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MARMARA ÜNİVERSİTESİ
AVRUPA TOPLULUĞU ENSTİTÜSÜ
AVRUPA BİRLİĞİ İKTİSADI ANABİLİM DALI**

**INSURANCE REGULATION AND SUPERVISION IN TURKEY
AND THE EUROPEAN UNION**

YÜKSEK LİSANS TEZİ

Burak DELİGÖZ

İstanbul - 2006

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Danışman: Doç. Dr. Murat ÇOKGEZEN

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ABSTRACT

Insurance regulation and supervision has been a hot topic for last decades throughout the world. New laws and regulations have been adopted, the coverage of the supervision has been extended and new supervisory systems have been structured. In parallel with rest of the world, there are considerable developments in this area in both the European Union (EU) and as a prospective EU Member State, in Turkey. This study is aimed to examine insurance regulation and supervision generally and also these recent developments considering Turkey's ongoing EU accession process. In the first part of this study theoretical basis of generally financial and specifically insurance regulation and supervision is summarised. Then, historical evolutions and current situations of insurance regulation and supervision in the EU and Turkey are presented. Moreover, emphasis is given to recent developments in both sides. The last part of the study is an evaluation of regulatory and supervisory harmonization of Turkey to the EU in the field of insurance.

ÖZET

Son yıllarda sigortacılıkta düzenleme ve denetleme konusu tüm dünyada sektör gündeminin ön sıralarında yer almaktadır. Yeni düzenlemelerin yasalaşması, denetim kapsamının genişletilmesi ve yeni denetim sistemlerinin geliştirilmesi de bu artan ilginin somut göstergeleri haline gelmektedir. Dünya çapındaki gelişmelere paralel olarak Avrupa Birliği'nde ve tam üyeliğe aday bir ülke olarak Türkiye'de de bu konuda dikkate değer gelişmeler yaşanmaktadır. Bu çalışmada, Türkiye'nin katılım sürecini de göz önünde tutarak sigortacılıkta düzenleme ve denetleme ve bu konudaki güncel gelişmeler incelenmektedir. Çalışmanın ilk bölümünde finans ve özel olarak sigorta sektöründe düzenleme ve denetlemenin teorik temeli özetlenmektedir. Daha sonra, Avrupa Birliği ve Türkiye'de konunun tarihsel gelişimi ve mevcut durumu verilmektedir. Her iki tarafta yaşanan güncel gelişmelere de ayrı bölümler ayrılmıştır. Son bölümde ise Türkiye'nin sigortacılık düzenleme ve denetiminde Avrupa Birliği ile uyumu değerlendirilmektedir.

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LIST of ABBREVIATIONS

CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
EIOPC	European Insurance and Occupational Pensions Committee
EU	European Union
ibid	ibidem
IASB	International Accounting Standards Board
IAA	International Actuarial Association
IAIS	International Association of Insurance Supervisors
IFRS	International Financial Reporting Standards
MCR	Minimum Capital Requirement
p	page
pp	pages
SCR	Solvency Capital Requirement
TSRSB	Association of Insurance and Reinsurance Companies of Turkey

I. INTRODUCTION

Insurance briefly means a compensation mechanism in cases of unexpected events for policyholders, the insured or the beneficiaries, for some amount of premium paid in advance. Therefore, it is a very important tool for managing risks and avoiding wealth loss, including labour, commodity and capital in today's more fragile and harsh market conditions. It has become one of the main pillars of financial markets in the world.

As being the place of origin and the world's biggest market with 34,4% premium share in 2004, the European Union (EU) is a centre of insurance. The importance of insurance in European economy can be seen in figures. As of the year 2004, total insurance premiums (which is € 866.798 million) constitutes 8,5% of total GDP of 25 Member States. Average premium per capita reaches to € 1.897. The sector comprises of 4933 companies operating in the market with 942.044 employees. Moreover, in Europe insurance plays an important role for directing created funds into other sectors of economy as investment. Insurance companies' investments have a share of 53,4% in total investments.

When compared to the European Union, insurance market in Turkey constitutes a small part of the economy. According to 2004 data, total insurance premium income in Turkey is € 3.725 million and average premium per capita is approximately € 55. On the other hand, 53 companies operate in Turkish insurance market with 12.140 employees.¹ Mostly, the major reasons for under-development of insurance business in Turkey are stated as lack of education and awareness; lack of trust to the sector and cultural factors. However, it is expected that with economic growth and development, insurance figures will converge to developed countries' and insurance will become more functional.

The importance and weight of insurance in economies of European and other developed countries arises another important issue; regulation and supervision of insurance sector. Stemming from its definition, insurance business is based on confidence between

¹ European Insurance in Figures (2006). Comité Européen des Assurances (CEA). Statistics No 24 (June). Brussels. pp. 28-69. Retrieved July 27th, 2006 on <http://www.cea.assur.org/cea/download/publ/article243.pdf>

insurer and the consumer. Therefore, regulation and supervision in insurance focus on ensuring this confidence in the sector by guaranteeing soundness of firms, stability of the market and protecting the consumer.

Recently, in both European and other developed countries and also in Turkey, the interest on insurance regulation and supervision has been increasing and remarkable developments have been occurring. In this study, considering Turkey's integration process to the European Union, current situation and recent developments on this particular area in both the EU and Turkey are examined.

In Chapter II, the necessity of regulation and supervision in financial markets and specifically its necessity in the insurance sector; types of regulatory and supervisory measures; responsible authorities and major criticisms against financial regulation and supervision are summarised.

Chapter III is devoted to insurance regulation and supervision in the EU. Here, within the framework of Single Insurance Market, enacted insurance legislation by the Community since Rome Treaty; supervisory structures in Member States and recent developments on the subject, especially Solvency II, are presented.

In Chapter IV, historical development and current situation of Turkish insurance legislation; supervision system and recent developments in mainly legislative field are summarised.

Chapter V is an evaluation of harmonization level of Turkish insurance legislation and supervision to the EU's, considering the fastening pace of Turkey's accession to the Union.

II. THEORETICAL BASIS OF REGULATION AND SUPERVISION

The large financial crises in both developed and developing countries and the changing business environment in the last decades have increased the interest on financial regulation and supervision.

Why is there a need for regulating financial markets? Why are there legislative frameworks, government interventions and specialized boards and institutions for regulation and supervision? On the other hand, are the existing regulations adequate, up to date and rational? Do they help the regulators reach their objectives of establishing stable markets and protecting the consumers? Do they answer to the needs of evolving economic and business structures, new markets, products and technologies? Moreover, to what extent these regulations are complied by market participants? By whom and how is the compliance is monitored and the participants are supervised? Which actions are taken in the cases of breaches of regulation? How is the trust in regulatory and supervisory authorities maintained?

These questions became main concerns of academicians, government officials, bureaucrats and national / international institutions. The revision of legislation, foundation of new institutions and development of new regulatory / supervisory tools are the evidences of increase in interest and works on financial regulation and supervision.

In this chapter some answers to the questions of the necessity of legislative frameworks, government interventions and specialized boards and institutions for regulation and supervision in financial markets and in particular, insurance market will be given. Some criticisms against financial regulation and supervision are also summarized.

2.1. The Necessity of Financial Regulation and Supervision

Before analysing the need for regulation and supervision, it may be useful to define some terms that are usually confused and used together² :

Regulation: the establishment of specific rules of behaviour

Monitoring: observing whether the rules are obeyed

Supervision: the more general observation of the behaviour of financial firms

Today, all financial markets throughout the world are regulated, monitored and supervised. The weights and ways differ but its main objectives are the same:³

- To protect the consumer
- To sustain systemic stability
- To maintain the safety and soundness of financial institutions

The regulation for protecting the consumer is needed because there are information asymmetries in markets. This is the situation in which, one party has inaccurate and insufficient knowledge about the other party and it causes the need for increasing information available to other party in order to maintain reliable, efficient and stable financial markets. Asymmetric information in the financial system leads to two basic problems⁴ :

Adverse Selection: Suppose there is a loan transaction between a lender and a borrower. Adverse selection occurs before the transaction takes place because the borrower, who potentially could not pay the loan back, would be willing to borrow money with high interest rates. The point here is that it is so possible for lender to select the borrowers that possibly would fail. The borrower could be a firm which would use the money for its highly risky investment or a bank which collects deposits from people in return of high interest rates.

² Llewellyn, David T. (1999). The Economic Rationale for Financial Regulation. *FSA Occasional Paper Series* 1, p. 6. Retrieved January 18th, 2006 on <http://www.fsa.gov.uk/pubs/occpapers/OP01.pdf>

³ Llewellyn, *ibid*, p. 9.

⁴ Mishkin, Frederic S. (2000). Prudential Supervision : Why It Is Important And What Are The Issues? *NBER Working Paper* 7926, p.2. Retrieved January 6th, 2006 on <http://www.nber.org/papers/w7926.pdf>

So the possibility of not getting paid back because of inaccurate and insufficient information may lead the investors not to make any investment or make loans. Here, the regulation which forces firms to disclose information about themselves helps the investors or consumers evaluate the other party of the financial transaction and reduces the adverse selection problem⁵.

Moral Hazard: In the same loan transaction stated above there could be another information asymmetry problem called moral hazard. This problem occurs after the transaction takes place because the borrower may involve in risky businesses which the lender would not lend money if he knows the other party will involve in. The point here is that the borrower has the incentive to use the money in risky investments for higher returns. However if he loses, most of the loss will be the lenders'. There is a conflict of interests between the lender who expects to gain profit by getting an interest of the money he lends and the borrower who expects to gain return on investment, which is likely more profitable with higher risk. The moral hazard problem may lead the lenders not to make any loans⁶. Therefore in order to reduce the moral hazard problem, regulations are put into force, like enforcing restrictions on contract terms, building financial transaction monitoring processes etc.

Also, information asymmetries create important and common deficiencies on behalf of consumers in the cases of any transaction including selling and buying of any financial product / service. The consumer may not, however should, be certain about the quality of the products / services at the point of purchase. There is inequality between sellers and buyers in assessing the quality of some financial products because of their technicalities. Also, the definitions of financial products / services may be imprecise for regular citizen but they should be clear and understandable for rational decision-making before buying⁷. Here some compulsory disclosures and types of information sheets will help to fill information gaps and protect the consumers and lead them to make more accurate decisions.

⁵ Mishkin, Frederic S. (2006). *The Economics of Money, Banking and Financial Markets*. 7th Edition Update, Pearson Addison Wesley. p. 177.

⁶ Mishkin, Frederic S. (2000). Prudential Supervision : Why It Is Important And What Are The Issues?, *NBER Working Paper 7926*, p.2. Retrieved January 6th, 2006 on <http://www.nber.org/papers/w7926.pdf>

⁷ Llewellyn, *ibid*, pp. 21,22.

Another reason for regulation based on asymmetric information arises because of the fact that some financial contracts are long-term. The values of many financial products are determined by the behaviour of the financial institutions, after products / services have been purchased by consumers. Here, only the firm has the correct and up to date information of its behaviour and their potential outcomes leading to information asymmetry between the firm and the consumers.

In some cases, the existence of asymmetric information can reduce consumer demand for services and contracts. An additional role of regulation, therefore, is to set minimum standards and make the consumer distinguish the good products / services from bad ones at the market so decreasing the effects of information asymmetry. In this sense, firms may also demand for regulation, which sets minimum standards and enhances confidence in the market. The fall in the sales of life assurance and personal pensions products in 1994 and 1995 in the UK is shown as an evidence of this situation. The consumer confidence in the industry was decreased following a series of scandals and hazardous selling practices.⁸

Setting minimum standards is also needed in order to sustain market stability and well functioning of markets. Firms may know how they should behave towards customers but nevertheless adopt risky strategies in order to gain competitive advantages over their competitors. They also think that their competitors will also invest in risky investments. In this case, the firms that conduct business in rational way will not be chosen by consumers because their products will be expensive or interest rates will be lower. The continuity of the situation will cause the low risk firm to lose its market. This is not acceptable with respect to the ultimate regulation objectives of consumer protection and maintaining safety and soundness of financial institutions and also well functioning, competitive markets. So, regulation has to set common minimum standards that all firms know will be applied equally to all competitors and affect the market by offering a guarantee that all participants in the market will behave within certain standards⁹.

⁸ Llewellyn, *ibid*, pp. 25,26.

⁹ Llewellyn, *ibid*, pp. 27,28.

In order to avoid from these problems and decrease information asymmetries, the consumers also have to put forth some efforts. They have to spend time, effort and resources investigating and monitoring whether the firms are and in the future will be committed to contracts and be financially healthy. However, these efforts may also cause necessities for regulation.

The consumer has to evaluate the safety and soundness of financial institutions, in order to check whether the institutions will be able to survive and abide their contractual obligations, only for an affordable cost. However, mostly, this costs much more. Here, the reason for existence of specialized regulatory / supervisory agencies, can be explained by the strong efficiency reasons for consumers to delegate monitoring and supervision to specialized agencies to act on their behalf as the transactions costs, here costs made for acquiring information and monitoring, for the consumer, are lowered by such delegation. There are potentially substantial economies of scale to be gained by supervision of financial firms by regulatory / supervisory agencies¹⁰.

Also, because of the inability of the consumers in making enough investment for information acquisition, a problem called “free-rider” arises. The free-rider problem occurs because people who have allocated little resources for gaining information about the firm or product / service can use the information that the others have collected and act in the same way. So the same actions taken, especially in securities markets, erase the advantage of people trying to gain more information. This will bring the reduced production of information and adverse selection problem which will prevent the well-functioning of markets¹¹.

Moreover, although there are costs, consumer demand for regulation is another rationale for regulation. Here, consumers may feel comfortable if markets are regulated, firms are supervised and governments provide “safety net” arrangements¹².

Another important component of economic rationale for regulation and supervision in financial services, especially in banking, is systemic problems. There are potential

¹⁰ Llewellyn, *ibid*, pp. 23,24.

¹¹ Mishkin, *ibid*, p. 3.

¹² Llewellyn, *ibid*, pp. 30,31.

systemic problems associated with *externalities* which are particular form of market failure and imperfections. The need to regulate and supervise financial institutions arises because there is a possibility that the social costs of failure of financial institutions (particularly banks) may exceed private costs and such potential social costs are not incorporated in the decision making of the firm.¹³ For example, following the failure of an insolvent bank, which has not considered the future consequences of its current risky operations at that time, depositors can withdraw their deposits from other banks. These withdrawals may put the whole banking system in jeopardy. Then, because of the its crucial role of being source of finance for a large number of borrowers and managing the payments system, lack of confidence and possible panic behaviour of depositors in banking system may bring problems in other parts of economy.¹⁴ On the other hand, systemic risks are less important for non-banking financial institutions and the effects of a failure of an insurance company may not be as destructive on the markets as a failure of a bank. So, banking regulation and supervision focuses more on avoiding systemic problems.

To sum up, financial regulation and supervision is necessitated mostly because of the existence of information asymmetries, the problems they bring and systemic problems which make consumers unprotected, markets instable and institutions unsafe and unsound.

2.2. The Necessity of Regulation and Supervision in Insurance

The economic rationales for financial regulation and supervision are also valid for insurance sector. However, some of them have more importance, some have less. In this section, some specific points in the necessity of regulation in insurance will be discussed.

The main objectives of financial regulation do not differ in insurance. The consumer, here the policyholder, the insured or the third party in particular, needs to be protected.

¹³ Llewellyn, *ibid*, p. 13.

¹⁴ Llewellyn, *ibid*, p. 13.

Also a stable and sound insurance market is needed to be developed. Moreover, public confidence in insurance companies is needed to be sustained.

Insurance can be defined as a tool which offers financial protection for an individual, company or another entity in the case of unexpected events. In the occurrence of these events, the policyholder or the victim is provided with a service or paid money to compensate the damages. The insurer plays its role of this compensation in exchange for paid premiums in advance.¹⁵

Stemming from its definition, confidence in the insurance institutions is especially important. By signing the insurance contract, the consumers pay some amount of premium and when the risk is actualized they will be waiting for compensation of their losses in the terms of the contract. Here, both the realization of the risk and its time is uncertain. Moreover, in some life insurance contracts the repayment is 10 – 15 years from the signature. Because of this feature of insurance, the consumer should confide in insurer that it can and will abide its promises.¹⁶

However, through the time passed from signing of the contract and the realization of the loss, insurer's financial profile may have gone so bad that it could not be able to pay its obligations. Therefore, financial soundness of insurers and mechanisms for intervention and safeguarding interests of consumers should be established. The long-term reliability and solvency (the ability to pay) of the insurance institutions has to be secured because under a liberalized environment, insolvencies are more likely to happen. Competitive pressures may lead insurers to involve in risky, unsound practices in order to gain competitive advantage.¹⁷ The rationale for monitoring of the insurers arises since these kinds of practices probably will take the insurer to insolvency and the policyholders', the insured or the third parties' interests will be hampered.

¹⁵ Insurance Solutions for a Changing Society (2005), Comité Européen des Assurances (June) p. 6. Retrieved February 19th, 2006 on <http://www.cea.assur.org/cea/download/publ/article224.pdf>

¹⁶ Taşbaşı, İbrahim. (2005). Sigorta Sektöründe Denetim ve Gözetim. *I. Ulusal Sigorta Sempozyumu Bildiri Kitabı*, TSRŞB, İstanbul. p. 397.

¹⁷ Establishment of Effective Insurance Regulatory and Supervisory Systems (1995). UNCTAD Trade and Development Board, TD/B/CN.4/52 , p. 4. Retrieved August 28th, 2005 on r0.unctad.org/insuranceprogramme/1reg.pdf

The existence of information asymmetries also brings the need for regulation in insurance market. It can cause problems on both sides of the insurance contracts. On the one hand, because of the technical and legal complexity of the contracts, it is possible for insurers not to pay the claim and to abuse their experience and knowledge surplus in insurance business over policyholder. Moreover, as it is explained above, the financial situation of the insurance company is so crucial for functionality of this service. Under the case of inaccurate and insufficient information about the company, the consumer will face the problem of assessing and choosing the solvent and reliable company that he will hold the contract. Therefore, in both developed and developing countries, the protection of the public and its fair treatment is a major focus of most new insurance related legislation.¹⁸

On the other hand, in health insurance for example, the policyholders or the insured have more information on their bodies and health conditions than insurance companies. These policies may be abused by consumer in order not to pay the treatment bill for a beforehand known illness. Because of that, there are some protective measures for insurance companies against this kind of information asymmetries, like General and Special Conditions of the specific insurance branch.

Another rationale for insurance regulation arises from collected premiums, which constitute the funds that are accrued under the custody of the insurance company. These are the reserves to cover future claims and during this period they are invested to produce returns. Therefore, the management of these funds is important for the policyholder, the insured or the third party because their possible loss will be paid from these funds. Kinds and terms of these investments may be limited by regulation in order not to jeopardize the solvency of the insurer. Also, it is important for the insurer because the return on these investments will affect its profitability. Moreover, channelling these funds towards certain areas of the economy may contribute to the overall economic growth of a country. Governments can direct these funds towards specific sectoral investments where investment capital is scarce.¹⁹

¹⁸ UNCTAD, *ibid*, p. 6.

¹⁹ UNCTAD, *ibid*, p. 7.

2.3. Types of Financial Regulatory and Supervisory Measures

In the previous sections, reasons for regulating and supervising financial markets are listed. In this section, the regulatory measures that are taken by governments and regulatory authorities are summarized.

In order to protect the consumer against excessive prices and enhance the efficiency of financial markets governments use antitrust and competition policies. These policies are or should be designed so that competition in the market benefits both the consumers and the firms. By the help of increased competition, financial products and services would be more diversified, more affordable and better in quality.

Consumer protection requires the disclosure of mostly financial information about the institution because the consumer has less information about the liquidity, profitability and solvency of firm than the owners of the firm. So, regulators make it necessary for financial firms to follow certain accounting principles and disclose a wide range of information which helps the market assess the conditions of them.²⁰ Disclosure requirements, as a measure of regulation, are or should be designed to lessen the asymmetric information problems in the market.

Another regulatory measure for consumer protection is safety net arrangements like deposit insurance, lender of last resort and compensation schemes. Especially in banking, the contagious effect of a bank failure raises the need for protection of depositors and generally for restoring the public confidence.²¹ With deposit insurance, the depositors can have their money back in full or to some amount if the bank goes bankrupt. In many countries, after major banking crises, deposit insurance schemes are founded. Moreover, for example in insurance sector, there are protection mechanisms like “Guarantee Funds” for the policyholders, the insured or the third party in case of an insurer failure.

²⁰ Mishkin, Frederic S. (2006). *The Economics of Money, Banking and Financial Markets*. 7th Edition Update, Pearson Addison Wesley. p. 268.

²¹ Mishkin, *ibid*, p.261.

