance markets varies considerably between Member States. The analysis of insurance density which is a better sign of convergence since it eliminates the country-size effect reveals that life and non-life insurance densities differ significantly between Member States. The importance of the insurance sector in the national economies varies also between Member States since insurance penetration of the individual Member States largely deviates from the EEA average.

Insurance markets are dominated by different lines of business and product differentiation still persists between the markets of different Member States. There is no comovement and any shocks which affect one of those lines of business have different impacts in Member States.

While average size of life companies in terms of premium production is larger than the size of non-life companies, size of the insurers differ from one Member State to another. Size of the insurers is in line with the market size of their home Member State. Since companies do not use cross-border selling opportunities, their size is restrained by the size of their national insurance market.

The ratio of investments of the insurers to GDP shows large disparities between Member States and variation of allocation of the insurers' investments between Member States is still substantial. Therefore, market shocks will be asymmetric in the European single insurance market and there is no mechanism to balance and compensate such asymmetric shocks.

The competitive power of the insurers in one Member State differs largely from the competitive power of those established in another Member State since their solvency ratio and size in terms of premium production, amount of asset and amount of capital are not identical.

The efficiency of the insurers in one Member State differs largely from the efficiency of the insurers in another Member State since cost ratio of non-life business and profitability of the insurers captured by combined ratio and rate of return are not identical.

The productivity of the insurers in one Member State differs largely from the productivity of the insurers in another Member State since total premium production to total number of persons employed is not identical.

The use of agencies, brokers or banks as the main type of distribution channel in both life and non-life business varies greatly between Member States. The differences in the distribution systems between individual Member States make the market entry through FOS or FOE difficult and costly.

For the purpose of this thesis, integration is defined as the use of FOS and FOE in order to penetrate into foreign insurance markets. Therefore, market indicators may well give an incomplete picture of integration. As a result, market share of foreign insurers in domestic markets, i.e. the share of the EEA insurers operating in the other Member States is analyzed as the main integration indicator. For the calculation of this indicator, three different kinds of foreign presence are taken into account. First, foreign presence through direct cross-border sales without physical establishment is examined. Second, foreign presence through locally established branches and agencies is analyzed.

Foreign branches are subdivided into EEA and non-EEA branches in order to capture the shares of EEA and non-EEA insurers separately. The domination of these two types of foreign presence would show the existence of an integrated insurance market where companies operate in several Member States through either FOS or FOE. Third, foreign presence through merger with or acquisition of domestic insurers is investigated. M&A activities in the EEA are subdivided into domestic and cross-border activities in order to capture the Europeanization of the insurers. On the contrary of the first two types, the domination of this type of foreign presence would indicate the existence of separate national markets where few large insurance groups operate on European-wide basis.

The analysis of the use of FOS and FOE reveals that neither life nor non-life insurance market in Europe is integrated. In general, the level of integration in life insurance market is even less advanced than the level of integration in non-life insurance market.

Cross-border activities through FOS are restricted. FOS is used temporarily by large European insurance groups before establishing in the other EEA insurance markets and the ultimate aim is physical establishment in the Member State where they wish to operate. Premium production through FOS is relatively high only in four small Member States, namely Luxembourg, Malta, Liechtenstein and Ireland. The use of FOS in life business is higher than in non-life business. Cross-border insurance is used for large commercial and industrial risks in wholesale insurance markets in the form of pure or own-initiative cross-border insurance. The volume of cross-border retail business is negligible. It mostly concerns people living in border areas and expatriates in the form of consumption-abroad cross-border insurance.