In order to sustain the systemic stability, a substantial number of regulatory measures are being used throughout the world. Some examples of these measures are asset restrictions, capital adequacy standards, deposit insurance, disclosure standards, fit and proper entry tests, interest rate ceilings on deposits, liquidity requirements, reserve requirements and restrictions on service and product lines.²²

Restrictions on asset holdings and capital requirements are ways to make financial undertakings avoid too much risk. Regulations may limit the types of assets that they can hold because of their incentive to take on higher risk for higher return. Also, the amount of compulsory equity capital which the undertaking has to hold may be determined in order to prevent it from high risky activities.²³

However, it is not enough to have regulations which encourage firms for less risk taking. They have to be monitored whether they are complying with the regulations or not. This can be made by on-site examinations in which required capital, reserves, assets and disclosures are monitored.²⁴ In order to ensure that companies are financially sound and reliable there has to be supervisory bodies which monitor operations of financial institutions on an ongoing basis. In insurance sector, for example, regulators and supervisors focus on insurers' solvency margin requirements, minimum capital requirements, reserving requirements, investment limitations and valuation of assets. To be more specific, reserving requirements include technical reserves (mathematical reserves for life and health insurance, premium reserves for unexpired risk, claim reserves for covering future claim payments, fluctuation and catastrophic risk reserves) in order to cover contractual commitments to policyholders.²⁵

However, after some major crises, the regulators throughout the world have realized that simple capital and reserve requirement calculations and assessment of firms' balance sheets at a point in time are not enough to evaluate the actual risk of financial institutions.

²² Herring, Richard J. & Anthony M. Santomero. (1999). What is Optimal Financial Regulation? *Financial Institutions Center Working Paper* 00-34, Wharton School – University of Pennsylvania (May) pp.4,5. Retrieved January 6th, 2006 on <http://fic.wharton.upenn.edu/fic/papers/00/0034.pdf>

²³ Mishkin, *ibid*, pp.264,265.

²⁴ Mishkin, Frederic S. (2000). Prudential Supervision : Why It Is Important And What Are The Issues?, *NBER Working Paper* 7926, p.15. Retrieved January 6th, 2006 on <http://www.nber.org/papers/w7926.pdf>

²⁵ UNCTAD, *ibid*, pp. 12-17.

So, with the Basel Accord (1988), risk-based capital requirements for banks have been calculated. In recent years, the need of reform in first Basel Accord brought the Basel II, which is based on three pillars. First pillar of Basel II, includes capital requirements which are more closely linked to actual risks, second pillar is about the supervisory process which concentrates on risk management quality of banking institutions and the third pillar focuses on improving market discipline.²⁶ The reflection of Basel II type regulation and supervision of banking system can also be seen in other financial markets. For example, the European Union has started a project called Solvency II in regulation and supervision of insurance market.

Another important measure of regulation in financial markets is licensing and registration for a new entrant. Before starting the business, the company is usually required to obtain a license from government or regulatory authority. Generally, admission requires articles of incorporation or association; qualification, experience and criminal record of managers and directors (so-called fit and proper tests); a business plan to assess the financial strength of the initiative and deposit part or the whole of the paid-up capital with a designated entity. In insurance, specifically, these requirements may include authorization of doing business in determined classes of insurance, company's intended reinsurance program, principles of premium and reserving calculations and investment return projections. Moreover, in many countries, intermediaries (agents, brokers) are also needed to be licensed.²⁷

The above mentioned measures generally deal with solvency, safety and soundness of financial institutions which, in literature are called "prudential regulation". Besides that there is "conduct of business regulation" which focuses on how financial firms conduct business with their customers and mainly designed to establish rules and guidelines and appropriate behaviour and business practices.²⁸ In many countries, insurance regulators and supervisors monitor underwriting, rates and tariffs of insurance products / services and how policies are distributed and marketed. Also complaints from public are collected,

²⁶ Mishkin, *ibid*, pp.265,266.

²⁷ UNCTAD, *ibid*, pp. 10,11.

²⁸ Llewellyn, *ibid*, p. 11.

efforts for education of consumers are made and fraud (including money laundering) attempts are checked on as measures of conduct of business regulation and supervision.²⁹

There are different ways of actions taken by authorities throughout the world in cases of breach of the regulations explained above. It depends on the severity of the situation and ranges from requesting improvement plans for risk reduction and additional capital to withdrawal of license and legal / administrative penalties. Fair and continuous implementation of these actions plays an important role in the efficiency of regulatory and supervisory measures which is linked to efficiency of markets.

2.4. Regulatory and Supervisory Authorities

Financial regulations that are introduced in the previous section and supervision of the market are conducted by generally specialized boards and institutions. However, it is difficult to clearly differentiate between regulatory and supervisory tasks. As Grünbichler & Darlap state, the border between both is not clear due to the fact that supervisors are assigned rule-making powers for refining legislation through laws. This makes supervisors secondary regulators besides the main institutions, like parliament or government that create primary legislation.³⁰

With respect to structure and powers of these institutions there are many differences between countries with different financial and legal tradition. Generally, regulators and supervisors for each financial market are separate and specialize and concentrate on matters relevant to the market. However, with changing environment of business and developments in financial products the distinction between markets is getting more indefinite. Related to this integration of sectors, there is a trend in many countries in Europe and in some developed countries like Australia and Canada, towards integrated

²⁹ UNCTAD, *ibid*, pp. 17-20.

³⁰ Grünbichler, Andreas & Patrick Darlap. (2003). *Regulation and Supervision of Financial Markets and Institutions A European Perspective*. Austrian Financial Market Authority. p.2. Retrieved August 30th, 2005 on <http://www.fma.gv.at/de/pdf/service2.pdf>

financial market regulators and supervisors. These bodies regulate and supervise banking, insurance and securities markets altogether or groups of these markets.³¹

An important matter of discussion in financial regulation and supervision is the independencies of the regulatory and supervisory authorities. According to Quintyn & Taylor, independence is defined by four different dimensions which are regulatory, supervisory, institutional and budgetary. They also add the independence should be both from political influence and from sectoral pressure groups. With regulatory independence it is meant that the ability of the agency to have an appropriate degree of autonomy in setting rules and regulations within the limits of law. Supervisory independence could be maintained by legal protection of supervisors, rule-based system of sanctions and interventions, appropriate salaries and career opportunities for supervisors and limits for unsophisticated court appeals. Also having the power of granting and withdrawal of license is important with respect to independence and persuasiveness. Institutional independence means separation from the executive and legislative branches of government and for example being part of a ministry which typically lacks independence. Appointment and dismissal of senior personnel, governance structure and the openness and transparency of decision making are critical questions in institutional independence. With budgetary independence it is meant that closeness to the influences of government that controls the budget. In some countries in order to avoid that the authority is funded through fees from beneficiaries of the regulation (the consumers).³²

2.5. Criticisms against Financial Regulation and Supervision

In the previous sections the necessity and measures of financial regulation and supervision are explained. However, critical viewpoints on the costs and benefits of regulation and supervision also exist in economic literature.

³¹ Grünbichler & Darlap, *ibid*, p.6,7.

³² Quintyn, Marc & Michael W. Taylor. (2002). Regulatory and Supervisory Independence and Financial Stability. *IMF Working Paper* WP/02/46 (March), p.14-22. Retrieved June 17th, 2006 on <http://www.imf.org/external/pubs/ft/wp/2002/wp0246.pdf>

Benston argues that although consumer protection is a common reason for financial regulation, consumers in financial markets are probably less subject to fraud, misrepresentation, discrimination and information asymmetries than consumers of other products. He states that although negative externalities are shown as another argument for regulation, there are few genuine externalities. He also claims that costs incurred by regulation and borne by consumers and tax payers probably exceed the benefits they receive. He adds that because of regulation some substantial unintended costs are incurred such as reduced diversification of financial institutions and the absence of less costly and more innovative products because of restrictions on entry to financial markets.³³

Llewellyn also lists some arguments of main scholars who are sceptical on the benefits of regulation.³⁴

- There are no market failures and imperfections; if they exist, they are not sufficiently serious
- In practice, regulation may not solve these failures; if it does, costs will exceed the costs of the original problem
- Serious problems may arise when regulation is imposed (For example, although “safety net” arrangements like deposit insurance, lender-of-last-resort and compensation schemes, protect depositors and prevent bank panics, they can create moral hazard problem of increased incentives of bank owners for taking excess risks for higher profits that might result in an insurance pay off. Also, depositors who know that they are protected by deposit insurance schemes, have little reason to impose discipline on the bank, which causes an adverse selection problem.³⁵)
- Regulation brings a wide range of costs which are paid by consumers (including reduction in competition, impeding market mechanisms)
- Regulation may lead to crises and bank failures around the world, which in theory, should prevent from

³³ Benston, George J. (1998) Executive Summary of “Regulating Financial Markets: A Critique and Some Proposals”. Retrieved July 15th, 2006 on <http://www.iea.org.uk/record.jsp?type=publication&ID=82>

³⁴ Llewellyn, *ibid*, pp.7,8.

³⁵ Mishkin, *ibid*, pp.262,263.

It should be noted that, if it is well designed, regulation will be useful in providing its ultimate goals and will not cause the drawbacks summarized above. In this design; a careful evaluation of costs and benefits, considering various aspects of regulation and parties which will be affected and structuring a system encouraging competition rather than impeding them, will be vital in the success of regulation and supervision.

III. INSURANCE REGULATION AND SUPERVISION IN THE EUROPEAN UNION

3.1. Legislation in the EU

The basic aim of EU legislation in the field of insurance industry is to achieve integration, globalisation and functioning of a Single Insurance Market. The primary basis of the legislation in this field is the Treaty Establishing the European Communities (the Treaty of Rome). In the Treaty, Articles 43-48 relating to the right of establishment, Articles 49-55 relating to freedom to provide services and Articles 56-60 relating to free movement of capital constitute the basis of single insurance, in general, financial market.³⁶

The right of establishment means that restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State and also on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State shall be prohibited. This applies also to self-employed persons who take up and pursue activities and set up and manage undertakings, under the conditions laid down for its own nationals by the law of the country where such establishment is effected. Here, the right of establishment is granted to both natural and legal persons.

The restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.³⁷

³⁶ Cejkova, Viktoria; Svatopluk Necas & Eva Vavrova. (2005). Harmonising the Czech Insurance Market with the Single European Market – An Analysis Part 2. *BIATEC* Volume XVIII 7/2005. p.26. Retrieved November 8th, 2005 on http://www.nbs.sk/BIATEC/BIA07_05/7_05AN.HTM

³⁷ Fernandez, M.T.Fabregas. (2005). “Right of Establishment and Freedom to Provide Services”. Explanatory Meeting of Screening Process with Croatia and Turkey. Retrieved April 22nd, 2006 on http://www.abgs.gov.tr/tarama/tarama_files/03/SC03EXP_Right_of_Establishments.pdf

On the other hand, free movement of capital enables all EU citizens to perform financial transactions like opening bank accounts and making investments throughout the EU. All restrictions on the movement of capital are prohibited. In the insurance sector, free movement of capital concerns mainly the indemnity of life assurance and credit insurance policies.³⁸

The other part of the EU insurance legislation for the achievement of Single Insurance Market is the two General Programmes that are adopted by the Council of Ministers on December 18th, 1961. The first program aimed abolition of restrictions on freedom to provide services and the second program aimed abolition of restrictions on freedom of establishment.³⁹

It should be noted that, the cases at and jurisdictions of European Court of Justice on primary and secondary legislation are also an important part of legislation regarding to provide services and freedom of establishment in the EU. For example, a very important principle that has been developed by case law is the *general good* principle. It enables national authorities to restrict these freedoms if certain public interests (consumer protection, prevention of fraud, worker protection etc.) are claimed to be violated. So the principle becomes one of the obstacles behind fully formation of the Single Insurance Market.⁴⁰

The weighted part of insurance legislation in the EU is several directives and other secondary legislation like regulations and communications. In this section, three generations of insurance directives that have constituted the legislative framework on the way to Single Insurance Market and also other related legislation will be introduced.

³⁸ Cejkova et al, *ibid*, p. 26.

³⁹ Arslan, Özge. (2003). *AB ve Türkiye’de Sigorta Şirketlerinde Yükümlülük Karşılama Yeterliliği*. TC Başbakanlık Hazine Müsteşarlığı Araştırma İnceleme Dizisi No: 37: Ankara. p.3.

⁴⁰ Beckmann, Rainer, Carsten Eppendofer & Markus Neimke. (2002). *Financial Integration within the European Union: Towards a Single Market for Insurance*. Ruhr University, Bochum. (January) p.6. Retrieved August 30th, 2005 on http://www.ecri.be/media/retail_finance-papers/insurance.pdf

3.1.1. First Insurance Directives

According to the first generation insurance directives that are summarised below, insurance undertakings might establish their own branches, offices or agencies within the Community on the basis of Host Country Control. If an insurance company which is established in a Member State wishes to operate in another Member State, the taking-up of the business is subject to official authorization of the latter Member State.⁴¹ Also branches are subject to supervision of both their home country and the host country authorities.⁴²

a. 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 assurance (*Official Journal L 063, 13/03/1979 p. 1 – 18.*)⁴³

Directive 79/267/EEC originally has five titles and an Annex. Title I, entitled General Provisions, states the coverage and exceptions of the Directive. The rest of the Directive includes “Rules applicable to undertakings whose head offices are situated within the Community” (Title 2), “Rules applicable to agencies or branches established within the Community and belonging to undertakings whose head offices are outside the Community” (Title 3), “Transitional and other provisions” (Title 4) and “Final provisions” (Title 5).

Annex A is the list of insurance classes, which are subject to authorization. These are life assurance, annuities and supplementary insurance carried on by life assurance undertakings; marriage assurance, birth assurance; the assurance which are linked to investment funds; permanent health insurance; tontines; capital redemption operations; management of group pension funds; the operations which are related to French Insurance Law; the operations which are about the principles of social security legislation on the length of human life.

⁴¹ Sterzynski, Maciej. (2003). *Liberalization and Deregulation of the Single Insurance Market in the European Union*. p.4. Retrieved August 30th, 2005 on http://www.dse.unibo.it/eefs/wp_eefs/Sterzynski.pdf

⁴² Vollbrecht, Jörg. (2000). *Insurance Regulation and Supervision in OECD Countries*. Insurance and Private Pension Compendium for Emerging Economies Book 1 Part 2:1)a. OECD. p.19. Retrieved February 19th, 2006 on <http://www.oecd.org/dataoecd/48/21/1815373.pdf>

⁴³ This directive is repealed by Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (*Official Journal L 345 , 19/12/2002 p. 1 – 51.*).

b. 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 assurance (Official Journal L 228 , 16/08/1973 p. 3 – 19.)

Directive 73/239/EEC originally has five titles and an Annex.⁴⁴ Title I, entitled General Provisions, states the coverage and exceptions of the Directive. The rest of the Directive includes “Rules applicable to undertakings whose head offices are situated within the Community” (Title 2), “Rules applicable to agencies or branches established within the Community and belonging to undertakings whose head offices are outside the Community” (Title 3), “Transitional and other provisions” (Title 4) and “Final provisions” (Title 5).

Annex A is the list of insurance classes, which are subject to authorization. These are accident, sickness, land vehicles, railway rolling stock, aircraft, ships, goods in transit, fire and natural forces, other damage to property, motor vehicle liability, aircraft liability, liability for ships, general liability, credit-insolvency, suretyship, miscellaneous financial loss- employment risks, legal expenses and assistance.⁴⁵

3.1.2. Second Insurance Directives

With the second generation insurance directives that are summarized below, realization of freedom to provide services and enabling the companies to conduct business without establishing branches in the particular Member State, are aimed.⁴⁶ With these

⁴⁴ Özşar, Berna. (2005). *EU Guide Relating to the Insurance Sector*. TSRŞB. (June). p.10. Retrieved August 28th, 2005 on <http://www.tsrbs.org.tr/NR/rdonlyres/35E70266-B108-47F9-9276-A509EF202A43/879/EUINSURANCEGUIDE.pdf>

⁴⁵ The number of classes are increased from 17 to 18 by Council Directive 84/641/EEC of 10 December 1984 amending, particularly as regards tourist assistance, the First Directive (73/239/EEC) (Official Journal L 339, 27/12/1984 p. 21 – 25.) and Council Directive 87/343/EEC of 22 June 1987 amending, as regards credit insurance and suretyship insurance, First Directive 73/239/EEC (Official Journal L 185, 04/07/1987 p. 72 – 76.)

⁴⁶ Sterzynski, *ibid*, p.4.

directives the “large risks” or industrial and commercial risks in non-life and services provided on the initiative of the policyholder would be considered in freedom to provide services.⁴⁷ Although the directives allow insurers to provide services, Sterzynski states that a lot of restrictions still remained:

“The liberalization process took place only in the sectors of the insurance market where the need to protect customers was insignificant. National supervisors kept their right to control foreign companies trying to provide business in the way of free movement of services. Therefore the integration effects of the Second Directives Generation seem to be definitely insufficient towards establishing free movement of services.”⁴⁸

a. 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 (*Official Journal L 330*, 29/11/1990 p. 50 – 61.)⁴⁹

The object of the Directive is stated as to supplement Directive 79/267/EEC and lay down specific provisions relating to freedom to provide services in respect of the activities referred to in the Directive 79/267/EEC.

Title I of the Directive gives definitions of some terms like “undertaking”, “Member State of establishment” and “subsidiary”. Under Title II, entitled Provisions supplementary to the First Directive, consists of additions to the Directive 79/267/EEC. The provisions relating specifically to the freedom to provide services are laid down by Title III of the Directive. Title IV and Title V set forth transitional and final provisions respectively.

b. 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 assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 73/239/EEC (*Official Journal L 172*, 04/07/1988 p. 1 – 14.)

⁴⁷ Vollbrecht, *ibid*, p.19.

⁴⁸ Sterzynski, *ibid*, p.4.

⁴⁹ This directive is repealed by Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (*Official Journal L 345*, 19/12/2002 p. 1 – 51.).

The object of the Directive is stated as to supplement the first Directive 73/239/EEC and lay down special provisions relating to freedom of services for the undertakings and in respect of the classes of insurance covered by that first Directive.

Title I of the Directive gives definitions of some terms like “Member State where the risk is situated”, “Member State of establishment” and “Member State of provision of services”. Title II (Provisions supplementary to the First Directive) consists of additions to the Directive 73/239/EEC. These are:

- definition of “large risk”
- the law applicable to contracts of insurance and covering risks situated within the Member States
- provisions regarding compulsory insurance contracts
- provisions regarding general and special conditions and scales of premiums
- provisions regarding powers of supervisory authorities and means necessary for supervision

The provisions peculiar to the freedom to provide services are laid down by Title III of the Directive. Title IV and Title V set forth transitional arrangements (for Greece, Ireland, Spain and Portugal) and final provisions respectively.⁵⁰

3.1.3. Third Insurance Directives

With the Third Generation Insurance Directives, the establishment of European Single Insurance Market is completed theoretically. The directives that are summarised below are aimed to abolish other restrictions and discrimination between local and other Member States’ companies.⁵¹

⁵⁰ Özşar, *ibid*, pp. 17,18.

⁵¹ Yavaş, Mahmut. (2005). Yürürlükteki Avrupa Birliği Mevzuatı ve Türkiye. *I.Ulusal Sigorta Sempozyumu Bildiri Kitabı*, TSRŞB. İstanbul. p.332.

In order to achieve this, the concept of *the single license*, the *Home Country Control principle* (in opposite to Host Country Control), abolition of prior control of premium and policy conditions for all insurance risks and all policyholders are introduced.⁵²

According to single license (also referred as single authorization or European passport) system, any insurance company, which its head office is in an EEA country and is authorised in that country, is permitted to offer its products through its agencies or branches or under the freedom to provide services without authorisation of the host country. Moreover, it is supervised only by authorities of home country. This is known as Home Country Control principle.⁵³ The system is mainly based on minimum coordination of financial and prudential rules of financial activities, mutual recognition of supervisory systems and single authorization and supervision by Home Member State.⁵⁴

a. 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 (third life Assurance Directive) (Official Journal L 360, 09/12/1992 p. 1 – 27.)⁵⁵

Directive 92/96/EEC has six titles and two annexes. Under Title I of the Directive there are some definitions like “assurance undertaking”, “home member state” and “control”. Also the scope of the Directive is given. Title II, entitled “The Taking-Up of the Business of Life Assurance”, states the replacements in the articles of Directive 79/267/EEC. Under Title III (Harmonization of Conditions Governing Pursuit of Business), the amendments in the old articles mainly regarding authorization, supervision and solvency of undertakings are mentioned. Title IV consists of provisions regarding to right of establishment and freedom to provide services. According to the Directive particular articles of past directives are replaced or deleted. Title IV and V are transitional and final provisions.

⁵² Sterzynski, *ibid*, p. 4.

⁵³ Vollbrecht, *ibid*, p. 19.

⁵⁴ Linder, Ulf (2005). “EU Rules Concerning Life Insurance Solvency”. Workshop on EU Insurance Legislation, Istanbul, 24 June 2005. Retrieved August 30th, 2005 on

<http://www.tsrbsb.org.tr/NR/rdonlyres/D1F9035E-B4AF-4525-A9F2-1EFF248BA721/838/ULinder1.ppt>

⁵⁵ This directive is repealed by Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (*Official Journal L 345*, 19/12/2002 p. 1 – 51.).

Annex I is about currency matching rules and Annex II is about information which is to be communicated to the policyholders on the contract and the undertaking.

b. 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 (third non-life insurance Directive) (Official Journal L 228, 11/08/1992 p. 1 – 23.)

Directive 92/49/EEC has six titles. Under Title I of the Directive there are some definitions like “insurance undertaking”, “home member state” and “competent authority”. Also the scope of the Directive is given. Title II (The Taking-Up of the Business of Insurance) lists the replacements in the past directives. Title III, entitled Harmonization of the Conditions Governing the Business of Insurance, is about amendments regarding mainly financial supervision of undertakings by competent authorities, technical provisions and solvency margin. Title IV (Provisions Relating to Right of Establishment and Freedom to Provide Services) repeals particular articles of the past directives. Title IV and V are transitional and final provisions.

3.1.4. Other Non-life and Life Directives

a. Council Directive 73/240/EEC of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance (Official Journal L 228, 16/08/1973 p. 20 – 22.)

According to the Directive, Member States are obliged to abolish restrictions preventing beneficiaries from establishing themselves in the host country under the same conditions as nationals of that country and discriminatory administrative practices. The main aim is to facilitate freedom of establishment.⁵⁶

⁵⁶ Özşar, *ibid*, p.12.

b. Council Directive 76/580/EEC of 29 June 1976 amending 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 (*Official Journal L 189, 13/07/1976 p. 13 – 14.*)

The Directive amends Directive 73/239/EEC in terms of definition of the term “unit of account”. The first definition of European Investment Bank’s has been changed with the Commission. However, European Monetary Union has made the Directive obsolete.⁵⁷

c. Council Directive 78/473/EEC of 30 May 1978 on the coordination of laws, regulations and administrative provisions relating to Community co-insurance (*Official Journal L 151, 07/06/1978 p. 25 – 27.*)

The Directive consists of provisions relating to co-insurance (coverage by a single contract at an overall premium and for the same period by two or more insurance undertakings) operations referring the Directive 73/239/EEC.

d. 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 (*Official Journal L 339, 27/12/1984 p. 21 – 25.*)

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 (*Official Journal L 185, 04/07/1987 p. 72 – 76.*)

These Directives amends the provisions on tourist assistance and credit insurance and suretyship insurance of the Directive 73/239/EEC.

⁵⁷ Özşar, *ibid*, p.12.

e. Council Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance (*Official Journal L 185, 04/07/1987 p. 77 – 80.*)

The purpose of this Directive is to coordinate the provisions laid down by law, regulation or administrative action concerning legal expenses insurance. The Directive sets forth provisions regarding coverage of legal expenses insurance.

f. Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (*Official Journal L 345 , 19/12/2002 p. 1 – 51.*)

This directive repeals the three life insurance directives and directives which amend these directives. Directive 2002/83/EC is a re-cast (its text design has been edited again) directive which preserves most of the scope of the past directives.

Directive 2002/83/EC has eight titles and six annexes. Under Title I of the Directive there are some definitions like “assurance undertaking”, “home member state” and “capital at risk”. Also the scope of the Directive is given. Title II (Taking-up of the Business of Life Assurance) consists of provisions regarding authorization of an assurance undertaking. Principles and methods of financial supervision, rules relating to technical provisions and their representation, rules relating to the solvency margin and to the guarantee fund, contract law and conditions of assurance and assurance undertakings in difficulty or in an irregular situation are regulated in Title III (Conditions Governing the Business of Assurance). Title IV consists of provisions regarding to right of establishment and freedom to provide services. Title V sets forth rules applicable rules applicable to agencies or branches established within the community and belonging to undertakings whose head offices are outside the community. Title VI includes rules applicable to subsidiaries of parent undertakings governed by the laws of a third country and to the acquisition of holdings by such parent undertakings. Title VII and VIII are transitional and other and final provisions respectively.

Annexes include classes of assurance (I), currency matching rules (II), information to be communicated to policyholders (III), professional secrecy, activities and bodies excluded from this directive, solvency margin, minimum solvency margin and guarantee fund (IV), list of repealed directives and deadlines of implementation (V) and correlation table (VI).

3.1.5. Directives Regarding Insurance Accounting

a. Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (*Official Journal L 374, 31/12/1991 p. 7 – 31.*)

This directive, known also as “Insurance Accounts Directive”, sets forth provisions concerning the balance sheets and loss and profit accounts of insurance undertakings. The Directive includes the layouts of the balance sheet and profit and loss account, provisions relating to certain profit-and-loss account items, valuation rules, contents of the notes on the accounts and consolidated accounts.⁵⁸ In the Annex of the Directive, special provisions are given for Lloyd’s and Lloyd’s syndicates.

b. Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (*Official Journal L 222, 14/08/1978 p. 11 – 31.*)⁵⁹

The Directive starts with the list of type of companies in Member States that are to apply the subsequent provisions. However, it is stated that the Member States need not to apply the provisions of this Directive to banks and other financial institutions or to

⁵⁸ Özşar, *ibid*, p.25-30.

⁵⁹ This Directive is amended by Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (*Official Journal L 193, 18/07/1983 p. 1 – 17.*)

insurance companies. It includes provisions concerning content and preparation of annual accounts.

c. Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings (Text with EEA relevance)

(Official Journal L 178, 17/07/2003 p. 16 – 22.)

In order to achieve completion of the internal market for financial services, the four directives that has been regulating accounting, was amended by the Directive 2003/51/EC, which is known as “Modernization of Accounts Directive”. According to the Directive it is permitted for insurance undertakings to use fair-value accounting, expressed through appropriate standards issued by the International Accounting Standards Board (IASB). It also repeals the Annex of the “Insurance Accounts Directive” (Directive 91/674/EEC) relevant to Lloyd’s.⁶⁰

3.1.6. Directives Regarding E-Commerce

a. 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 ('Directive on electronic commerce')

(Official Journal L 178, 17/07/2000 p. 1 – 16.)

The object of the Directive is stated as to contribute to the proper functioning of the internal market by ensuring the free movement of information society services between the Member States. According to the Directive, Each Member State shall ensure that the

⁶⁰ Özşar, *ibid*, p.24,25.

information society services provided by a service provider established on its territory comply with the national provisions applicable in the Member State in question which fall within the coordinated field and Member States may not, for reasons falling within the coordinated field, restrict the freedom to provide information society services from another Member State. However, as a service which can be provided from issuing contracts over the Internet, insurance is subject to some restrictions. For issues about conditions to carry on cross-border electronic insurance activities, advertising, contract law and information to policyholders on the insurance contract, insurance directives are valid.⁶¹

3.1.7. Directives Regarding Insurance Groups

a. 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 (*Official Journal L 330, 05/12/1998 p.1 – 12*)

According to the Directive, undertakings that are active in financial structure and management of insurance and reinsurance undertakings that are established within the borders of the EU, are also subject to supervision.⁶² The Directive gives definitions of parent undertaking, subsidiary undertaking, participant undertaking and related undertaking. Then it sets forth cases for application and scope of supplementary supervision of these undertakings. The supplementary supervision is exercised by the competent authorities of the Member State in which the insurance undertaking has received official authorisation. The Directive also focuses on intra group transactions and solvency margin.

b. Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending

⁶¹ Özşar, *ibid*, pp.31,32.

⁶² Yavaş, *ibid*, p.332.

Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (*Official Journal L 035, 11/02/2003 p. 1 – 27.*)

This Directive lays down rules for supplementary supervision of regulated entities (credit institutions, insurance undertakings and investment firms) which have obtained an authorisation and which are part of a financial conglomerate. It also amends relevant sectoral rules which apply to entities regulated by the Directives 73/239/EEC, 79/267/EEC, 93/22/EEC and 2000/12/EC. The Directive has provisions on prevention of using the same capital for minimum requirements of different undertakings in a conglomerate and on risk concentration and adequate risk management processes and internal control mechanisms. Moreover, it brings both the appointment of a single coordinator, responsible for coordination and exercise of supplementary supervision, among the competent authorities of the Member States concerned and cooperation and exchange of information between competent authorities.⁶³

3.1.8. Regulations Regarding Insurance Mediation

a. Council Directive 77/92/EEC of 13 December 1976 on measures to facilitate the effective exercise of freedom of establishment and freedom to provide services in respect of the activities of insurance agents and brokers (ex ISIC Group 630) and, in particular, transitional measures in respect of those activities (*Official Journal L 026, 31/01/1977 p. 14 – 19.*)

According to the Directive 77/92/EEC, insurance mediators (brokers, agents, sub-agents) have the right of establishment and provide services in all Member States. If in a Member State insurance mediation is subject to the fulfilment of certain qualifying conditions (possession of general, commercial or professional knowledge and ability), that

⁶³ Yavaş, *ibid*, p.334.

Member State shall accept knowledge and ability gained in another Member State through pursuing one of these activities for periods specified in the Directive.⁶⁴

b. Commission Recommendation 92/48/EEC of 18 December 1991 on insurance intermediaries (*Official Journal L 019, 28/01/1992 p. 32 – 33.*)

This recommendation gives definition of insurance intermediaries and has articles on their professional competence, registration and sanctions.

c. Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation (*Official Journal L 009, 15/01/2003 p. 3 – 10.*)

This Directive repeals the Directive 77/92/EEC and lays down rules for the taking-up and pursuit of the activities of insurance and reinsurance mediation by natural and legal persons which are established in a Member State or which wish to become established there. It includes registration requirements and information requirements for intermediaries to be provided to customers.

3.1.9. Regulations Regarding Motor Vehicle Insurance

Motor vehicle insurance is one of the most highly regulated fields in insurance. The object of the legislation is to abolish restrictions to provide services and achieve a single market for motor vehicle insurance. The directives abolish checking mechanisms on insurance against losses of third parties when crossing borders of Member States.⁶⁵

a. Council Directive 72/166/EEC of 24 April 1972 on the approximation of the laws of Member States relating to insurance against civil liability in respect of the use

⁶⁴ Özşar, *ibid*, p.35.

⁶⁵ Yavaş, *ibid*, p.337.

of motor vehicles, and to the enforcement of the obligation to insure against such liability (*Official Journal L 103, 02/05/1972 p. 1 – 4.*)⁶⁶

According to the Directive, Member States shall refrain from making checks on insurance against civil liability in respect of vehicles normally based in the territory of another Member State. Likewise, Member States shall refrain from making such insurance checks on vehicles normally based in the territory of a third country entering their territory from the territory of another Member State. Member States may, however carry out random checks. On the other hand, each Member State shall, with some derogation, take all appropriate measures to ensure that civil liability in respect of the use of vehicles normally based in its territory is covered by insurance for any loss or injury. For vehicles normally based in the territory of a third country or in the non-European territory of a Member State must, before entering the territory in which the Treaty establishing the European Economic Community is in force, be provided either with a valid green card⁶⁷ or with a certificate of frontier insurance.

Related to this Directive the Commission had issued Commission Recommendation 73/185/EEC of 15 May 1973, Commission Recommendation 74/165/EEC of 6 February 1974 and Commission Recommendation 81/76/EEC of 8 January 1981.

b. Second Council Directive 84/5/EEC of 30 December 1983 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles (*Official Journal L 008, 11/01/1984 p. 17 – 20.*)

The Directive 84/5/EEC has provisions regarding the coverage of the compulsory motor insurance that is stated in the past Directive. The Directive obliges the Member States to establish or authorize a body for providing compensation. It also has provisions regarding contractual clauses or statutory provision; cases of stealing and obtaining

⁶⁶ This Directive is amended by Council Directive 72/430/EEC of 19 December 1972 with a change in the text of an article.

⁶⁷ An international certificate of insurance issued on behalf of a national bureau in accordance with Recommendation No 5 adopted on 25 January 1949 by the Road Transport Sub-committee of the Inland Transport Committee of the United Nations Economic Commission for Europe.

vehicles and family members of the insured, the driver and any other person who is liable under civil law in the event of an accident and whose liability is covered by insurance.

c. Third Council Directive 90/232/EEC of 14 May 1990 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles (*Official Journal L 129, 19/05/1990 p. 33 – 35.*)

According to the Third Directive, insurance covers liability for personal injuries to all passengers, other than the driver, arising out of the use of a vehicle. Also, Member States shall take the necessary steps to ensure that all compulsory insurance policies against civil liability arising out of the use of vehicles cover, on the basis of a single premium, the entire territory of the Community and guarantee, on the basis of the same single premium, in each Member State, the cover required by its law or the cover required by the law of the Member State where the vehicle is normally based when that cover is higher. Moreover it has a provision regarding disputes between the compensation body and the insurer.

The decisions of the Commission relating to the Third Directive include provisions regarding associate and European Economic Area member countries. These are Commission Decision 91/323/EEC of 30 May 1991, Commission Decision 93/43/EEC of 21 December 1992, Commission Decision 97/828/EC of 27 October 1997, Commission Decision 1999/103/EC of 26 January 1999 and Commission Decision 2001/160/EC of 15 February 2001. All of the above are repealed by Commission Decision 2003/564/EC of 28 July 2003. According to that, As from 1 August 2003, each Member State shall refrain from making checks on insurance against civil liability in respect of vehicles which are normally based in another Member State or in the territory of the Czech Republic, Croatia, Cyprus, Hungary, Iceland, Norway, Slovakia, Slovenia and Switzerland, which are the subject of the Agreement of 30 May 2002 between the National Insurers' Bureaux of the Member States of the European Economic Area and other Associate States. There is also Commission Decision 2004/332/EC of 2 April 2004, which adds Estonia, Latvia, Lithuania, Malta and Poland into the scope.

d. Directive 2000/26/EC of the European Parliament and of the Council of 16 May 2000 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles and amending Council Directives 73/239/EEC and 88/357/EEC (Fourth motor insurance Directive) (Official Journal L 181, 20/07/2000 p. 65 – 74.)

The objective of the Directive is stated as to lay down special provisions applicable to injured parties entitled to compensation in respect of any loss or injury resulting from accidents occurring in a Member State other than the Member State of residence of the injured party which are caused by the use of vehicles insured and normally based in a Member State. It establishes a mechanism for the quick settlement of claims where the accident takes place outside the victim's Member State of residence. It gives injured parties in accidents enjoy a direct right of action against the insurance undertaking covering the responsible person against civil liability. Also, it institutes a position called "claims representative" who should be resident or established in the Member State where appointed and will be responsible for handling and settling claims arising from an accident.

Moreover, in order to ease the information gathering and speed up claims settlement, the Directive requires that Member States establish an information centre and compensation bodies.⁶⁸ The compensation bodies will be charged with settling claims in cases where there is no claims representative or where the insurer is too slow in dealing with the file and also if it is not possible to identify the vehicle, or if, within two months following the accident, it is not possible to identify the insurance undertaking.⁶⁹

e. Directive 2005/14/EC of the European Parliament and of the Council of 11 May 2005 amending Council Directives 72/166/EEC, 84/5/EEC, 88/357/EEC, 90/232/EEC and Directive 2000/26/EC of the European Parliament and of the Council relating to insurance against civil liability in respect of the use of motor vehicles (Fifth Motor Insurance Directive) (Official Journal L 149, 11/06/2005 p. 14-21.)

⁶⁸ Özşar, *ibid*, pp. 40,41.

⁶⁹ There is a Commission Decision (2003/20/EC of 27 December 2002) about the foundation of compensation bodies.

In the Fifth Motor Insurance Directive, some articles of the previous directives are replaced with new ones, deleted or amended in order to update and improve the protection of victims of motor vehicle accidents by compulsory insurance, ensure increased convergence as regards the interpretation and application of the Directives by Member States and provide solutions to problems which arise frequently to create a more efficient single market in motor insurance. The Directive sets forth provisions regarding minimum compensation amounts, pedestrians and cyclists, renewal of contracts and specific short term policies in which the vehicle is transported from one Member State to another for selling purposes. The latest date of Member States to bring into force the laws, regulations and administrative provisions necessary to comply with this Directive is 11 June 2007 at the latest.⁷⁰

3.1.10. Directives Regarding Reinsurance and Retrocession

a. 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 (*Official Journal P 056, 04/04/1964 p. 878 – 883.*)

According to the Directive, Member States shall abolish restrictions on taking up and pursuing the activities of self-employed persons in reinsurance and retrocession and in the case of natural persons, companies or firms dealing both in direct insurance and in reinsurance and retrocession, the part of activities concerned with reinsurance and retrocession. It should be noted that the provisions of Directive 64/225/EEC has been extended to other service sectors within the process of European integration.⁷¹

b. 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,

⁷⁰ Özşar, *ibid*, pp. 44,45.

⁷¹ Yavaş, *ibid*, p.341.

92/49/EEC as well as Directives 98/78/EC and 2002/83/EC (Text with EEA relevance.)
(Official Journal L 323 , 09/12/2005 P. 0001 - 0050)

The lack of harmonized reinsurance supervision rules in the EU has led to significant differences in the level of supervision of reinsurance undertakings between different Member States. In order to abolish barriers to trade and decrease administrative burden and costs, Directive 2005/68/EC has been introduced. The Directive lays down rules for the taking up and pursuit of the self-employed activity of reinsurance carried on by reinsurance undertakings, which conduct only reinsurance activities, and which are established in a Member State or wish to become established therein. According to the Directive, Home Country Control and Single Passport systems are extended to reinsurance undertakings. It also brings minimum regulatory requirements which are consistent with international standards. Moreover, the rules requiring posting of collateral are prohibited.⁷²

3.1.11. Directives Regarding Solvency

First Generation Insurance Directives required insurance undertakings to have solvency margins. The margins and calculations have remained unchanged until Third Generation Directives. With, so-called, Solvency I project (Directives 2002/12/EC and 2002/13/EC) solvency margin requirements of insurance undertakings have been revised. Solvency I brought a 50% increase of capital requirement for marine, aviation and general liability, which are known as most volatile classes. Also, supervisors' powers were improved on subjects of early intervention and solvency deduction for reinsurance. Moreover, monetary amounts were revised and index-linked.⁷³

⁷² Carr, Ben. (2006). "Reinsurance Directive 2005/68/EC". Explanatory Meeting of Screening Process with Croatia and Turkey. Retrieved June 3rd, 2006 on http://www.abgs.gov.tr/tarama/tarama_files/09/SC09EXP_reinsurance.pdf

⁷³ Linder, Ulf & Vesa Ronkainen. (2004). Solvency II – Towards a New Insurance Supervisory System in the EU. *Scandinavian Actuarial Journal* 6. p.463. Retrieved May 24th, 2006 on <http://search.epnet.com/login.aspx?direct=true&db=aph&an=15314048>

a. Directive 2002/12/EC of the European Parliament and of the Council of 5 March 2002 amending Council Directive 79/267/EEC as regards the solvency margin requirements for life assurance undertakings (Official Journal L 077, 20/03/2002 p. 11 – 16.)⁷⁴

According to the Directive, the available solvency margin shall consist of the assets of the assurance undertaking free of any foreseeable liabilities, less any intangible items. Article 19 of the Directive gives the calculation method of required solvency margin. To sum up, the required solvency margin is the sum of two results:

The first result is:

- A 4% fraction of the mathematical provisions, relating to direct business and reinsurance acceptance gross of reinsurance cessions shall be multiplied by the ratio, for the last financial year, of the total mathematical provisions net of reinsurance cessions to the gross total mathematical provisions. That ratio may in no case be less than 85%.

The second result is:

- For policies on which the capital at risk is not a negative figure, a 0,3% fraction of such capital underwritten by the assurance undertaking shall be multiplied by the ratio, for the last financial year, of the total capital at risk retained as the undertaking's liability after reinsurance cessions and retrocessions to the total capital at risk gross of reinsurance; that ratio may in no case be less than 50%.⁷⁵

However, the ratios could be different for particular classes of insurance. Also, there is another mechanism known as guarantee fund. One third of the required solvency margin constitutes the guarantee fund and the guarantee fund may not be less than a minimum of EUR 3 million.