Cross-border activities through FOE are also restricted in the European single insurance market. The number of EEA branches is far from its potential and they are very often set up in neighboring countries. The share of branches in terms of premiums is smaller compared to their share in terms of absolute number. Therefore, these are small establishments. On the other hand, the share of FOE has an increasing trend since the establishment of the European single insurance market. However, the share of non-EEA branches is still as important as the share of EEA branches. Although the establishment

of branches for EEA insurers benefiting from the single license principle is easier, less costly and does not require host country supervision, the share of non-EEA branches which are under the supervision of host countries is almost at the same level with the share of EEA branches. Furthermore, in contrast to the results related to FOS, the use of FOE in non-life business is higher than in life business. Branching is less important in big Member States with high premium production than small Member States with lower premium production. The share of premiums written by EEA branches is relatively higher in the non-life markets of Liechtenstein, Norway, Malta and Belgium and in the life markets of Liechtenstein and Latvia. Furthermore, branching is smaller in retail business than in wholesale business.

This thesis concludes that the preferred method of foreign market entry in the EEA is physical establishment in the host Member State since local customers are likely to be suspicious of a foreign insurer which does not have a local office. The physical establishment is not done through FOE since foreign insurers normally lack the experience to cope with a different insurance contract law and the understanding of local market conditions and preferences. Therefore, the establishment of a subsidiary, preferably through the acquisition or take-over of a majority shareholding of a local insurer is preferred since it has the advantage of gaining the necessary know-how about the domestic market conditions and consumer preferences as well as the access to local distribution channels.

Foreign presence increased in the European single insurance market since 1997 mainly due to the increase in the market share of foreign controlled insurers. Therefore, acquisition of local insurers is still the dominant strategy of the EEA insurers to access the other EEA insurance markets, rather than setting up new structures and new teams in those markets. Therefore, the European single insurance market is a market where customers are confined to their national markets and which is dominated by a few large European insurance groups. The increase in European insurance groups is not purely the result of the creation of the European single insurance market since single market principles are not the prerequisites of the establishment of foreign subsidiaries which are subject to the supervision of the Member State in which they are established.

This thesis contributes also to a better understanding of the obstacles to the European insurance market integration and summarizes the solutions to eliminate these obstacles. The fragmented nature of the European single insurance market is the result of a number of regulatory obstacles such as differences in regulation and supervision, contract law, general good principle, tax treatment and product definitions and natural obstacles such as differences in distribution channels, policyholder confidence and language.

Whereas insurance legislation is harmonized to a great extent, establishment process in the other Member States is a long process to complete. Therefore, the length of the process should be decreased. Moreover, whereas home country control principle prevents companies to face with several supervisory practices, in such a system, an insurer based in a Member State with a relatively liberal supervisory system has a potential advantage over domestic companies in another Member State that has a tighter supervisory system. Therefore, further harmonization of supervisory systems is required.

Insurance contract law which determines the policy conditions, thus the shape of the products, has not yet harmonized. Therefore, products should meet the different specific legal requirements of each Member State. Contract law should be harmonized throughout the EU in order to simplify cross-border operations and reduce the costs.

General good principle which may prevent cross-border operations of the insurers should be clearly defined. Since the term is not clearly defined, it creates free interpretation possibility for Member States which may use it as an instrument of protectionism against foreign competition to the detriment of the single market.

Insurance premium tax is not harmonized either. Tax rate is not the rate of the Member State where the insurer has its head office, but it is the rate of the Member State where the risk is located. Although this rule leads foreign insurers to compete on an equal basis with domestic insurers, it made it difficult for companies to operate throughout the single market since insurers have to comply with the differing tax rules and rates of each Member State.

Differentiation in the definitions and classifications of the same insurance products in different Member States creates lack of transparency of products for consumers. Pan-European products on an EU-wide scale should thus be designed without having to change the product terms to meet the local rules.

Differences in insurance distribution channels also prevent further integration since they may increase the costs for foreign insurers. The use of FOE is expensive and time consuming since foreign insurers should establish their own agency network or work with already established local agents. One potential response would be the use of direct selling, especially through e-commerce, which would facilitate cross-border sales of insurance products. However, the use of e-commerce is still minimal in most of the Member States. In addition, direct cross-border selling in the Member States where customers prefer agents and brokers to benefit from proximity would be difficult.