⁷⁴ This Directive is repealed by Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance (*Official Journal L 345 , 19/12/2002 p. 1 – 51.*)

⁷⁵ Linder, Ulf. (2005). "EU Rules Concerning Life Insurance Solvency". Workshop on EU Insurance Legislation, İstanbul. Retrieved August 30th, 2005 on <http://www.tsrbs.org.tr/NR/rdonlyres/D1F9035E-B4AF-4525-A9F2-1EFF248BA721/838/ULinder1.ppt>

b. Directive 2002/13/EC of the European Parliament and of the Council of 5 March 2002 amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life insurance undertakings (*Official Journal L 077, 20/03/2002 p. 17 – 22.*)

It is stated in the Directive that Each Member State shall require of every insurance undertaking whose head office is situated in its territory an adequate available solvency margin in respect of its entire business at all times, which is at least equal to the requirements in this Directive. The available solvency margin shall consist of the assets of the assurance undertaking free of any foreseeable liabilities, less any intangible items. Article 16a of 73/239/EEC (amended by Article 1(3) 2002/13/EC) gives the calculation method of required solvency margin. To sum up,

Required Solvency Margin is the higher one of two results:⁷⁶

- The premium basis: The premium basis shall be calculated using the higher of the gross written premiums or gross earned premium. Premiums in the classes aircraft liability ship liability and general liability should be enhanced with 50%. The amount so obtained shall be divided into two portions. The first up to EUR 50 million, the second comprising the excess. 18% and 16% of these portions should be calculated and added together. This sum should be multiplied with the ratio (retained claims/total claims) for the last three years of the enterprise. This ratio shall not be less than 50%.
- The claims basis: The amounts of claims paid in respect of direct business is added by amount of claims paid in respect of reinsurances or retrocessions and deducted by amount of recoveries effected and provisions for claims outstanding. Claims, provisions and recoveries in the classes aircraft liability, ship liability and general liability should be enhanced with 50%. The third (or one seventh) of the amount so obtained shall be divided into two portions. The first up to EUR 35 million, the second comprising the excess. 26% and 23% of these portions should be calculated and added together. This sum should be multiplied with the ratio

⁷⁶ Linder, Ulf. (2005). "EU Rules Concerning Non-Life Insurance and Reinsurance Solvency". Workshop on EU Insurance Legislation, İstanbul. Retrieved August 30th, 2005 on <http://www.tsrbs.org.tr/NR/rdonlyres/D1F9035E-B4AF-4525-A9F2-1EFF248BA721/840/UlfLinder2.ppt>

(retained claims/total claims) for the last three years of the enterprise. This ratio not shall be less than 50%.

Also, one third of the required solvency margin shall constitute the guarantee fund. The guarantee fund may not be less than EUR 2 million. However, for some of classes it shall be EUR 3 million.

3.1.12. Directive Regarding Reorganization and Winding-Up of Insurance Undertakings

a. Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganization and winding-up of insurance undertakings (*Official Journal L 110, 20/04/2001 p. 28-39.*)

According to the Directive, reorganization measures means measures involving any intervention by administrative bodies or judicial authorities which are intended to preserve or restore the financial situation of an insurance undertaking and which affect pre-existing rights of parties other than the insurance undertaking itself, including but not limited to measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims. Winding-up proceedings means collective proceedings involving realising the assets of an insurance undertaking and distributing the proceeds among the creditors, shareholders or members as appropriate, which necessarily involve any intervention by the administrative or the judicial authorities of a Member State, including where the collective proceedings are terminated by a composition or other analogous measure, whether or not they are founded on insolvency or are voluntary or compulsory. The Directive then sets forth provisions regarding these measures and proceedings for proper functioning of internal market and for protecting creditors.

3.1.13. Regulations Regarding Insurance Statistics

a. Commission Regulation (EC) No 1225/1999 of 27 May 1999 concerning the definitions of characteristics for insurance services statistics (*Official Journal L 154, 19/06/1999 p. 1-45.*)

b. Commission Regulation (EC) No 1226/1999 of 28 May 1999 concerning the derogations to be granted for insurance services statistics (Text with EEA relevance) (*Official Journal L 154, 19/06/1999 p. 46- 74.*)

c. Commission Regulation (EC) No 1227/1999 of 28 May 1999 concerning the technical format for the transmission of insurance services statistics (Text with EEA relevance) (*Official Journal L 154, 19/06/1999 p. 75-90.*)

d. Commission Regulation 1228/1999 of 28 May 1999 concerning the series of data to be produced for insurance services statistics (Text with EEA relevance) (*Official Journal L 154, 19/06/1999 p. 91-107.*)

These regulations are based on Council Regulation No 58/97 of 20 December 1996 concerning structural business statistics which establishes a common framework for the collection, compilation, transmission and evaluation of Community statistics on the structure, activity, competitiveness and performance of businesses in the Community.⁷⁷ Taking into account of the Regulation, the Commission has adopted the regulations listed above for insurance service statistics.⁷⁸

⁷⁷ This regulation is amended by Regulation No 410/98 of 16 February 1998.

⁷⁸ Özşar, *ibid*, pp.47-49.

3.1.14. Regulations Regarding Insurance Committee

a. Council Directive 91/675/EEC of 19 December 1991 setting up an insurance committee (*Official Journal L 374, 31/12/1991 p. 32 – 33.*)

With this Directive, an Insurance Committee, composed of representatives of Member States and chaired by the representative of the Commission, was established in order to deliver opinions on draft measures and proposals. The Committee also examine any question relating to the application of Community provisions concerning insurance sector.

b. Commission Decision 2004/6/EC of 5 November 2003 establishing the Committee of European Insurance and Occupational Pensions Supervisors (Text with EEA relevance) (*Official Journal L 003, 07/01/2004 p. 30 – 31.*)

With the Decision 2004/6/EC, a Committee of European Insurance and Pensions Supervisors (CEIOPS) has been established to act as an independent advisory group on insurance and occupational pensions. It is composed of high level representatives from the national public authorities competent in the field of supervision of insurance, reinsurance and occupational pensions.

c. Commission Decision 2004/9/EC of 5 November 2003 establishing the European Insurance and Occupational Pensions Committee (Text with EEA relevance) (*Official Journal L 003, 07/01/2004 p. 34 – 35.*)

With the Decision 2004/9/EC, The European Insurance and Occupational Pensions Committee (EIOPC) has been established and after a directive repealing the advisory functions of Insurance Committee will be published, it will replace the Insurance Committee and assist the Commission in adopting implementing measures for EU Directives. It is composed of high level representatives of Member States and chaired by a representative of the Commission.

3.1.15. Regulations Regarding International Agreements Related to Insurance

There is an agreement that is signed between European Economic Community and Swiss Confederation on direct insurance other than life assurance. The legislation listed below is related to this agreement.

a. Council Regulation (EEC) No 2155/91 of 20 June 1991 laying down particular provisions for the application of Articles 37, 39 and 40 of the Agreement between the European Economic Community and the Swiss Confederation on direct insurance other than life assurance (*Official Journal L 205, 27/07/1991 p. 1-1.*)

b. Council Decision 91/370/EEC of 20 June 1991 on the conclusion of the Agreement between the European Economic Community and the Swiss Confederation concerning direct insurance other than life assurance (*Official Journal L 205, 27/07/1991, p. 2-2*)

c. Council Directive 91/371/EEC of 20 June 1991 on the implementation of the Agreement between the European Economic Community and the Swiss Confederation concerning direct insurance other than life assurance (*Official Journal L 205, 27/07/1991, p. 48-48*).

d. 2001/776/EC: Decision No 1/2001 of the EC-Switzerland Joint Committee of 18 July 2001 amending the Annexes and Protocols to the Agreement between the European Economic Community and the Swiss Confederation on direct insurance other than life assurance and finding that the domestic legislation of the Contracting Parties is compatible with that Agreement (*Official Journal L 291, 08/11/2001, p. 52-55*).

3.1.16. Other Issues

An important issue in business markets is taxation. However, harmonization in the field of taxation in European insurance markets is lacking. There are still different regulations in force in Member States.⁷⁹ Disharmony in taxation is one of the most controversial issues in European integration.

Also, one of the areas where differences still exist between Member States is pensions system. This is directly related to the national social security systems. However, integration efforts in this area have begun with the adoption of Directive 2003/41/EC of the European Parliament and the Council on the activities and supervision of institutions for occupational retirement provision. Its objective is stated as to allow pension funds to benefit from the Internal Market principles of free movement of capital and free provision of services and to establish rigorous prudential standards ensuring that pension fund members and beneficiaries are properly protected.⁸⁰

3.2. Supervision in the EU

Although the institutions of the Community propose and enact legislation and regulate the insurance sector in order to achieve Single Insurance Market, there is not a single, Community-wide insurance supervision authority, institution or a unit. Supervision is left to national level. On the other hand, Member States has the ability to set additional capital requirements, rules governing the valuation of assets and liabilities. So this means different countries adopt different approaches to prudential supervision.⁸¹

⁷⁹ Sterzynski, *ibid*, p.14.

⁸⁰ Website of The European Commission DG Internal Market. Retrieved August 6th, 2006 on http://ec.europa.eu/internal_market/pensions/index_en.htm

⁸¹ Dan Jespersen, Jesper. (2002). Supervision Risk Analysis in Denmark. *KPMG International Insurance Insight – Solvency II special edition*. p.14. Retrieved August 30th, 2005 on <http://www.us.kpmg.com/microsite/FSLibraryDotCom/Docs/intininsight.pdf>

However there are directives in order to support cooperation and information exchange in supervision between Member State authorities. In Article 7 of Directive 98/78/EC (Insurance Groups Directive), it is stated that, if insurance undertakings which are established in different Member States have relationship or a common participating undertaking, the competent authorities of each Member State shall communicate and cooperate closely. Also, according to Directive 2000/64/EC, Member States may conclude cooperation agreements for exchanging information with authorities or bodies of third countries.⁸²

With regard to authorities' structure, the trend in formation of single financial regulatory and supervisory agencies is clearly seen in EU States. 15 of 25 Member States have formed (mostly in recent years) authorities, which are responsible for regulating and supervising multiple financial sectors. With respect to independency, there are also different implementations. In some countries the agencies are tied to ministries but in others independency is especially targeted.

In this section, the authorities responsible for insurance supervision in 25 EU Member States will be introduced and their major activities will be summarised.

Austria: In Austria, Financial Market Authority (FMA) (established in 2002) is the independent, autonomous and integrated supervisory authority which is responsible for the supervision of credit institutions, insurance undertakings, pension funds, staff provision funds, investment funds, investment service providers, companies listed on the stock exchange as well as stock exchanges themselves. In the area of insurance, according to Insurance Supervision Act, FMA supervises the business activities of the insurance companies (monitoring technical provisions, equity capital, financial and profit situation, conduct of business), gives authorization to conduct business, protects the interests of the insured and represents Austria in European and international institutions.⁸³

Belgium: Banking, Finance and Insurance Commission (CBFA), is established as a result of the integration of the Insurance Supervisory Authority (ISA) into the Banking and

⁸² Özşar, *ibid*, p.9.

⁸³ Website of Financial Market Authority. Retrieved May 22nd, 2006 on <http://www.fma.gov.at>

Finance Commission (BFC). It is (since 1 January 2004) the single supervisory authority for the Belgian financial sector. Its areas of responsibility include insurance companies, insurance intermediaries, pension funds, supplementary pension, credit institutions, investment firms, bureaux de change, collective management of savings products, public offers, listed companies, financial markets, settlement and clearing, mortgage credit, surety companies and consumer protection. In Belgium, also Insurance and Pension Ombudsman is in charge.⁸⁴

Cyprus: In Cyprus, The Insurance Companies Control Service (established under Ministry of Finance) is responsible for the supervision of the operations of insurance undertakings and the implementation of the law. The Service examines license applications (insurers and intermediaries), financial statements of undertakings and supervises undertakings' investments and operations. The Superintendent and Assistant Superintendent are appointed by Council of Ministers.⁸⁵

Czech Republic: In Czech Republic, until April 2006, Ministry of Finance's Office of State Inspection in the Insurance and Pension Scheme Industry was responsible for insurance supervision. As of that date, Czech National Bank will carry on duties of the Office. These duties include authorization, off-site and on-site inspections.⁸⁶

Denmark: The Danish Financial Supervisory Authority (Finanstilsynet) (established in 1988) is an institution under the responsibility of the Minister of Economic and Business Affairs. Finanstilsynet's activities are in supervision, regulation and information. Financial undertakings including insurance, pension funds and insurance brokers and also securities market are supervised by Finanstilsynet. Moreover, one of the main objectives of it is stated as the drafting of financial laws and the issuing of executive orders. It also collects and publishes statistics and key figures concerning the financial sector.⁸⁷

Estonia: The Financial Supervision Authority (an agency of the Bank of Estonia) (established in 2001) conducts financial supervision in the name of the state and is

⁸⁴ Website of Banking, Finance and Insurance Commission. Retrieved May 22nd, 2006 on <http://www.cbfa.be>

⁸⁵ Website of Insurance Companies Control Service. Retrieved May 22nd, 2006 on <http://www.mof.gov.cy>

⁸⁶ Website of Czech National Bank. Retrieved May 22nd, 2006 on <http://www.cnb.cz>

⁸⁷ Website of Finanstilsynet. Retrieved May 22nd, 2006 on <http://www.finanstilsynet.dk>

independent in the conduct of financial supervision. The supervised entities by The Financial Supervision Authority are credit institutions, insurance companies and intermediaries, fund management companies; securities market participants, investment and pension funds, investment firms, fund managers and providers of e-money.⁸⁸

Finland: The Insurance Supervisory Authority (ISA) is an institution subordinate to the Ministry of Social Affairs and Health but with independent decision-making powers. Its objectives are stated as protection of the interests of the insured; promote security and efficiency in the insurance markets and strength confidence in the Finnish insurance system. ISA has the duties of monitoring compliance of institutions under its supervision to laws, good insurance practices and proper procedures and evaluating their financial position, management, control and risk management systems, operational preconditions and changes in their operational environments.⁸⁹

France: Different from other Member States, in France, there are two main supervisory authorities in insurance sector. These are The Insurance Companies Committee (CEA) and The Insurance, Mutual Insurance and Contingency Insurance Providers Control Commission (CCAMIP). CEA is responsible for accrediting insurers and CCAMIP is responsible for ensuring whether all applicable laws, regulations and contracts are complied with and monitoring insurers' financial position. CCAMIP has rights for making recommendations and imposing sanctions.⁹⁰

Germany: In Germany, responsibility of insurance supervision is divided between the Federal Government and the Federal States. On behalf of the Federal Government, The Federal Financial Supervisory Authority (BaFin) (established in 2002) (which is also responsible for the supervision of credit institutions, financial services institutions and securities trading) supervises private insurance companies operating in Germany which are of material economic significance and the competing public-law insurance companies which operate across the borders of a Federal State. The Federal States' supervisory authorities mainly supervise the public-law companies whose activities are limited to the

⁸⁸ Website of Financial Supervision Authority. Retrieved May 22nd, 2006 on <http://www.fi.ee>

⁸⁹ Website of Insurance Supervisory Authority. Retrieved May 22nd, 2006 on <http://www.vakuutusvalvonta.fi>

⁹⁰ Insurance Regulation in the EU (2005). Freshfields Bruckhaus Deringer, (June). Retrieved December 4th, 2005 on <http://www.freshfields.com/practice/disputeresolution/publications/pdfs/12036.pdf>

particular Federal State in question and the private insurance companies of lesser economic significance. Supervision by BaFin or the Federal State supervisory authorities extends to all private and public-law insurance companies which conduct private direct insurance business within the scope of the Insurance Supervision Act and have their principal place of business in Germany. The supervision of insurance consists of mainly authorization process and on-going supervision. BaFin has the right of taking action in order to protect the interests of policyholders.⁹¹

Greece: In Greece, Ministry of Development – Directorate of Insurance Undertakings and Actuaries used to supervise the sector. However, a new supervisory authority, called Insurance Supervision Commission, has been established which is planned to be operational by 2006.⁹²

Hungary: Hungarian Financial Supervisory Authority supervises institutions in money markets (credit institutions and financial enterprises), capital markets (investment and management firms), funds, and insurance companies and keeps a register of insurance intermediaries and advisors.⁹³

Ireland: The Irish Financial Services Regulatory Authority (Financial Regulator) (established in 2003) is responsible for the regulation of all financial services firms in Ireland. Financial Regulator, according to EU Directives and the Insurance Acts and Regulations-1909 – 2004 carries out the authorisation and supervision of insurance companies. The main purpose is to ensure companies are able to meet their obligations to policyholders and claimants. Authorization is possible if a company shows that it has sufficient capital, necessary expertise to write insurance and a viable business plan. Companies are supervised by a process of monitoring of financial returns, on-site visits and meetings with companies.⁹⁴

⁹¹ Website of Federal Financial Supervisory Authority. Retrieved May 22nd, 2006 on <http://www.bafin.de>

⁹² Greece: Financial System Stability Assessment (2006). *IMF Country Report* No.06/6 (January). Retrieved May 22nd, 2006 on <http://www.imf.org/external/pubs/ft/scr/2006/cr0606.pdf>

⁹³ Website of Hungarian Financial Supervisory Authority. Retrieved May 22nd, 2006 on <http://www.pszaf.hu>

⁹⁴ Insurance Statistical Review (2003). The Irish Financial Services Regulatory Authority. Retrieved August 30th, 2006 on http://www.ifsra.ie/data/pub_files/insurance%20statistical%20review%202003.pdf

On the other hand, occupational pension schemes and Personal Retirement Savings Accounts in Ireland are monitored and supervised by another authority called the Pension Board.

Italy: In Italy, the supervisory body for private insurance is Istituto Per La Vigilanza Sulle Assicurazioni Private E Di Interesse Collettivo (ISVAP) (established in 1982), which is a public corporation with legal status. The primary scope of its regulatory and supervisory powers is to ensure the stability of the market and of undertakings as well as the solvency and efficiency of insurance market participants, with a view to protecting the interests of consumers and of the public in general. It also grants authorization, monitors financial position of undertaking, conducts on-site inspections and introduces lines of conduct. Moreover, it collects complaints about supervised companies and follows the solutions of disputes.⁹⁵

On the other hand, another authority called Commissione Di Vigilanza Sui Fondi Pensione (COVIP) supervises pension funds.

Latvia: The Financial and Capital Market Commission (established in 2001) is a public institution, which carries out the supervision of Latvian banks, insurance companies and insurance brokerage companies, participants of financial instruments market and private pension funds. The goals of the Commission are determined as to protect the interests of investors, depositors and the insured, and to promote the development and stability of the financial and capital market.⁹⁶

Lithuania: Insurance Supervisory Commission of the Republic of Lithuania aims to ensure reliability, efficiency, safety and stability of the insurance system and protection of interests and rights of the policyholders, insured, beneficiaries, and injured third parties. In order to provide this, it prepares legislation, grant licences, supervise undertakings, apply sanctions and establish various procedures and set rules related to insurance business.⁹⁷

⁹⁵ Cervellati, Enrico Maria. (2003). Financial Regulation and Supervision in EU Countries. *EFMA 2003 Helsinki Meetings*. pp.33-35. Retrieved August 30th, 2005 on <http://ssrn.com/abstract=391998>

⁹⁶ Website of Financial and Capital Market Commission. Retrieved May 22nd, 2006 on <http://www.fktk.lv>

⁹⁷ Website of Insurance Supervisory Commission. Retrieved May 22nd, 2006 on <http://www.dpk.lt>

Luxembourg: In Luxembourg there are two supervisory authorities. Commissariat aux Assurances for insurance sector and Commission de Surveillance du Secteur Financier for other financial sectors including pension funds.

Malta: The Malta Financial Services Authority (MFSA) is the single regulator for financial services activities in Malta. It regulates and supervises credit and financial institutions, investment, trust and insurance business and also houses the country's Companies Registry. Insurance business in Malta is regulated under the Insurance Business Act which provides for the authorisation and supervision of insurance companies and the MFSA is the Competent Authority for the purposes of the Act.⁹⁸

Netherlands: In Netherlands, the Nederlandsche Bank (DNB) has the duty of supervising banks and other credit institutions, pension funds, insurance companies and other institutions including investment firms and money transaction offices. The Nederlandsche Bank (DNB) authorises insurers that meet statutory requirements and monitors their compliance with the Act on the Supervision of the Insurance Industry, the Prepaid Funeral Services Insurance Supervision Act and various royal decrees and ministerial regulations. It can also publish regulations, policy rules and recommendations.⁹⁹

There is another financial supervisor called the Netherlands Authority for the Financial Markets (AFM) that supervises the way financial institutions treat their customers, particularly the provision of information by insurance companies to consumers and businesses according to the Financial Services Act.¹⁰⁰

Poland: The Insurance and Pension Funds Supervisory Commission is a state body (under superintendence of Minister of Finance) for insurance and pension supervision. Its supervision activities include insurance, insurance mediation, pension funds and occupational pension programs. The main goal of the supervision activity is determined as protection of the interest of insurers, the insured and beneficiaries and entitled from insurance contracts, members of pension funds and members of occupational pension

⁹⁸ Website of Malta Financial Services Authority. Retrieved May 22nd, 2006 on <http://www.mfsa.com.mt>

⁹⁹ Website of Nederlandsche Bank. Retrieved May 22nd, 2006 on <http://www.dnb.nl>

¹⁰⁰ Website of Authority for the Financial Markets. Retrieved May 22nd, 2006 on <http://www.afm.nl>

programs. The Commission's activities include issuance and withdrawal of authorization, resolutions on undertakings board members, trustees, selling and purchasing of shares, liquidation of undertakings and pension programs and imposing penalties.¹⁰¹

Portugal: The Portuguese Insurance Institute (ISP) is the official body that controls and supervises the business of insurance and reinsurance, pension funds and brokerage. The ISP, which is a state-owned corporate body with administrative and financial autonomy, produces technical rules and cooperates on the drafting of new legislation that governs the taking up and the pursuit of the insurance and pension fund businesses. It also monitors insurance undertakings, brokers and pension fund managers and controls the compliance with the rules and regulations that govern the sector.¹⁰²

Slovakia: The Financial Market Authority (established in 2002) conducts the supervision over the activity of a trader with securities, a branch office of a foreign trader with securities, investment services provider, Security Stock Exchange, Securities Central Depository, trustee company, shareholders fund, insurance company, branch office of foreign insurance company, insurance broker and other persons and subjects and over groups of persons and subjects which are obliged by special laws in the field of capital market or insurance. It also cooperates with the Ministry of Finance of the Slovak Republic in the preparation of generally binding draft legislative regulations in the field of capital market and insurance.¹⁰³

Slovenia: The Insurance Supervision Agency's main objectives are stated as mitigating and eliminating irregularities in insurance; protecting policyholders' interests; and facilitating the functioning of the insurance economy, which in turn has a positive impact on the entire economy. According to the Insurance Act, the Insurance Supervision Agency is responsible for supervision of the insurance market in the Republic of Slovenia. Its main responsibility is supervising insurance undertakings, insurance agencies and insurance brokerage companies, and insurance agents and brokers. The Agency also is

¹⁰¹ Website of Insurance and Pension Funds Supervisory Commission. Retrieved May 23rd, 2006 on <http://www.knuife.gov.pl>

¹⁰² Website of Portuguese Insurance Institute. Retrieved May 23rd, 2006 on <http://www.isp.pt>

¹⁰³ Website of Financial Market Authority. Retrieved May 23rd, 2006 on <http://www.uft.sk>

responsible to issue authorisations to pension companies and to supervise their operations. Moreover it prepares and issues implementing regulations in line with the Insurance Act.¹⁰⁴

Spain: In Spain, the Directorate General for Insurance and Pensions Funds (established within Ministry of Finance) supervises and controls Spain's insurance and pension fund sector. It is responsible for ensuring that the sector functions properly and for providing customers of insurance agencies and members of pension funds with appropriate protection. The Directorate General is empowered to regulate, issue instructions to supervise the institutions that constitute the sector. It is also charged with authorising new institutions wishing to work in the sector and with monitoring the business operations undertaken thereby.¹⁰⁵

Sweden: The Swedish Financial Supervisory Authority (established in 1991), Finansinspektionen, is a public authority, which its role is to promote stability and efficiency in the financial system as well as to ensure an effective consumer protection. It operates in the areas of supervision (financial stability and market supervision), regulation and permits/licences and applications of all companies operating in Swedish financial markets (banks and other credit institutions; securities companies and fund management companies; stock exchanges, authorised marketplaces and clearing houses; insurance companies, insurance brokers and friendly societies). The Finansinspektionen is accountable to the Ministry of Finance.¹⁰⁶

United Kingdom: The Financial Services Authority (FSA) (established in 2001), is an independent body that regulates the financial services industry in the UK. FSA has been given a wide range of rule making, investigatory and enforcement powers in order to meet the objectives of market confidence, public awareness, consumer protection and reduction of financial crime. It is the single statutory regulator responsible for the authorisation and regulation of deposit taking, insurance, general insurance advice, investment business, mortgage lending and mortgage advice.¹⁰⁷

¹⁰⁴ Website of Insurance Supervision Agency. Retrieved May 23rd, 2006 on <http://www.a-zn.si>

¹⁰⁵ Website of Directorate General for Insurance and Pensions Funds. Retrieved May 23rd, 2006 on <http://www.meh.es>

¹⁰⁶ Website of Finansinspektionen. Retrieved May 23rd, 2006 on <http://www.fi.se>

¹⁰⁷ Website of Financial Services Authority. Retrieved May 23rd, 2006 on <http://www.fsa.gov.uk>

On the other hand, The Pensions Regulator has been established as the new regulatory body for work-based pension schemes in the UK. It has replaced The Occupational Pensions Regulatory Authority in 2005. The work-based pension schemes include any schemes that an employer makes available to employees, including occupational, stakeholder and personal.¹⁰⁸

¹⁰⁸ Website of Pensions Regulator. Retrieved May 23rd, 2006 on <http://www.thepensionsregulator.gov.uk>

3.3. Recent Developments

3.3.1. General Developments

For the last decades, regulation and supervision of financial services has been in focus in the EU. The main aim is to accomplish a Single Market for financial services. In order to achieve this, the Financial Services Action Plan was prepared with the strategic objectives of a single wholesale market, open and secure retail markets, state-of-the-art prudential rules and supervision and a general objective of wider conditions for an optimal single financial market in 1999.¹⁰⁹ Along with this, financial services regulation and supervision has considerably changed with regulations like Capital Requirements Directive, Financial Conglomerates Directive and Markets in Financial Instruments Directive.

With respect to insurance, recent years has also been busy with the adoption of Insurance Mediation, Reinsurance and Fifth Motor Directives. Also the Commission has started a study towards harmonization of insurance guarantee schemes. However, since the second half of the 90's to today, the whole insurance sector's, including the Union institutions, national regulators / supervisors and companies', concern has been on solvency. During this time period existing rules have been revised, supervision scope has been extended; new agencies have been formed in both EU and national level. Some countries like the UK and the Netherlands have concentrated on a more risk based solvency regime. Parallel with these developments, the European Union has started a project on solvency in 2000, which is composed of two stages. The first stage (Solvency I) has been ended with the adoption of Directives 2002/12/EC and 2002/13/EC and the second stage (Solvency II) has been going on. The next section gives information on Solvency II in more detail.

¹⁰⁹ Financial Services Implementing the Framework for Financial Markets: Action Plan (1999). European Commission. Retrieved June 17th, 2006 on ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf

3.3.2. SOLVENCY II

a. Introduction to Solvency II

On April 1997, the Conference of Insurance Supervisors of the Member States of the European Union was held where the solvencies of insurance undertakings were discussed. The conference was culminated in a report called Müller Report which evaluated that European solvency system was generally satisfactory however it recommended a two-stage review of the solvency rules. These are:

- The rules on the solvency margin in the existing directives were to be amended
- A more in-depth discussion would be held of other aspects of the rules designed to ensure the solvency of insurance undertakings.¹¹⁰

The approach was also approved by the Insurance Committee and in 2000 the Commission has initiated the “Solvency I” project. Directives 2002/12/EC and 2002/13/EC have revised solvency margin requirements of insurance undertakings.

On the other hand, regarding to the second recommendation presented in the Müller Report and coming remarks of many Member States that the changed business situation for insurance undertakings would call for a more fundamental review of the whole EU insurance supervisory architecture has led to “Solvency II” project. Linder summarizes other motives behind Solvency II as follows:¹¹¹

- Increased competition and pressure of shareholders
- Fall of stock markets, low interest rates
- Convergence between sectors, formation of financial conglomerates
- Developments of risk analysis methods
- International developments, namely works of International Association of Insurance Supervisors (IAIS), International Actuarial Association (IAA),

¹¹⁰ Note To The Solvency Subcommittee Of The Insurance Committee Solvency II: Presentation Of The Proposed Work (2001) The European Commission DG Internal Market, MARKET/2027/01–EN, Brussels. Retrieved June 17th, 2006 on March 18, 2006 on http://ec.europa.eu/internal_market/insurance/docs/markt-2027/markt-2027-01_en.pdf

¹¹¹ Linder, Ulf. (2005). “Solvency II – General Introduction”. Workshop on EU Insurance Legislation, İstanbul. Retrieved August 30th, 2005 on <http://www.tsrbsb.org.tr/NR/rdonlyres/D1F9035E-B4AF-4525-A9F2-1EFF248BA721/842/UlfLinder3.ppt>

International Accounting Standards Board (IASB) and some countries (UK, Netherlands, Australia etc.)

Depending on these motives, Solvency II project has been launched in 2000. The project has been divided into two phases. In the first phase, several areas like use of risk based capital systems, lessons to draw from the bankers' Basle process, use of internal models, Lamfalussy developments and links between financial reporting and supervisory accounts were studied by Member States and the Commission in order to decide on the general design of a new supervisory regime. This phase ended in the beginning of 2003 and introduced the general considerations for the new system.¹¹² The two important reports of this phase that effected the design of the new system are "Study into the Methodologies to Assess the Overall Financial Position of an Insurance Undertaking from the Perspective of Prudential Supervision" (known as KPMG Report) and "Prudential Supervision of Insurance Undertakings Report" (known as Sharma Report).

As general starting points, it is concluded that:¹¹³

- The new system should provide supervisors with the appropriate tools to assess the "overall solvency" (not only quantitative ratios and indicators but also qualitative aspects that may influence the risk-standing) of an insurance undertaking.
- The solvency system should be based on a Basle-type three-pillar approach, which is adapted to the needs and specific aspects of insurance sector.
- The solvency system should be more risk-oriented which includes encouraging and giving an incentive to insurance undertakings to measure and manage their risks; developing common EU principles on risk management and supervisory review; the quantitative solvency requirements covering the most significant risks to which an insurance undertaking is exposed and the recognition of internal models that are developed by undertakings.

¹¹² Linder & Ronkainen, *ibid*, p.464.

¹¹³ Note Prepared by the Commission Services : Design of a Future Prudential Supervisory System in the EU – Recommendations by the Commission Services. (2003) The European Commission DG Internal Market, MARKT/2509/03–EN, Brussels. pp.3-5. Retrieved March 18th, 2006 on http://ec.europa.eu/internal_market/insurance/docs/markt-2509-03/markt-2509-03_en.pdf

- A two level approach in capital requirements where the first “target” requirement would be based on the need for economic capital at a certain ruin probability and the second “minimum” requirement for taking action.
- The solvency system should be compatible with the approach and rules used in the banking field in order to ensure consistency across financial sectors.
- The increasing share and formation of insurance groups and financial conglomerates constitutes one of the aims of the new system as more efficient supervision of these groups.
- The new system should, to the extent possible, be built on the principle of maximum harmonization of supervisory methods on the contrary of minimum harmonization principal in the current directives.
- Lamfalussy or comitology techniques should be used in order to build a supervisory framework that is efficient and flexible.
- A future system should also take international developments into account. International Association of Insurance Supervisors (IAIS) has been working on solvency principles, standards and guidance. International Association of Actuaries (IAA) has been also working on solvency capital structure. On the other hand, International Accounting Standards Board (IASB) has an insurance account project that would have a clear impact on the Solvency II project.

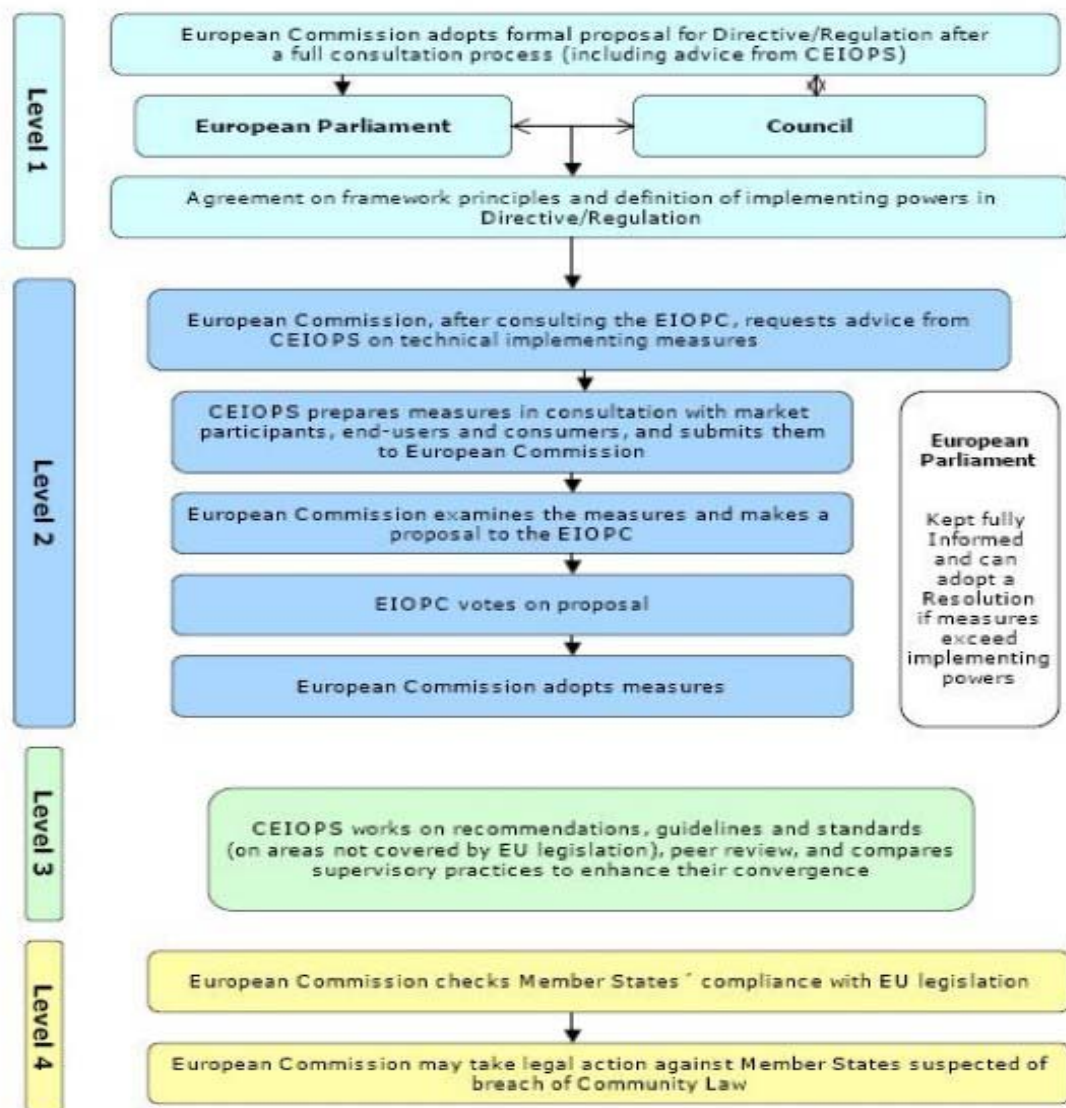
The second phase of the project includes preparation of legal texts and more detailed technical rules and guidance. The new Solvency II Directive will contain provisions of the current legislation and provisions, which reflects the new system. The existing 14 Directives including Life, Non-life, Reinsurance, Insurance Groups and Winding-up Directives, will be codified into one directive. Approximately three-fourths of the Directive will constitute these re-cast provisions. The remaining part will include new provisions.¹¹⁴

The project will be completed under the Lamfalussy structure. According to that, a high level Framework Directive (Level 1) will be adopted by a process including Council of Ministers, European Parliament and Commission. The detailed rules (implementing

¹¹⁴ Website of the European Commission DG Internal Market. Retrieved June 17th, 2006 on http://ec.europa.eu/internal_market/insurance/solvency2/index_en.htm

measures) of the new Solvency II articles will be prepared by the Commission after adoption of Level 1 Framework legislation, with guidance from European Insurance and Occupational Pensions Committee (EIOPC) and its insurance solvency sub-committee (Level 2). Also, Committee of European Insurance and Pensions Supervisors (CEIOPS) will prepare recommendations, guidelines etc and compare supervisory practices (Level 3). After the adoption of legislation, the Commission plays the role of Guard of EU rules (Level 4). An illustration of Lamfalussy structure in insurance legislation is given in Figure 3.1.

Figure 3.1. Lamfalussy Structure in Insurance Legislation



Source: Tertak, Elemer. (2006). "The European Commission's Perspective: Questions to be Answered". ABI Solvency II Conference. Retrieved May 27th, 2006 on http://www.abi.org.uk/Display/File/Child/608/Elemer_Tertak_slides.ppt

CEIOPS is the party, which the Commission consults on technical issues in preparation of the Directive with three waves of “Calls for advice”.¹¹⁵ First wave included internal control and risk management, supervisory practices, investment management rules and asset liability management. Second wave was about technical provisions, solvency capital requirement, reinsurance, powers of supervisory authorities, solvency control levels, peer reviews and group and cross-sector issues. Third wave addressed eligible elements to cover the capital requirements, cooperation between supervisory authorities, supervisory reporting and public disclosure, procyclicality and small undertakings. All the three waves of “Calls for Advice” have been answered and submitted to the Commission by CEIOPS.

Moreover, in order to assess the quantitative impacts of new system, the Commission has requested CEIOPS to conduct Quantitative Impact Studies (QIS). The first QIS, which focused on the level of prudence in the current technical provisions and benchmarking them against some predefined confidence levels, has been conducted and the results were introduced in March 2006. The second QIS has been launched on May 2006 and it will analyse the effect on insurance undertakings of the possible restatement of the value of both assets and liabilities under the Solvency II framework, as well as some possible options for setting the capital requirement (Minimum Capital Requirement and Solvency Capital Requirement). At the end of QIS 2, CEIOPS aims to get information about the practicability of the calculations involved; the possible impact on the balance sheets and the amount of capital that might be needed and the suitability of the possible approaches to the calculation of the Solvency Capital Requirement. The results will possibly be obtained until October 2006.¹¹⁶

b. The Three Pillar System of Solvency II

The proposed Solvency II system is designed on a three-pillar structure which is similar to the system relevant for banks and financial firms based on Basle II and Capital Requirements Directive of the EU.

¹¹⁵ Solvency II - Current Developments and Implications (2005). Towers Perrin Tillinghast. pp.3,4. Retrieved March 23rd, 2006 on

http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2005/200510/Solvency_II.pdf

¹¹⁶ The documents on QIS 1 &2 and summary report of QIS 1 can be accessed from website of CEIOPS : <http://www.ceiops.org>

i. Pillar I – Quantitative Requirements

The first pillar includes required solvency margins and technical rules for the valuation of assets and liabilities.

The two required solvency margins are called “Solvency Capital Requirement” (SCR) and “Minimum Capital Requirement” (MCR) of which their calculations are not clear yet. In the draft outline of Solvency II Directive, referring to the works of CEIOPS, MCR is defined as:¹¹⁷

“The minimum capital requirement reflects a level of capital below which an insurance undertaking’s operations present an unacceptable risk for policyholders and therefore, immediate supervisory action is needed.”

and SCR is defined as:

“The solvency capital requirement should reflect the amount of capital necessary to meet all obligations over a specified time horizons (including the present value of future obligations to a defined confidence level, taking into account all significant, quantifiable risks).”

The MCR is intended to be a safety net and will serve as a trigger level for severe supervisory actions. According to CEIOPS, it should be calculated in a simple, robust and objective manner. The current Solvency I requirements would be used for a set transitional period and after the period, a calculation based on the existing Solvency I requirements (in the case of the non-life formula, possibly with some amendments to make the formula more suitable for interim calculations); a MCR determined as a margin over liabilities; or a simple calculation based on the standard formula of the SCR or some combinations of these ways could be chosen.¹¹⁸

The SCR is aimed to be the capital level which enables an insurance undertaking to absorb significant unforeseen losses over a specified time horizon and gives reasonable

¹¹⁷ Draft Outline of a Solvency II Framework Directive Annex to Document MARKT/2507/05 – EN (2005). The European Commission DG Internal Market, Brussels. Retrieved March 18th, 2006 on http://ec.europa.eu/internal_market/insurance/docs/2005-market-docs/markt-2507-05-annex_en.pdf

¹¹⁸ Answers to the European Commission on the second wave of Calls for Advice in the framework of the Solvency II Project (2005). CEIOPS. DOC-07/05 (October). pp. 53,54. Retrieved March 26th, 2006 on http://www.ceiops.org/media/files/publications/submissionstotheec/Doc07_05-AnswersEC2ndwaveSII.pdf

assurance to policyholders that payments will be made as they fall due. According to CEIOPS, it should cover all the relevant true risks of an insurance undertaking which are underwriting, credit, market, liquidity, operational and other. It shall be calibrated so that the probability of failure of an undertaking within (for example) one year is sufficiently low (for example 0, 5%).

The work on calculation of the SCR is still being continued. It is likely that there would be a standard formula, a calculation depending on full internal models and partial internal models of undertakings.