Furthermore, foreign insurers may overcome natural obstacles such as policyholder confidence and preferences by better informing the policyholders, designing tailor made products, converging consumer protection rules and establishing fast and effective out-of-court systems. However, these measures indispensably increase the cost of operating in foreign markets. The increase in direct selling through e-commerce would decrease transaction and information costs of the insurers.

Insurance markets of the EEA Member States are still far from being integrated markets. This thesis claims also that Turkey, a candidate country to the EU, harmonized its insurance legislation with the EU insurance legislation to a great extent during its harmonization process with the EU.

Following the entry into force of the new Insurance Law in 2007 and the introduction of a great number of comprehensive secondary legislation enacted between 2007 and 2010, Turkish insurance legislation has been aligned with the EU insurance *acquis* to a great extent. Since Turkey is not a member of the EEA, Turkish insurance market is not part of the European single insurance market and thus there is no freedom of establishment or freedom of services between the EEA Member States and Turkey. However, important parts of the EU insurance *acquis* have already been included in the

Turkish legislation. Since 2007, Turkey Regular Reports prepared by the European Commission state that the alignment with the *acquis* is partial in insurance services. The wording “partial” has a stronger meaning than the wording “limited” that is used by the European Commission for parts of the legislation that are not sufficiently aligned with the EU *acquis*. Full alignment of the insurance services would indeed be achieved only on the date of the EU membership.

Licensing requirements for the insurers such as obtaining license for each branch, presentation of a business plan, showing evidence of compliance with the system of governance, holding adequate own funds, fit and proper criteria for founders and managers and taking-up capital for each branch are in line with the EU *acquis*. In addition, licensing requirements for the insurance intermediaries such as registration, professional and educational requirements, possessing professional indemnity cover and having adequate financial capacity are also in line with the EU *acquis*.

Furthermore, prohibition of the establishment of new composite insurers, classification of life and non-life insurance branches, calculation of technical reserves, the rules on the assets covering the technical reserves, content of financial statements, auditing of the financial statements by independent audit firms, financial reporting standards, calculation of capital requirements, supervisory requirements, criteria of financial weakness, rules on better policyholder protection, compensation of personal injuries in case of non identification of the insured for all types of compulsory insurances, out of court settlement of disputes between policyholders and insurers are found to be largely in line with the EU *acquis*.

There is no discrimination between domestic and foreign insurance companies and branches in their taking up and pursuit of insurance and reinsurance business in Turkey. Foreign agents operating in Turkey are also subject to the same rules required for insurance agents established in Turkey. Furthermore, there is no reinsurance monopoly. If they are located in Turkey, insurable interests of the residents of Turkey have to be insured by the insurers operating in Turkey. On the accession date of Turkey to the EU, cross-border sales of all types of insurance policies by the EEA based insurers should be allowed.

On the other hand, prior approval of general conditions, lack of liberal tariff system in compulsory insurances, deposit system in life insurers, mandatory membership to TSRSB which is a professional organization of the insurance business in Turkey, lack of compensation of damages to property in case of non identification of the insured for all types of compulsory insurances and minimum cover limits in MTPL insurance are found to be in contradiction with the EU insurance *acquis* and thus should be further harmonized. In addition, specific rules on reinsurance and insurance groups should be adopted. However, the harmonization process should not be a simple copy and paste process but it should rather takes into account the local specificities of the Turkish insurance market during the transposition of the related insurance directives. To this end, harmonization should be gradual and transitional periods should be envisaged even after the EU membership for sensitive areas, such as cover in traffic insurance and further liberalization in compulsory insurances, where a rapid and outright harmonization can be harmful for the market.

Integration of the Turkish insurance market to the European single insurance market would at the end depend on consumers' preferences and on further market convergence. This thesis examines the convergence of insurance density, insurance penetration, lines of business, distribution channels, as well as size, investments, competitive power, efficiency and productivity of insurers in the European single insurance market and Turkey and concludes that European single insurance market and Turkey do not converge. Therefore, as of today, integration between the two markets does not seem possible in case of the EU membership of Turkey.