The standard formula will relate capital requirements to key risk categories (underwriting, credit, market, operational and liquidity). However, the structure of formula is not determined yet. It can be based on a factor-based formula, probability distribution-based formula, scenarios or the combinations of these. However, different specifications of life, non-life and reinsurance business require analysis in developing a standard formula.¹¹⁹ Moreover, the standardized approach has the limitation of considering the average firm and delivering only an approximation to a risk-based capital requirement.¹²⁰

The SCR may also be calculated by the undertaking's own internal model which is validated and approved by competent authorities. However the model's risk measure, time horizon and scope of risks covered must not be less prudent than the standard approach's. The details of this compliance are not determined yet. It is believed that, the capital requirements of the internal model approach will be better aligned to the undertaking's risk profile.¹²¹ Because, the increasing complexity of financial products and their valuation methods make the companies the right entity to understand and assess their own risks better. The company-specific risks are modelled with theoretical models using company's data and which consider parameters like time horizon, scale of risk and confidence level.

¹¹⁹ Draft Amended Framework for Consultation on Solvency II. (2005) The European Commission DG Internal Market, Annex to MARKET 2505-05. Brussels. p.5. Retrieved May 27th, 2005 on http://ec.europa.eu/internal_market/insurance/docs/2005-market-docs/market-2505-05-annex_en.pdf

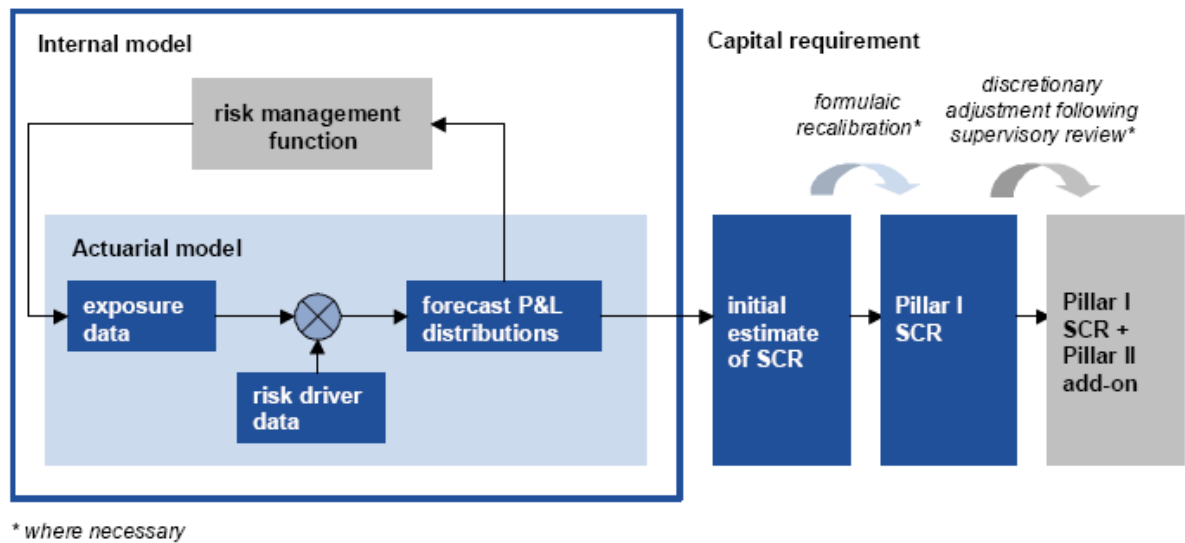
¹²⁰ Solvency II: A New Framework for Prudential Regulation of Insurance in the EU – A Discussion Paper (2006). HM Treasury & FSA. p.35. Retrieved March 3rd, 2006 on http://www.fsa.gov.uk/pubs/international/solvency2_discussion.pdf

¹²¹ CEIOPS, *ibid*, p.114.

At the end, company's own claims experience and risk exposures are translated into company's own risk capital requirement.¹²²

Calculation of SCR with internal model approach is illustrated as follows:

Figure 3.2. Calculation of SCR with Internal Model



Source: CEIOPS, *ibid*, p.117.

Here,

- Risk exposure data: how many contracts of which types are written
- Risk driver data: historic information on the likelihood of certain events
- P&L: profit and loss
- Actuarial model: the whole system that transforms input data into forecast P&L distributions
- Internal model: the model, which includes the way in which firm's internal risk management system integrates with the actuarial model
- Formulaic recalibration: the estimate of SCR computed by firm's model may needed to be recalibrated into SCR that is specified by regulatory framework

¹²² Guhe, Jürgen & Helmut Kesting. (2004) *Paradigm Change in Insurance Supervision*. Allianz Group Dresdner Bank. pp.7,8. Retrieved August 30th, 2005 on http://www.allianz.com/Az_Cnt/az/_any/cma/contents/257000/saObj_257934_Versicherungsaufsicht_engl.pdf

- Adjustment following supervisory review: SCR could be adjusted after Pillar II supervisory review

Partial models could also be used in calculating the SCR. By partial model, it is meant that one of the standard and internal model approach could be applied to some business lines and/or some risk categories. However, there is a probability that firms could intend to select partial model solely for minimizing capital requirements, also known as “cherry picking”. According to CEIOPS, there should be additional constraints on the use of partial models in order to avoid cherry picking.¹²³ An option is to require only the approval of the model. The other is to limit which model can be applied to which risk category, as it is done in Capital Requirements Directive.¹²⁴ Examples of partial models are given in Figure 3.3.

Figure 3.3. Examples of Partial Models

(a) partial models: no further restrictions than model approval

		Risks			
Business		Underwriting	Credit	Market	Operational
1	Model	Standardized approaches			Model
2					
3					

(b) partial models: application to all business lines

		Risks			
Business		Underwriting	Credit	Market	Operational
1	Model	Standardized approaches			Model
2					
3					

Source: HM Treasury & FSA, *ibid*, p.37

What if the SCR and MCR limits are breached? With Solvency II, in the cases of not providing required capital, the intervention of authorities will be gradual or as it is called a “ladder approach” is introduced. According to this approach, if the available capital of the

¹²³ CEIOPS, *ibid*, p.133.

¹²⁴ HM Treasury & FSA, *ibid*, p.37.

company is greater than SCR (or adjusted SCR) there is no need to take action. However the trend of capital level is being followed. If the available capital falls below the SCR but not breaches the MCR limit, supervisory authorities request the company to take action like presenting a capital increase program or risk reducing activities. The MCR is the reference point for more serious measures, which may lead to withdrawal of the license.

The other part of the first pillar is technical rules for the valuation of assets and liabilities and related to that, technical provisions. Valuation of provisions constitutes a very important part of the discussion in Solvency II project and has not been come to light yet. The Commission, states that an increased harmonization for technical provisions is a cornerstone in the new system. The Commission recommends that, considering expected IASB developments, technical provisions would include a “best estimate” of liabilities added by a risk margin.¹²⁵ CEIOPS, which has been called for advice on the issue, has not reached a common view. Since there are long lasting and divergent traditions and practices in Member States, CEIOPS has asked for political guidance and added technical provisions into the scope of QIS 2.¹²⁶

In order to be more illustrative, a comparison of the current Solvency I style balance sheet figure including assets, liabilities and solvency margin and the proposed Solvency II style balance sheet figure is given in Figure 3.4.

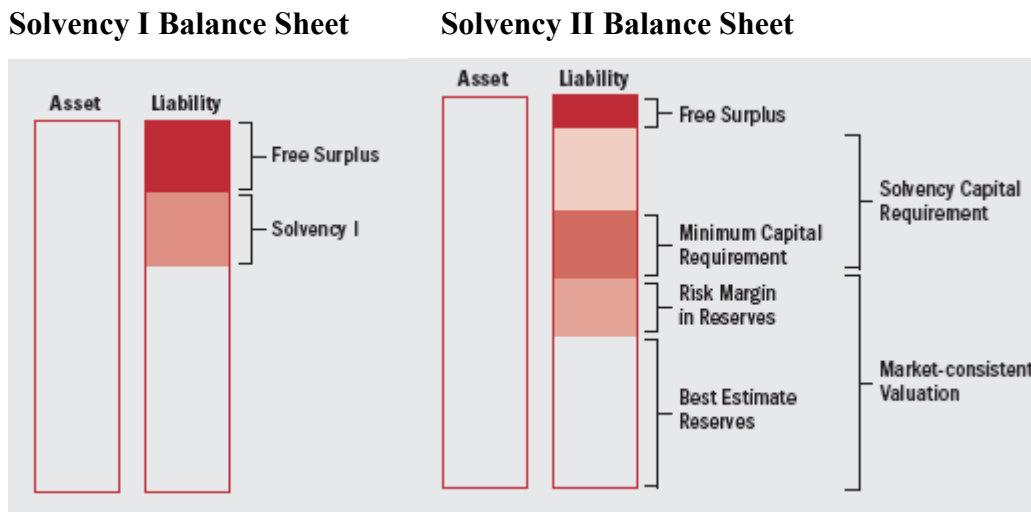
With regard to quantitative approach to investment policies and assets covering technical provisions, SCR and MCR, it is proposed to bring increased level of harmonization among the Member States with Solvency II. However, it is still not clear whether new rules would be composed of an eligible elements list or principles governing the elements.¹²⁷

¹²⁵ DG Internal Market, *ibid*, p.5.

¹²⁶ Tertak, Elemer. (2006). “The European Commission’s Perspective: Questions to be Answered” at ABI Solvency II Conference. Retrieved May 27th, 2006 on http://www.abi.org.uk/Display/File/Child/608/Elemer_Tertak_slides.ppt

¹²⁷ Sterzynski, Maciej & Jan Dhaene. (2006). Solvency II: changes within the European single insurance market. p.9. Retrieved June 3rd, 2006 on http://www.cesfd.org.cn/paper/conferences/2006-5-12/Sterzynski,%20Maciei/MS_JD_SolvencyII_China.pdf

Figure 3.4. Comparison of Solvency I and Solvency II Balance Sheets



Source: Quantitative Impact Studies for Solvency II (2006). Ernst&Young, p.1. Retrieved June 3rd, 2006 on http://www.ey.nl/download/publicatie/0606_QuantitativeImpactStudiesSolvencyII.pdf

ii. Pillar II – Supervisory Review Process

The second pillar is about supervisory review process that would complement capital requirements (Pillar I) and disclosures (Pillar III). The process has two aims:

- to help ensure that a firm is well run and meets adequate risk management standards
- to help ensure that the firm is adequately capitalised.¹²⁸

In order to achieve that, Solvency II will bring undertakings to develop internal control and sound risk management principles. These requirements are reflected in the draft of the Framework Directive as follows¹²⁹:

“The Home Member State shall require every insurance undertaking to have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, and to have internal control mechanisms. The internal control mechanisms should be adequate for the nature and scale of the insurance undertaking’s business and should include sound administrative and accounting procedures.”

¹²⁸ HM Treasury & FSA, *ibid*, p.39

¹²⁹ Draft Outline of a Solvency II Framework Directive Annex to Document MARKT/2507/05 – EN (2005). The European Commission DG Internal Market, Brussels. Retrieved March 18th, 2006 on http://ec.europa.eu/internal_market/insurance/docs/2005-market-docs/markt-2507-05-annex_en.pdf

“The Home Member State shall require every insurance undertaking to identify and assess the nature and the significance of the risks it faces (risk management). Insurance undertakings shall manage their risks with a view to provide reasonable assurance of maintaining the undertaking’s overall financial soundness. In order to achieve this, insurance undertakings shall have in place effective strategies and processes, comprehensive and proportionate to the nature and scale of the risks they face.

As part of the risk management, a Home Member State shall require every insurance undertaking:

- to develop and carry out active concrete policies specially focused on the definition, follow-up and control of its solvency position (policy on solvency management).
- to have in place Reinsurance Management and Risk Mitigation Management, ensuring appropriate reinsurance arrangements.”

On the other hand, all quantitative and qualitative requirements that are summarized above have to be followed by supervisory authorities whether they are complied and/or adequate. With Solvency II, it is intended to harmonise many important aspects of supervisory review process at EU level, though tailoring of supervision may be needed according to individual companies. For example, a common framework for assessing corporate governance could be built. Also, early warning indicators, reference scenarios for stress tests¹³⁰, minimum set of common statistics and minimum criteria for on-site inspections could be harmonized at EU level. By that way, increased communication between supervisors and more converged supervision is aimed. Also, Solvency II will bring coordinated supervisory action in crisis situations that affect undertakings or the entire sector, especially operating in many countries and in different financial sectors.

A very important part of Pillar II is the definition and scope of intervention powers and responsibilities of authorities against undertakings that fail to fulfil requirements. The Framework Directive will include an enabling article on supervisory powers and a list of specific powers. The supervision will consist of both quantitative and qualitative aspects. On the quantitative part the SCR and MCR will be the solvency control levels. The breaches of these thresholds require supervisory authorities to take action ranging from requesting a corrective plan from the undertaking to withdrawal of licence. The supervisory authority also will have the right to adjust SCR that is calculated by the company’s model if it does not reflect the true risk profile of the company. According to CEIOPS, in these cases, supervisors should be able to require the undertaking to hold more

¹³⁰ Stress testing is a risk management tool used to evaluate the potential impact on a firm of a specific event and/or movement in a set of financial variables.

capital against existing risks or to take no additional risks or to reduce its overall level of risk retained.¹³¹

The supervisory authorities will have wide range of powers in the new regime. However in order to provide transparency and accountability of the supervisory authorities, the general criteria and evaluation methodology of the supervisory authorities must be publicly available.¹³² Solvency II will bring new requirements not only to undertakings but also to supervisory authorities.

Another concept that is to come to insurance supervision with Solvency II is the peer reviews. With the idea of supervisory authorities can and should learn from another; peer reviews, which are organized by CEIOPS, will increase confidence in the robustness of European markets and in the quality of supervision in the EU.¹³³

Moreover, Pillar II is expected to include qualitative requirements on management of assets and liabilities. According to CEIOPS Answers to Second Calls for Advice, these requirements may include qualitative investment policies, rules and plans (for example adequate asset liability management - ALM), an investment strategy that is approved by firms Board of Directors and subject to internal control and asset liability policy.¹³⁴

iii. Pillar III – Market Discipline

The aim of the third pillar is to reinforce market mechanisms and risk-based supervision through disclosures and transparency. These are key aspects in efficiency of financial markets with respect to competition and price formation. They also bring market discipline that in the long term will lead to more stable financial markets. On the other

¹³¹ CEIOPS, *ibid*, p.163.

¹³² Note Prepared by the Commission Services : Design of a Future Prudential Supervisory System in the EU – Recommendations by the Commission Services. (2003) The European Commission DG Internal Market, MARKT/2509/03–EN, Brussels. p.9. Retrieved March 18th, 2006 on http://ec.europa.eu/internal_market/insurance/docs/markt-2509-03/markt-2509-03_en.pdf

¹³³ CEIOPS, *ibid*, p.196.

¹³⁴ CEIOPS, *ibid*, pp.75-78.

hand, high quality public disclosure will help market participants in their decision making.¹³⁵

With regard to these motives, Pillar III is planned to include both public disclosures and supervisory reporting which will be complementary to the first two pillars. Public disclosures mainly include accounting/financial reporting requirements but in Pillar III there will be additional and more detailed information based on Pillar I and Pillar II. These are intended to provide information to all stakeholders (market participants, regulators, policyholders etc.) to evaluate their decisions or possible future actions. On the other hand, supervisory reporting will consist of all information required for supervisory purposes. This information could be both qualitative and quantitative which reflects not only the structure and risk profile of the undertaking but also the processes and strategies of the undertaking. Disclosure requirements of Solvency II will consider IASB and IAIS works on disclosure standards.¹³⁶

Moreover, an important issue in the discussion upon Pillar III of Solvency II project is whether certain supervisory information about financially troubled undertakings should or should not be disclosed to public. It is considered that this kind of information could worsen the situation.¹³⁷

c. The Next Steps in Solvency II Project

The draft of Solvency II Framework Directive is being prepared by the Commission Services taking into consideration the three Calls for Advices. The Framework Directive will be a codification of existing directives and also include new elements. The Commission plans to introduce the draft text in October 2006. Besides the draft Directive, there will be an Impact Assessment report which will give a background to, argumentation for and an assessment of the impact of the critical choices made during the preparation of the Framework Directive. The Impact Assessment will have both quantitative (referring to

¹³⁵ Answers to the European Commission on the third wave of Calls for Advice in the framework of the Solvency II Project (2006). CEIOPS. DOC-03/06 (May). pp.77,78. Retrieved May 27th, 2006 on <http://www.ceiops.org/media/files/publications/submissionstotheec/CEIOPS-DOC-03-06Answerstothirdwave.pdf>

¹³⁶ CEIOPS, *ibid*, pp.81,82.

¹³⁷ DG Internal Market, *ibid*, p.10

CEIOPS's Quantitative Impact Studies) and qualitative (referring to studies with stakeholders) aspects.

In the Lamfalussy structure, implementation measures (Level 2) will follow the approval of the Framework Directive by the Council and the Parliament which is envisaged to realize in 2007. 2008 and 2009 is the term for determination of implementation measures and adoption of the Directive by Member States. By 2010, it is planned to put Solvency II into force.

However these are not the exact dates and as mentioned above there are many unsolved issues in the details of the structure like valuation of technical provisions and formulation of the standard SCR. Also the developments and conclusions of IASB and IAIS works, on which some measures of Solvency II are planned to be based on, may affect the course of the project.

d. The Effects of Solvency II on Insurance Sector

Although there are many unsolved issues in the details of Solvency II, the proposed structure already indicates that the new system will have wide range of effects on the insurance industry. The three-pillar system will have macro scale implications on European and non-European insurance markets, consumer protection and market stability. Solvency II will also mean micro scale but somewhat revolutionary changes in insurance undertakings and supervisory authorities.

The first macro scale implication of Solvency II will be on insurance market integration in the EU. Although the regulation and supervision in insurance has been Europeanized with the help of three generations of insurance directives and other related directives, there are still many differences in supervision structures and styles between Member States. This difference creates an obstacle in formation of Single Insurance Market and more generally Single Financial Market. Nielsen explains the situation as follows:¹³⁸

¹³⁸ Towards a Better Reflection of Risks – Dr. Rolf Stölting interviews Henrik Bjerre Nielsen (2006). Munich Re, Topics 1/2006. p. 22. Retrieved June 3rd, 2006 on http://www.munichre.com/publications/302-04915_en.pdf?rdm=174

“If we want to have a common European insurance market, supervisory practices will have to converge too.”

As it is stated in previous section, the second pillar of Solvency II requires maximum harmonization in supervisory activities within Member States. So the new approach aims the supervisory standards become more unified in order to increase the level of integration within Single Insurance Market.¹³⁹

The other main obstacle in front of Single Insurance Market is valuation of assets and liabilities of undertakings and related to those, technical reserves. Valuation differs from one Member State to another and disharmony gives different solvency results. Whereas, undertakings which have similar assets and liabilities should be required to hold similar capitals throughout the internal market in order not to impede competition. With Solvency II's Pillar I, although the details are not clear yet, valuation of balance sheet items will be harmonized and based on IASB's fair value techniques.¹⁴⁰

With Solvency II, not only European insurance markets but also other world markets will be affected. Because like many other financial markets, insurance has become a more global activity with increasing number of financial conglomerates and groups. There are many non-European undertakings operating in Europe by establishing companies or through agencies. Also many European companies' subsidiaries or branches write insurance business in many countries. So, Guhe & Kesting suggest that Solvency II will enhance the trend to international convergence of supervisory systems and methods in the insurance sector.¹⁴¹

Insurance markets' structure will also be effected from Solvency II regulations. This is because of the possible increase in capital and other requirements, where small undertakings may find it difficult to survive. At this point, with respect to scale economies, Solvency II may lead these small enterprises to mergers and acquisitions. This is a

¹³⁹ Sterzynski & Dhaene, *ibid*, p.5.

¹⁴⁰ Sterzynski & Dhaene, *ibid*, p.4.

¹⁴¹ Guhe & Kesting, *ibid*, p.11.

possibility in markets, for example German insurance market, where there are many small insurance undertakings.¹⁴²

The second macro implication of Solvency II is on protection of policyholders, the insured and third parties. With the more risk-based solvency regime and market valued technical provisions of Pillar I, insurers' commitment of covering contracts to consumers will be nearly guaranteed. Unlike the current solvency system, the new regime will include risk categories like market, credit etc. for calculation of capital requirement. These quantitative requirements will also be supported by qualitative ones under Pillar II and if necessary they will be revised in order not to put the insurer into financial trouble. If the signs of insolvency are seen (for example, the breach of SCR) supervisory authorities will intervene in different ways according to severity of the situation. The ultimate goal is to protect consumers from insurers' inability to meet their obligations by requesting adequate requirements after determining the true risk profile of the company.