Size of the insurance markets varies considerably between the EEA and Turkey. Life and non-life insurance density and penetration in Turkey deviate largely from the EEA average. European single insurance market is dominated by life insurance products whereas the Turkish insurance market is largely dominated by non-life insurance products. Traditional insurance products dominate the Turkish non-life insurance market. Furthermore, most of the life insurance products which are widespread in the EEA insurance markets do not exist in Turkish insurance market. Therefore, Turkish life and

non-life insurance markets do not comove with most of the already fragmented EEA insurance markets.

Premium production of the insurers established in Turkey is smaller than the European insurance groups. While the average size of life insurers in Turkey is well behind the EEA average, the average size of non-life insurers operating in Turkish insurance market is above the EEA average due to high number of small monoliners which operate in only one specific insurance branch in the EEA.

The ratio of investments of the insurers to GDP shows also large disparities between the EEA and Turkey. With most of the investments allocated to fixed-income securities and deposits, the allocation of insurers' investments in Turkey is more conservative than the investments of the EEA insurers.

The competitive power of Turkish insurers is found to be considerably smaller than the EEA insurers since their size in terms of premium production, amount of asset and amount of capital are not comparable to the EEA average.

Whereas the cost ratio in Turkish insurance market is similar to the EEA cost ratio, divergent combined ratios suggest the existence of efficiency divergences between the insurers in the EEA and Turkey. Labor productivity in the insurance business also varies greatly between the EEA and Turkey.

Furthermore, as in the case of the European single insurance market, differences in distribution systems between the EEA Member States and Turkey would make the market entry in Turkey through FOS or FOE difficult and costly.

However, foreign insurers widely operate in Turkish life and non-life insurance markets but non-life insurance market is slightly more open than life insurance market. Share of foreign insurers has been increasing not only in terms of number but also in terms of capital and premium production since 2005 and reached around half of the market in 2009. Whereas opening of the EU membership negotiations in 2005 has an effect on the acceleration of foreign penetration into the Turkish insurance market, at micro-level growth potential and profitability opportunities and at macro-level young

population, macro-economic results and political stability are the main motivations behind this acceleration. However, increasing involvement of foreign insurers in Turkish insurance market did not result in higher product differentiation, more effective risk management and further equity capital in terms of quality and quantity. In contrast, it did result in excessive price competition. Thus, profitability of the companies has been considerably deteriorated.

Whereas the insurers operating in Turkey are not benefiting from FOS and FOE, majority of the foreign insurers operating in the Turkish insurance market are EEA-based insurers which are established in Turkey through M&A. It reflects the fact that the EU insurers are widely operating in the Turkish insurance market without feeling the need to wait for the membership of Turkey to the EU. However, the level of integration between the Turkish insurance market and the European single insurance market after the membership of Turkey to the EU cannot be quantified since there has not yet been FOS or FOE between the two markets.

Therefore, expectations of the managers in the Turkish insurance sector on the level of integration as well as their perceptions and expectations on the arguments and claims presented in this thesis are investigated by a survey covered 52 managers from 33 different companies. Whereas harmonization in licensing requirements, tariff liberalization and MTPL insurance are predicted to be incomplete, Turkish insurance sector believes that Turkish insurance legislation is harmonized with the EU insurance legislation. The perception of the sector is in line with the findings of this study that although there are still areas to be further harmonized, Turkish insurance legislation is harmonized with the EU insurance *acquis* to a great extent. However, there is not a widespread assumption in the sector that the harmonization process is the main motivation behind the foreign penetration into the Turkish insurance market.

Turkish insurance sector believes that the membership of Turkey to the EU would be beneficial for the Turkish insurance market. Non-life insurers predict higher benefits than life insurers and foreign insurers predict higher benefits than domestic insurers. Increase in penetration, density, product differentiation, consumer protection and consumer confidence are predicted by the insurance sector. However, neither

increases in profitability nor reductions in prices are anticipated results of the EU membership of Turkey. The sector believes that Turkish insurance market would not be faced with competition and insolvency problems. On the other hand, further consolidation is their most important concern.