Other important parts of Solvency II are disclosures and transparency, under Pillar III. The extended content and availability of reporting will decrease information asymmetry between the company and stakeholders. This will help the consumers in assessing the true financial situation of the company and in deciding which company offers insurance cover with a high probability of future claims payments. In other words, which company is more reliable as the insurance business is based on confidence. Also, shareholders will be able to consider whether to keep investing in the company or because of high risk profile, stop investing.

Finally, it can be concluded that the risk based and customized solvency system and supervision and sufficient disclosure and transparency, altogether, will enhance confidence and market stability in European insurance market.

The effects of Solvency II on insurance companies will be considerable. First of all, under Pillar I, companies will have the chance of determining their regulatory capital with their own models. However, the development and implementation of these models will require significant cost and effort. This means companies should start intensive, complex

¹⁴² Guhe & Kesting, *ibid*, p.12.

projects which companies have to allocate significant technical and systems resource with management support and understanding.¹⁴³ In order to give an idea of how much these modelling projects costs, large banks' expenses in order to comply Basel II requirements, is a good example. According to estimations, large banks (those with more than €30 billion of assets) would spend €115 million over a five year period to introduce Basel II requirements, including obtaining model approval.¹⁴⁴

One can not be sure but it is expected that internal models will mean less capital requirements. However, it is certain that using internal models will bring the companies the advantage to understand their business better. The internal models will help to extend companies' viewpoint of what kind of and how much risk the company has and how it is managed. Moreover, consideration will be given to which products or business segments add or subtract value. This analysis may also include product design, marketing, sales and asset-liability management. Therefore, insurers may be able to get a competitive advantage by choosing to develop internal models for regulatory capital calculation.¹⁴⁵

Secondly, under Pillar II, insurance companies are demanded to have and effectively implement risk management and internal control mechanisms. This means for many companies, which are not already have begun advanced risk management systems, to redesign their business management, to enhance existing policies and procedures and identify and quantify the risks they are exposed to. Moreover, as required by Pillar II, effective internal control and governance structures should be established within the company. The changes in risk measurement, management, controlling and reporting will require organizational changes and developing new technical skills.¹⁴⁶ It is obvious that all of the above mean increased expenditure on human resources and information systems. The companies which have available resources will gain advantage in complying the new regime and stay in the market. However, especially small undertakings will find it difficult to respond the increasing demands from regulators / supervisors and from the market itself.

¹⁴³ Towers Perrin Tillinghast, *ibid*, p.20.

¹⁴⁴ HM Treasury & FSA, *ibid*, p.36.

¹⁴⁵ Munich Re, *ibid*, p.27.

¹⁴⁶ Solvency II (2006). Ernst&Young. p. 8. Retrieved June 3rd, 2006 on http://www.ey.nl/download/publicatie/Solvency_II_brochure.pdf

Similar to developing internal models, building up advanced risk control and management systems will bring competitive advantage to companies which perceive and effectively implement these concepts not only as regulatory requirements but functional and rational management behaviour.

With respect to product and pricing of insurance products it is expected that risk based capital requirements will have some impacts. High risks will be reflected in capital allocation so companies will consider pricing of some insurance classes according to how they correspond to technical provisions and solvency requirements. However, as Nielsen explains, this relationship is not simple, since insurers may choose to price policies on their own capital requirements, which may exceed regulatory capital.¹⁴⁷

On the other hand, Solvency II will bring several implications on supervisors. Supervision will also be risk based so authorities should prepare themselves for assessing both quantitative and qualitative aspects, which reflects the situation of the undertaking. The supervisory authorities will have to invest in human resources and information technologies. Because they should be capable of assessing the accuracy and compliance of internal models that are developed by insurance undertakings. This kind of control requires a wide understanding on insurance business and a deep knowledge in mathematical / technical modelling.

Moreover, under Pillar II, communication and cooperation between supervisory authorities will be strengthened. With Solvency II, it is proposed to move beyond the current “mutual recognition” concept to “maximum harmonization”. However, the convergence needs effort and time.

To sum up, Solvency II is not only a project focusing only on prudential supervision but a project which will have considerable effects on insurance markets and its participants.

¹⁴⁷ Munich Re, *ibid*, p.23.

IV. INSURANCE REGULATION AND SUPERVISION IN TURKEY

4.1. Legislation in Turkey

In the history of the Republic of Turkey, the first regulations regarding insurance was a chapter in the Commercial Code, dated 29.05.1926 and the Law No. 1149 Regarding Inspection and Supervision of Insurance Companies, dated 25.06.1927.¹⁴⁸ The responsible authority was the Ministry of Trade.

For a long time period, insurance law was based on these laws. In 1956, the Turkish Commercial Code was adopted and the 5th Book of the Code was on insurance law. On the other hand, with the aim of providing the secure conduct and development of insurance business in the country; making the entities and institutions which take part in the sector, act in professional rules; enabling the created funds contribute to economic development and assure the rights and claims of the parties deriving from insurance contracts, Law No. 7397 Regarding the Supervision of Insurance Companies came into force on December 30th, 1959.¹⁴⁹

On June 11th, 1987, this law was amended by Law No. 3379 Regarding Insurance Supervision and it is titled as “Insurance Supervision Law”. The same year, with the adoption of Statutory Decree No. 303, the authorization of regulation and supervision in insurance was taken from Ministry of Industry and Trade and given to Prime Ministry’s Undersecretariat of Treasury. Another important change, according to Law No. 3379, is that foreign companies operating in Turkey became subject to same principles with Turkish companies, by incorporating or opening branches and reserving some amount of premium that are underwritten in the country.

¹⁴⁸ Arslan, *ibid*, p.51.

¹⁴⁹ Esenkaya, İ. Erdem (2000). “Sigorta Şirketlerinde Mali Denetim Türkiye ve AT Karşılaştırması”. İstanbul Üniversitesi Sosyal Bilimler Enstitüsü. Yayınlanmamış Doktora Tezi. p. 134

With Law No. 4059, dated 09.12.1994, Insurance Supervisory Board was transformed to central audit unit and the General Directorate of Insurance was founded within the Undersecretariat of Treasury with the function of regulation of insurance sector.¹⁵⁰

The Undersecretariat of Treasury has the duty and authorization of governmental supervision and monitoring in the sector. Here, Insurance Supervision Board is assigned the duty of supervision; on the other hand Insurance Supervision Board and General Directorate of Insurance are both assigned the duty of monitoring.¹⁵¹

Until 1990, the rates and tariffs were determined by Insurance Supervision Board. After the free tariff system, the importance of more effective supervision and update in regulation was needed, so on September 15th, 1993 Statutory Decree No. 510 was enacted. The decree has amended some articles of Insurance Supervision Law however it was annulled by the Constitutional Court. Lately, the annulment of Law No. 3991, which is the basis of the Statutory Decrees, has caused uncertainty in implementation of Statutory Decree No. 539 that amends some articles of Law No. 3379 and regulations based on the decree.

It should be noted that there are three important regulations in insurance besides above mentioned ones. First one is Statutory Decree No. 587 regarding Compulsory Earthquake Insurance, dated 27.12.1999, which came into affect after 1999 earthquakes. The second one is Law No. 4632 Individual Pension Saving and Investment System which came into force on October 7th, 2001 with the aim of directing personal savings to investment, based on voluntary and predetermined contributions; increasing welfare in retirement period; creating long-term resources for economy and increasing employment and economic development. The last one is Law No. 5363 Agricultural Insurance Law, dated 14.06.2005. The aim of the law is to establish agricultural insurance for producers against losses specified in the law.¹⁵²

¹⁵⁰ Arslan, *ibid*, p.52.

¹⁵¹ Taşbaşı, *ibid*, p.403.

¹⁵² Arslan, *ibid*, pp.53,54.

Turkish legislation on insurance generally consists of Insurance Supervision Law concerning regulatory and supervisory issues, Turkish Commercial Code's 5th Book concerning contract law, some specific insurance laws like pension and agricultural insurance, regulations, circulars and communiqués. Table 4.1 is a list of laws, statutory decrees and regulations on insurance in force.

Table 4.1. Turkish Legislation in Force

Name of Legislation	Enforcement Date
<i>Laws and Statutory Decrees</i>	
Law No. 7397 Insurance Supervision Law	30.12.1959
Statutory Decree No. 587 Regarding Compulsory Earthquake Insurance	27.12.1999
Law No. 4632 Individual Pension Saving and Investment System	07.10.2001
Law No. 5363 Agricultural Insurance Law	14.06.2005
<i>Regulations</i>	
Regulation Regarding Principles and Procedures of Operation of the Association of Insurance and Reinsurance Companies of Turkey	30.01.1989
Regulation Regarding Principles and Procedures of Operation of Turkish Motor Vehicle Bureau	26.10.1991 (last revision : 05.05.2006)
Insurance Experts Regulation	01.05.1992 (last revision : 05.04.2002)
Regulation Regarding Principles of Establishment and Operation of Insurance and Reinsurance Companies	01.01.1995 (last revision : 06.09.2005)
Insurance Expert Committees Regulation	15.06.1995
Insurance Producers Regulation	02.08.1995 (last revision : 05.04.2002)
Actuaries Regulation	03.08.1995 (last revision : 05.04.2002)
Life Insurance Regulation	01.08.1997
Insurance and Reinsurance Brokers Regulation	01.11.2000 (last revision : 27.04.2006)
Traffic Guarantee Insurance Account Regulation	03.07.2002 (last revision : 07.08.2004)
Regulation Regarding Independent Audit in Insurance and Reinsurance Companies	08.09.2003
Regulation Regarding Principles of Independent Audit in Insurance	08.09.2003

Traffic Insurance Information Centre Regulation	16.12.2003
Regulation on Insurance Accounting System	01.01.2005
LPG Market License Regulation	16.09.2005
Agricultural Insurance Implementation Regulation	22.09.2005 (last revision : 18.05.2006)
Regulation Regarding Third Party Liability Insurance for Turkish and Foreign Civil Aviation Vehicles Flying over Turkish Territory	01.01.2006
Regulation Regarding Calculation and Evaluation of Capital Adequacies of Insurance, Reinsurance and Pension Companies	23.03.2006
Regulation Regarding Procedures and Principles of Operation of Agricultural Insurance Pool	18.05.2006 (last revision : 22.09.2006)

Source: Website of TSRSB. Retrieved several occasions on <http://www.tsrbsb.org.tr>

Besides these there are many circulars and communiqués regarding insurance and related subjects. Also, the scope and limitations of insurance policies are determined in General Conditions which constitute important part of insurance law.

Moreover, insurance companies are obliged to comply with other, mainly financial, legislation. This kind of legislation includes accounting, financial reporting, capital markets (if the shares are quoted in stock exchange) and tax legislation. Regulation on Insurance Accounting System and Uniform Chart of Accounts and its Prospects Communiqué, which are enacted in order to be consistent with International Financial Reporting Standards, are effective since 01.01.2005. On the other hand, according to Circular No:12471 of Undersecretariat of Treasury dated 03.03.2005, until adoption of Insurance Financial Reporting Standards, Capital Market Board's Serial:11 No:25 Communiqué will be valid for accounting of asset, liabilities and financial investments which risks are born by policyholders.¹⁵³

¹⁵³ Sarıaslan, Metin. (2006). *Avrupa Birliği ve Türk Sigorta Muhasebesi: Uluslararası Finansal Raporlama Standartlarıyla Karşılaştırılmalı*. TSRSB Sigorta Araştırma ve İnceleme Yayınları-5. p. 27. İstanbul.

4.2. Supervision in Turkey

Article 30 of the Law No. 7397, entitled “Insurance Supervision Board”, states that insurance and reinsurance companies, entities operating in insurance sector (owners, partners and managers of intermediaries, experts and actuaries) are subject to supervision according to insurance legislation in force by Insurance Supervisory Board. The Board’s organization and functions are determined by Regulation Regarding the Undersecretariat of Treasury Insurance Supervision Board, dated 08.08.1998 and Law No. 4059 Regarding Organization and Functions of the Undersecretariat of Treasury and Foreign Trade, dated 09.12.1994.¹⁵⁴

In Turkey, government supervision on insurance and reinsurance companies is composed of chartering (licensing) and material audit. A company (entrepreneur) which is wishing to conduct business in insurance has to get a license. Also, the company is supervised in all stages from its start up to its end. Generally, insurance or reinsurance undertakings are supervised in three stages. In start up or incorporation stage, they are examined whether they provide the conditions that are stated in Law. Thorough the conduct of business of the company, the continuity of the compliance is examined. The supervision consists of financial, administrative, legal and technical aspects which affects the financial and managerial structure of the companies.

Administrative supervision deals with, whether there are management problems in conduct of business and qualification of management team in terms of education, experience and ethical values. Legal aspect of supervision consists of compliance of undertakings’ operations and transactions to insurance legislation. The structure of portfolio, the ways of price determination, rationality of reinsurance policies are some issues in technical aspect of supervision.¹⁵⁵

Insurance Supervision Board examines financial positions of the insurance companies annually. If any deficiency is detected, according to Article 20 of the Law No.

¹⁵⁴ Esenkaya, *ibid*, p.135.

¹⁵⁵ Taşbaşı, *ibid*, pp.404-406.

7397, necessary measures may be requested to be taken by the supervisor. The examinations basically consist of:

- Solvency
- Technical reserves and ratios
- Financial analysis ratios and
- Conservation ratios

First solvency regulations in insurance legislation in Turkey were included in Regulation Regarding Establishment and Operation of Insurance and Reinsurance Companies, dated 21.06.1988.¹⁵⁶

In order to harmonise Turkish legislation on solvency with European Union's directives and evaluate the risks of an insurance undertaking with a risk based modelling, General Directorate of Insurance has prepared a regulation and the Regulation Regarding Calculation and Evaluation of Capital Adequacies of Insurance, Reinsurance and Pension Companies has been published in the Official Gazette on March 23rd, 2006. The aim of this regulation is ensuring that the insurance, reinsurance and pension companies hold adequate capital against losses that could result from current and potential risks.

According to the Regulation, firms' equity capital, which is described in the Article 4, can not be less than required capital (solvency margin), which its calculation is described in the Article 6. If not, the firm has to prepare a payment plan and complete the missing capital. In the cases of not preparing a payment plan, disapproval of the plan by the Undersecretariat or not obeying the plan, necessary acts are taken based on clauses in the Insurance Supervision Law and the Individual Pension Savings and Investment System Law.

According to the new regulation, solvency margin is the higher one of obtained results calculated from two methods.

¹⁵⁶ Arslan, *ibid*, pp.55,56.

First Method:

Solvency margin in *non-life branches* including health and personal accident is the higher result obtained after calculations are made on both the premium basis and claims basis.

Solvency margin according to premium basis is calculated as follows:

Firstly, of the gross premiums written last year (free of repealed and cancelled) up to YTL 85 million is multiplied by 18 %, the rest is multiplied by 16 % and the sum of these amounts is gained. If the ratio of the claims remaining to be borne by the firm to the gross claims in the last 3 years is below 50 %, the solvency margin is 50 % of the amount calculated above. If not, it is calculated by multiplying the sum by the ratio itself.

Solvency margin according to claims basis is calculated as follows:

The claims paid in the last 3 years are added by outstanding claims reserve (including reserves for direct and indirect businesses) for the last year. Then this amount is subtracted by recourse revenues and last year's (the sixth year's in credit and agricultural insurance) outstanding claims reserves. The 1/3 of this amount (1/7 in credit and agricultural insurance) is taken into consideration and up to YTL 60 million of it is multiplied by 26 %, the rest is multiplied by 23 % and the sum of these amounts is gained.

If the ratio of the claims remaining to be borne by the firm to the gross claims in the last 3 years is below 50 %, the solvency margin is 50 % of the amount calculated above. If not, it is calculated by multiplying the sum by the ratio itself.

The calculations of the solvency margin are based on annual premiums or the last 3 years average of claims. However, in credit and agricultural insurance average of claims of the last 7 years is taken into consideration.

Solvency margin in *life branch* is the sum of the two results regarding liability and risk.

The result regarding liability is calculated as follows:

Firstly, the sum of life mathematical reserves (including direct and indirect businesses) and unearned premium reserves for one year life insurance is multiplied by 4 %. If the ratio of the sum of net mathematical reserves and net unearned premium reserves for one year life insurance and the sum of gross ones is below 85 %, the result regarding liability is 85 % of the amount calculated above. If not, it is calculated by multiplying the amount by the ratio itself.

The result regarding risk is calculated as follows:

The capital at risk which is calculated by subtracting mathematical reserves and unearned premium reserves from the amount to be paid to the insured in the case of death is multiplied by these ratios:

- 0,1 % if the insurance period is up to maximum 3 years
- 0,15 % if the insurance period is longer than 3 years but shorter than 5 years
- 0,3 % if the insurance period is longer than 5 years.

If the ratio of the amount of last year's capital at risk after reinsurance cessions to the capital at risk before reinsurance cessions is below 50 %, the result regarding risk is 50 % of the amount calculated by addition of three amounts above. If not, it is calculated by multiplying the amount by the ratio itself.

Solvency margin in *pension branch* is minimum 0,5 % of the accumulations of the participants' individual pension accounts. If this amount exceeds the limit that is determined in the Article 8 of the Individual Pension Savings and Investment Law, the exceeding part is ignored.

Second Method:

This method is described in the Article 8 of the Regulation Regarding Calculation and Evaluation of Capital Adequacies of Insurance, Reinsurance and Pension Companies. This method is based on multiplying specific items by some determined factors and aims to reflect the required capital according to main titles of risks which an insurance undertaking is exposed to. Asset, reinsurance, excess premium increase, outstanding claims reserve,

underwriting and interest / exchange risks are considered and the required solvency margin is the total of the below-mentioned results.

The Asset Risk is calculated by multiplying asset items by specific risk weights. For example,

a) Cash	0,000
b) Bank Accounts	0,010
....	
r) Real-estates for investment purposes	0,200
...	

The Reinsurance Risk is calculated by multiplying proportional reinsurance premium that is ceded by 0,05 risk weight for degree A and B reinsurers and pools in Turkey (0,010 for Agricultural Insurance Pool) and by 0,150 risk weight for the rest of the degrees.

In the calculation of The Excess Premium Increase Risk, if the rate of increase in premium according to last year is greater than 50 % of the sector's average, the excess is multiplied by 0,2 %. For the newly incorporated firms this risk is taken zero.

The Outstanding Claims Reserve Risk is calculated by multiplying the amounts of outstanding claims reserves by specific risk weights for every branch. For example,

a) Life	0,025
b) Fire	0,050
...	
i) Accident (Automobile)	0,125

The Underwriting Risk is calculated by multiplying annual earned premiums free of proportional reinsurance cessions by specific risk weights for every branch. For example,

a) Personal Accident	0,050
b) Life	0,050
...	
j) Accident (Automobile)	0,230

The Interest / Exchange Risk is calculated by multiplying the sum of the results calculated above by 0,03.

Besides required capital there are also obligatory cautionary allowances which should be set aside by insurance companies in Turkey. The amount of these allowances in non-life branches is a specific proportion (which is determined by the Undersecretariat of Treasury) of premiums free of repealed and cancelled, by the end of fiscal period. In life branch it is the result of a calculation including mathematical, outstanding claims and dividend reserves. The newly incorporated firms should set aside 20 % of their paid-in capital until the next allowance period. The details of the cautionary allowances are described in the Article 12 of the “Insurance Supervision Law”.¹⁵⁷

On the other hand, there are some restrictions on investments. Investment decisions should consider security, liquidity and profitability criteria. In order to protect the interests of the insured, winding up of insurance undertakings is also under supervision which is the third stage of supervision.¹⁵⁸

4.3. Recent Developments

One of the recent main developments in regulation of insurance sector in Turkey is the Draft Proposal of Insurance Law¹⁵⁹. In May 2005, the Undersecretariat of Treasury has presented the Draft Proposal for public opinion before sending it to the Prime Ministry. The aim of the Draft Proposal is stated as setting the structure of insurance activities in a more systematic way, responding to the changing circumstances and needs, efficient functioning of the system in order to protect the rights and interests of the insured and harmonization of the regulation to the international standards.¹⁶⁰

¹⁵⁷ Arslan, *ibid*, p.57.

¹⁵⁸ Taşbaşı, *ibid*, p.406.

¹⁵⁹ Text of The Draft Proposal can be retrieved from web site of the Turkish Association of Insurance and Reinsurance Companies, <http://www.tsrbs.org.tr>

¹⁶⁰ Press Bulletin (2005). Undersecretariat of Treasury, No:2005/59 (May): Ankara. Retrieved April 8th, 2006 on http://www.hazine.gov.tr/GuncelDuyuru/SGM_20050518_sigortakanuntas.pdf

The Draft Proposal brings establishment and licensing conditions of insurance and reinsurance undertakings which are compliant to the EU rules. Articles 3 – 10 of the Draft Proposal includes clauses regarding establishment of insurance and reinsurance companies, license, evaluation of license application, license abrogation, alteration in the articles of association, organization of the insurance and reinsurance companies, gaining usufruct and voting rights and restriction on asset reduction operations.