Turkish insurance sector believes that the EU membership of Turkey would not result in the integration of the insurance markets. However, foreign insurers have a relatively stronger belief in the realization of the integration. While FOS is only expected to be used in wholesale insurance market, Turkish insurance sector is relatively more optimistic about the use of FOE. However, the opinion of the sector is that M&A will not be replaced by FOS and FOE, but will continue to be the dominant foreign market entry strategy even after the accession of Turkey to the EU.

Therefore, taking into account the market indicators of the Turkish insurance sector, harmonization process should be gradual, should consider the specificities of the Turkish insurance market and should not be harmful for the insurers and policyholders. The priority should thus be the proper implementation of the existing insurance legislation by all market players rather than to impose new and rigid regulatory requirements with the aim of further harmonization.

On the other hand, in world insurance market, many major initiatives which would affect also the Turkish insurance market are coming at once. Among them, the EU Solvency 2 Directive and the new financial reporting standards (IFRS 4 phase 2) will be especially important for the Turkish insurance market which shall implement them sooner or later. The volume and complexity of these forthcoming regulations may impose heavy cost and distraction on the insurance companies and may complicate business planning. Therefore, the impact of these regulatory initiatives on the Turkish insurance market deserves special attention in future academic papers.

APPENDIX 1

SURVEY ON PERCEPTIONS AND EXPECTATIONS ABOUT THE INTEGRATION OF THE TURKISH INSURANCE MARKET WITH THE EUROPEAN SINGLE INSURANCE MARKET

I. Indicate your agreement with the following statements concerning the level of harmonization of the Turkish insurance market with the European single insurance market:

	totally disagree	disagree	neither disagree nor agree	agree	totally agree
1. Turkish insurance legislation has been aligned with the EU insurance legislation to a great extent.					
2. The main difference between the two markets is not the difference of legislation but the difference of mentality.					
3. Insurers established in Turkey is not as free as the EU insurers in pricing of the insurance products.					
4. Many of the insurance products that exist in the EU do not exist in the Turkish insurance market.					
5. The establishment process of the insurers in Turkey does not differ from the establishment process in the EU.					
6. Turkish insurance market is now closely supervised as the EU insurance market.					
7. During the harmonization process, workload in the Turkish insurance market has increased.					
8. In order to harmonize with the EU insurance acquis, legislation on technical provisions has been changed.					
9. Reporting requirements during the harmonization process have increased.					
10. Financial statements are now prepared in line with the EU criteria.					
11. Solvency requirements are in line with the EU solvency legislation.					
12. Due to harmonization process, insurers established in Turkey had to increase their capital.					
13. EU rules on traffic insurance are also implemented in Turkish insurance market to a large extent.					
14. Requirements for insurance intermediaries have increased during the harmonization process.					
15. During the last years, life insurance rules in Turkey have become closer to that of the EU.					
16. The way of doing business in Turkish insurance market is still far from that of the EU insurers.					
17. During the harmonization process, organizational structure of the insurers has significantly changed.					
18. During the harmonization process, internal systems in the insurers established in Turkey have become more important.					
19. With the increase in the harmonization, EU insurers have started to operate more and more in Turkish insurance market.					

II. Indicate your agreement with the following statements concerning the Turkish insurance market after the membership of Turkey to the EU:

	totally disagree	disagree	neither disagree nor agree	agree	totally agree
1. When Turkey becomes member of the EU, **profitability of the insurers increases.**					
2. When Turkey becomes member of the EU, **assets of the insurers increase.**					
3. When Turkey becomes member of the EU, **the share of the insurance in the economy increases.**					
4. When Turkey becomes member of the EU, **life insurance density increases.**					
5. When Turkey becomes member of the EU, **non-life insurance density increases.**					
6. When Turkey becomes member of the EU, **the price of insurance products decreases.**					
7. When Turkey becomes member of the EU, **product differentiation increases.**					
8. When Turkey becomes member of the EU, **compulsory insurances increase.**					
9. When Turkey becomes member of the EU, **policyholder protection increases.**					
10. When Turkey becomes member of the EU, **mergers and acquistions in the insurance sector increase.**					
11. When Turkey becomes member of the EU, **supervisory requirements increase.**					
12. When Turkey becomes member of the EU, **insolvency in the insurers increases.**					
13. When Turkey becomes member of the EU, **Turkish insurers have competitive problems.**					
14. When Turkey becomes member of the EU, **employment in the insurance sector increases.**					
15. When Turkey becomes member of the EU, **income of the employers in the insurance sector increases.**					
16. When Turkey becomes member of the EU, **reinsurance costs decrease.**					
17. When Turkey becomes member of the EU, **trust of the citizens in the insurance sector increases.**					
18. When Turkey becomes member of the EU, **number of policyholders increases.**					
19. When Turkey becomes member of the EU, **share of foreigners in the insurance sector increases.**					
20. When Turkey becomes member of the EU, **corporate governance becomes more important.**					
21. When Turkey becomes member of the EU, **the costs in the sector increase.**					
22. When Turkey becomes member of the EU, **policyholders take into account not only the price but also the coverage of the insurance products.**					

III. Indicate your agreement with the following statements concerning the level of integration of the Turkish insurance market with the European single insurance market:

	totally disagree	disagree	neither disagree nor agree	agree	totally agree
If Turkey becomes an EU member tomorrow, EU insurers would operate in Turkey by:					
1. direct selling from their home countries without establishing in Turkey					
2. opening a branch in Turkey as they do not have to have a license from Turkish authorities					
3. acquiring a Turkish insurer					
4. acquiring a majority shareholding of a Turkish insurer					
5. acquiring a minority shareholding of a Turkish insurer					
If Turkey becomes an EU member tomorrow, Turkish insurers would operate in the EU by:					
6. direct selling from Turkey without establishing in the EU Member State where they wish to operate					
7. opening a branch in an EU Member State as they do not have to have a license from the authorities of that State					
8. acquiring an EU insurer					
9. acquiring a majority shareholding of an EU insurer					
10. acquiring a minority shareholding of an EU insurer					
11. If Turkey becomes an EU member tomorrow, EU insurers would operate more in Turkish **life** insurance market.					
12. If Turkey becomes an EU member tomorrow, EU insurers would operate more in Turkish **non-life** insurance market.					
13. If Turkey becomes an EU member tomorrow, EU insurers would operate more in Turkish **traffic** insurance market.					
14. If Turkey becomes an EU member tomorrow, EU insurers would operate more in Turkish **casco** insurance market.					
15.If Turkey becomes an EU member tomorrow, **individual customers** would buy insurance products from the insurers established in the EU Member States					
16. If Turkey becomes an EU member tomorrow, **corporate customers** would buy insurance products from the insurers established in the EU Member States					

APPENDIX 2

List of Participants to the Survey

Acıbadem Sağlık ve Hayat Sigorta
Aegon Emeklilik ve Hayat
Aksigorta
Allianz Sigorta
Allianz Hayat ve Emeklilik
Anadolu Sigorta
Anadolu Hayat ve Emeklilik
Ankara Sigorta
Aviva Sigorta
AvivaSa Emeklilik ve Hayat
Axa Sigorta
Deniz Emeklilik ve Hayat
Ergo Sigorta
FİBA Sigorta
Finans Emeklilik ve Hayat
Fortis Emeklilik ve Hayat
Garanti Emeklilik ve Hayat
Groupama Sigorta
Genworth Financial
Güneş Sigorta
Halk Sigorta
Hür Sigorta
Liberty Sigorta
Mapfre Genel Sigorta
Mapfre Genel Yaşam Sigorta
Milli Reasürans
Neova Sigorta
Ray Sigorta
TSEV
TSRSB
Yapı Kredi Emeklilik
Ziraat Sigorta
Ziraat Emeklilik
Zurich Sigorta

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