The Draft Proposal also brings solvency requirements which are compliant to the EU rules. Article 18 of the Draft Proposal, entitled “Strengthening Financial Structure”, regulates the procedures that could be taken by the authority (the responsible Minister) when a company fails to meet the solvency margins, cautionary allowances, technical provisions or obligations from insurance contracts; or has serious financial troubles that put the rights and interests of the insured at risk. The criteria of financial structure infirmity are determined by specific regulation.

Technical provisions are designed in order to comply with the EU rules. In the Article 15 of the Draft Proposal of Insurance Law, it is stated that insurance and reinsurance companies have to set aside reserves for obligations which are born by insurance contracts. These are:

- Unearned Premiums Reserve
- Ongoing Risks Reserve
- Mathematical Reserve
- Outstanding Indemnity Reserve
- Bonuses and Discounts Reserve
- Stabilization Reserve
- Investment Risk Technical Reserve

The procedures and principles of calculation of reserves and assets that these reserves could be hold are determined by specific regulation.

Foundation of an Arbitration (Ombudsman) Institution in order to speed up insurance dispute resolution is a very revolutionary step in Turkish insurance system. With the aim of resolution of disputes between the insured and the insurers, foundation of the Insurance

Arbitration Commission by (under the auspices of) the Turkish Association of Insurance and Reinsurance Companies is planned. In the Article 25 of the Draft Proposal, entitled “Arbitration in Insurance”, it is underlined that the arbitration system is based on willingness and in order to benefit from the system, the companies should have to notify their affirmation to the TSRSB. According to the new regulation, the party which is in dispute with the insurance company has to prove that his application about the case to the company is totally or partially rejected. Also, recourse to the Commission is possible if the company fails to respond to the application in one month. Moreover if the dispute has been already passed to the judiciary, one can not recourse to the Commission. The cases in the arbitration are evaluated by independent Insurance Rapporteurs and Referees. The organization and duties of the Commission, its procedures and principles and rapporteurs’ and referees’ procedures and principles are determined by regulation.

The Draft Proposal gives opportunity to insurance experts and agencies to form associations. As a professional institution of a public body nature, Turkish Insurance Experts Association is formed by licensed experts. In the Article 26 of the Draft Proposal, the duties, organization, management structure and rights of the Association regarding its members’ activities are represented. On the other hand, Article 27 of the Draft Proposal regulates the duties, organization, management structure and rights of the Association regarding its members’ activities of the Turkish Insurance Agencies Association. The association is also a professional institution of a public body nature.

Moreover the Draft Proposal brings the formation of Guarantee Accounts for certain compulsory insurance branches as in EU regulation. According to the Article 19 of the Draft Proposal, a Guarantee Account is constituted for covering losses within the limits of the compulsory insurance, in cases that are represented in the Article. These compulsory insurances are regulated by Article 13 of the Draft Proposal, Law No. 7397, Highway Traffic Law and Highway Transportation Law. Each of compulsory insurances has its own Guarantee Account. The Accounts are controlled by TSRSB and its revenues are composed of insurers’ and policyholders’ contributions. However, it should be noted that similar accounts have already been established and used in Turkey.

Lastly, judicial and administrative penalties are separated in the Draft Proposal. In the Article 33 of the Draft Proposal, entitled “Penalties”, administrative and judicial penalties are represented separately in the cases of violation of the rules and regulations.

The other main development is on insurance clauses in the Turkish Commercial Code. The Turkish Commercial Code has preserved its position as one of basic laws in Turkey since 1957. However, with the changing economic environment, the start of EU accession negotiations and latest improvements in commercial law in some European countries has accelerated the efforts on a new Turkish Commercial Code.

The Draft Code has been presented by the relevant commission of Ministry of Justice in February 2005 for opinion from academic, public, judiciary and professional institutions. The Draft Code aims to regulate commercial relations in line with the recent changes in the local and global business environment as well as technological and legal developments including EU legislation.

The Draft Code consists of 6 books, namely Commercial Business, Commercial Enterprises, Securities (Valuable Papers), Transportation, Marine Trade and Insurance Law. Articles 1379 to 1498 include clauses on insurance.

In the justification of the Draft Code, the changes in general are stated as follows¹⁶¹:

- The systematic of the Code is changed.
- The insurance terms are defined more carefully; the insurance policy is not defined as a security and its content is not determined.
- General clauses are expanded.
- More importance is given on disclosure to consumers.
- Clauses regarding some special branches like fire and agriculture are not regulated separately but included in both general and loss clauses.
- The number of statutory clauses is decreased for the sake of the development of insurance. The remaining clauses took place in order to guard the interests.

¹⁶¹ Metezade, Zihni. (2005). Türk Ticaret Kanunu değişiyor – Sigorta Hukuku’na yeni düzenlemeler geliyor. *Birlik’ten Dergisi* (Sayı 1), p.19.

- The importance of actuary in insurance is taken into consideration and clauses regarding actuary are embodied in the draft.
- As international rules are considered in marine insurance, clauses regarding this branch are removed.
- In order to cover losses of third parties that are caused by some professionals, liability insurance is regulated in detail.
- Clauses regarding life insurance are redesigned and expanded in parallel with needs.

Moreover, Draft Code brings important changes in accounting system. With the adoption of the Code, only the Turkish Accounting Standards Board will determine accounting standards in Turkey and all sectors will have to implement Turkish Accounting Standards. These standards are compliant with International Financial Reporting Standards.¹⁶²

¹⁶² Oksay, Suna & Onur Acar. (2005). *Sigorta Sektöründe Uluslar arası Finansal Raporlama Standartları – Kurumlar ve Standartların Özetleri*. TSRŞB Sigorta Araştırma ve İnceleme Yayınları-3. pp. 56-57 . İstanbul.

V. HARMONIZATION OF TURKISH INSURANCE REGULATION AND SUPERVISION TO THE EUROPEAN UNION'S

The history of Turkey's ambition to be a member of the European Union dates back to 1950's. However, through nearly fifty years only little progress has been achieved. After 1999 Helsinki Summit of European Council, with the declaration of Turkey's official candidacy to the Union, a new phase has begun. Following that, Turkey has adopted many harmonization packages and many legal and structural changes have been made in order to fulfil the Copenhagen Criteria. Five years later from Helsinki Summit, in 2004, European Union decided to open negotiations for full membership. The accession negotiations between Turkey and EU actually have begun on June 12th, 2006. Negotiations will be based on 35 chapters and one of them is on Financial Services (Chapter 9) under which insurance will be discussed. Also, with regard to basic freedoms, The Right of Establishment and Freedom to Provide Services (Chapter 3) is also related.

Like most of the other topics, implementation of the *acquis* in the right of establishment and freedom to provide services and financial services, particularly in insurance, will require considerable will, effort and conscious. The two National Programmes for the Adoption of *Acquis* (2001 and 2003) generally draft the framework and timeline of work in order to implement the EU rules regarding the chapters.

In order to give an idea of what level of harmonization has been achieved and in which areas some developments are needed in insurance area, an evaluation of the situation, considering the latest developments in both Turkish and European legislation and supervision is summarised below.

5.1. Harmonization of Legislation

Turkey's membership to the European Union means considerable legislative consequences. Primary basis of insurance legislation for Single Insurance Market, the Treaty articles regarding the right of establishment, freedom to provide services and free movement of capital in particular, will be valid with the accession. Also, all the existing secondary legislation, the Community's international agreements with third countries and jurisdictions of the European Court of Justice will be binding. After concluding the Accession Treaty, the conditions that are stated by Treaty provisions and all other legal instruments, will have to be provided by Turkey.

On the other hand, it should be noted that, based on Ankara Agreement and within the scope of Turkey-EU Association Council, talks are under way in order to establish freedom to provide services between Turkey and the EU before full membership, since 2000 with little progress.¹⁶³

The three generations of insurance directives constitutes a very important part of EU insurance legislation. They complete the primary legislation, aiming to abolish restrictions and discrimination for integration of European insurance markets. They are composed of wide range of issues on regulation and supervision of both life and non-life insurance markets. Because of the Directives' extensive content, national implementation of their provisions in force (most of the provisions were amended through time) may affect separate national regulations. For example, provisions under the title of Conditions Governing the Business of Assurance in Directive 2002/83/EC, are diversified from principles and methods of financial supervision to contract law. In order to transpose the Directive into Turkish legislation, amendments or in some cases repeals will have to be made in Insurance Law on principles and methods of financial supervision and on the other hand in Turkish Commercial Code for contract terms.

¹⁶³ Atalay, Ali Utku. (2004). *Avrupa Birliği Perspektifiyle Hizmetlerin Serbest Dolaşımı Kapsamında Türk Sigortacılık Sektörünün Değerlendirilmesi*. Avrupa Birliği Genel Sekreterliği Uzmanlık Tezi. Ankara. pp.17,18.

With directly linked to basic freedoms and three generation directives, in other words to the internal market, there are regulations which will have to be transposed to Turkish legislation and implemented during further progress in accession. EU legislation regarding e-commerce, insurance mediation, motor vehicle insurance (particularly between the borders of the Union), reorganization and winding-up of insurance undertakings, reinsurance and retrocession, statistics and the EU's international agreements on insurance (and their amendments made during the period of accessions or new regulations) will have to be implemented when Turkey become part of the Single Insurance Market. Moreover, as stated in the Commission's "Turkey Progress Report 2006", specific regulations regarding co-insurance, credit insurance, legal expense insurance and tourist assistance will have to be enacted.¹⁶⁴

As it is introduced in previous sections, the recent developments in Turkish insurance legislation (new capital adequacy regime, Insurance Law proposal, Commercial Code proposal and adoption of international accounting standards) are positive developments with respect to harmonization to the European Union. Because in all "Regular Reports on Turkey's Progress towards Accession", it has been pointed out that the alignment of Turkish insurance legislation with the *acquis* is limited. It is also positive that the proposals have been shared with public, industry and academicians for their contributions. This is important because drafting a regulation considering different stakeholders' views will have the advantage of better alignment to the needs and accomplishment of its objectives. With regard to harmonization of Turkish insurance regulation and supervision to the EU's, these developments will form the basis.

The Draft Insurance Law Proposal brings revised conditions of establishment and licensing and improved financial requirements and technical reserves for insurance and reinsurance undertakings which are compliant to existing EU rules. These kinds of measures aim to ensure well managed, sufficiently capitalised and financially sound undertakings operate in the market for the ultimate objective of consumer protection and stable markets.

¹⁶⁴ Turkey 2006 Progress Report. (2006). European Commission. COM (2006) 649 final. Brussels.

However, the adoption of the Draft Proposal will not be solely enough for proper harmonization. All the secondary legislation, mainly regulations, which are mentioned in the text will also have to be prepared as soon as possible considering the existing EU rules and put into force.

On the other hand, with the adoption new Commercial Code, an important part of insurance regulation will be based on more definite and contemporary commercial law and more efficient and fair economic environment. As explained in the previous section, the Draft Code gives more importance on information disclosure to customers relevant to EU directives which include information to be communicated to the policyholders.

Insurance accounting and financial reporting is also can be called as a hot topic both in the EU and Turkey. With the projects carried out by International Accounting Standards Board, a global stance has come into accounting and financial reporting and both the EU (with Directive 2003/51/EC and Regulation No 1606/2002 on the application of international accounting standards) and Turkey (with recent regulations) has taken IAS / IFRS standards into consideration. The recent developments in Turkey in this field are reflected in “Turkey Progress Report 2005” as follows:¹⁶⁵

“The Treasury adopted a new accounting plan and the relevant implementing legislation, which aim at improving the information gathering and reporting standards in the insurance sector and to improve the alignment with EU standards. Furthermore, a new implementing legislation for the accounting system has been introduced to further align the standards for the financial tables.

It should be noted that from a macro point of view, increased and extended disclosure for both products and financial position will play an important role in decreasing information asymmetries and enhance protection for consumers and investors.

Current situation, recent developments and level of harmonization to the EU in main areas of insurance legislation is summarised in Table 5.2.

¹⁶⁵ Turkey 2005 Progress Report. (2005). European Commission. COM (2005) 561 final. Brussels.

Table 5.2. Harmonization of Turkish Insurance Legislation to the European Union's

AREA	CURRENT SITUATION	RECENT DEVELOPMENTS	LEVEL OF HARMONIZATION
Treaty articles, regarding the right of establishment, freedom to provide services and free movement of capital	Not totally valid for Turkey currently	Talks are under way in order to establish freedom to provide services between Turkey and the EU based on Ankara Agreement, with little progress since 2000	Conditions (possible transition periods etc.) will be determined in more detail during accession process
The three generations of insurance directives and other non-life / life directives (Extensive content)	<ul style="list-style-type: none"> • Some parts have already been transposed to Turkish legislation (For example solvency regime) • Some parts which are related to three freedoms are not totally valid for Turkey currently (For example Single License System) • Some parts are about to be transposed to Turkish Legislation 	<ul style="list-style-type: none"> • Example: Regulation Regarding Capital Adequacy • Directly linked to progress in accession • Example: The Draft Insurance Law Proposal (Provisions regarding conditions of establishment, licensing, financial requirements and technical reserves etc.) 	<ul style="list-style-type: none"> • Compliant with EU rules (Also includes broader provisions) • Conditions (possible transition periods etc.) will be determined in more detail during accession process • Drafted in order to comply with EU rules

	<ul style="list-style-type: none"> Some parts have no equivalent in Turkish Legislation 	<ul style="list-style-type: none"> Example: New Turkish Commercial Code Proposal (Provisions regarding information disclosure to consumers etc.) Example: Credit insurance, tourist insurance etc. 	<ul style="list-style-type: none"> Drafted in order to comply with EU rules Non-compliant with EU rules
Other insurance and related regulations (e-commerce, insurance mediation, motor vehicle insurance (particularly between the borders of the Union), reorganization and winding-up of insurance undertakings, reinsurance and retrocession, insurance statistics and the EU's international agreements on insurance	Not totally valid for Turkey currently	Directly linked to progress in accession	Conditions (possible transition periods etc.) will be determined in more detail during negotiation process
Accounting and financial reporting	Trend is towards standardization in both global and EU level	<ul style="list-style-type: none"> Regulation on Insurance Accounting System Uniform Chart of Accounts and its Prospects Communiqué 	Generally compliant with EU and international rules

Source: Own evaluations

5.2. Harmonization of Supervision

Harmonization of supervisory structures and systems will complement harmonization of Turkish insurance legislation to the EU's. With this respect, the main subjects are institutional capacity, supervision of financial soundness of companies in the sector and ongoing Solvency II project in the EU.

Firstly, an important aspect of harmonization is forming adequate institutional capacity for efficient regulation and supervision. In Turkey, drafting of regulations and monitoring and supervision of compliance to the regulations are duties of specialized authorities, which are called "General Directorate of Insurance" and "Insurance Supervisory Board". These two institutions, which have 153 personnel in total, are organized under the Undersecretariat of Treasury which is tied to Ministry of State and many of the actions are handled by the responsible Minister. The situation, for example, in banking sector is different where Banking Regulation and Supervision Agency has both regulation and supervision duties and is more independent respectively. Also there is a trend towards single financial regulatory / supervisory authorities throughout the world and many European countries have formed this type of agencies. Most of the European agencies have sufficient powers and independencies. Taking these into consideration, institutional structure of Turkish insurance regulation and supervision will need to be redesigned in the process of EU harmonization. Moreover, the option of setting up a Turkish single financial authority can be a matter of discussion. Advantages and disadvantages of a single authority should be analyzed and if it is determined to be eligible a single financial authority can be formed in order to regulate and supervise the more converging financial markets and also the groups operating in most of financial sectors.

Secondly, convergence in supervision of financial situations of insurance undertakings constitutes another part of harmonization. The recently adopted capital adequacy regime is also designed according to existing EU Solvency I regime, but also includes a risk-based approach used by some European and other developed countries. Risk-based capital systems may have different calculation methods ranging from factor based method (as it is in recent Regulation Regarding Calculation and Evaluation of

Capital Adequacies of Insurance, Reinsurance and Pension Companies) to more advanced mathematical model based method. It is important for Turkish insurance sector to channellize interest on evaluating current and potential risks and to take action before undesired failures and hampering interests of the insured.

Also, increasing mergers and appearance of giant financial groups in the EU has brought new regulations and supplementary supervision on these groups. However, there is no specific regulation for insurance groups and consolidated supervision implementation and consolidated financial statement requirement for insurance and reinsurance companies in Turkey.¹⁶⁶ Related to this, in the Turkish banking regulation there is a provision which states that, if the parent bank has control and significant influence on credit institutions, insurance companies and other financial institutions, they are subject to consolidation.¹⁶⁷ The supervision of financial groups is one of the areas which need to be carefully considered during accession process because banks in Turkey mostly have subsidiaries operating in different financial sectors including insurance.

Thirdly, in analysing harmonization of Turkish insurance regulation and supervision to the EU's, Solvency II project should also be taken into account. Although there are many unsolved issues in the details of Solvency II, the basic structure is drafted and it is clear that it will mean substantial changes in insurance supervision. It is planned to be put into force by 2010. On the other hand, Turkey's membership to the Union seems to occur not before than 2015. So, Solvency II will be in force in the date of Turkey's accession which will mean that both the Turkish legislation and supervisory system should be compliant to the new system.

With Solvency II, supervision will focus more on protecting consumers from insurers' inability to meet their obligations and profiling the true risk profile of the company by requesting both quantitative and qualitative requirements. The calculation methods will be changed and areas to be monitored will be extended. Another important

¹⁶⁶ Agenda Item II: Insurance And Occupational Pensions (2006).Screening Chapter 09 Financial Services – Country Session: the Republic of Turkey 2-3 May 2006. Retrieved June 18th, 2006 on http://www.abgs.gov.tr/tarama/tarama_files/09/SC09DET_II_INSURANCE_MORNING_SESSION.pdf

¹⁶⁷ Agenda Item V: Banking and Financial Conglomerates (2006).Screening Chapter 09 Financial Services – Country Session: the Republic of Turkey 2-3 May 2006. Retrieved June 18th, 2006 on http://www.abgs.gov.tr/tarama/tarama_files/09/SC09DET_V_BANKING.pdf

part of Solvency II is convergence in valuation of assets and liabilities which is currently highly dependent on financial system traditions of Member States. Also, disclosure requirements will be extended in order to increase transparency and activate market discipline. This is very important especially for developing countries like Turkey. Moreover, increased harmonization in supervisory tools and for certain circumstances joint activities is aimed which will result in increased cooperation between national authorities.

The changes summarized above will be binding for all Member and prospective Member States including Turkey, which will have to adopt the regulations and carry on supervision according to new perspective eventually. Therefore, government, regulatory and supervisory authorities, sectoral institutions, companies and insurance buyers in Turkey should carefully follow Solvency II developments and participate in the project when occasion arises. It is important for the whole insurance sector to get ready and integrate easily.

VI. CONCLUSION

As an important part of the financial markets, insurance is one of the most heavily regulated sectors. Regulation and supervision in insurance is needed basically in order to protect the consumer against existing asymmetric information in the market. Because, mostly, consumers have disadvantage in assessing the quality of the product / service and financial situation of the undertaking in order to make rational decisions. With regulation and supervision, it is also aimed to sustain confidence in the sector and maintain insurers' safety and soundness. Insurance sector is regulated and supervised in many areas from solvency (briefly the ability to pay) of the undertaking to accounting, from necessities for establishing an insurance undertaking to winding-up and from contractual issues to information disclosure. There are basic regulatory measures and supervisory structures in the world; however, it may vary according to the financial system and traditions of countries.

On the other hand, recently, the efficiency and scope of current applications have been a question and debated throughout the world. There are many developments, for example, increasing interest on risk management and information disclosure, which will have considerable, worldwide effects on the insurance sector.

In the EU, Solvency II project has been going on since the beginning of this decade. Although there are many unsolved issues in the details of Solvency II, the proposed structure indicates already that the new system will have both macro and micro scale changes. With Solvency II, it is expected that the level of integration within the Single Insurance Market will increase, supervisory systems and methods in the international insurance sector will converge, mergers and acquisitions will increase, consumer protection will be enhanced with increased transparency, disclosure and adequate requirements for companies according to their true risk profile and finally confidence and market stability in European insurance market will be enhanced. With respect to micro scale effects, it is expected that significant cost and effort will be needed in order to adopt the new regime for both the companies and supervisors, a better understanding of business

will be revealed with the support of effective risk management and internal control systems and possible product and price revisions will be considered.

In Turkey, also, the interest and efforts on the issue has increased with the preparations on the new Insurance Law, the new Commercial Code, adoption of new solvency regime, developments in insurance accounting and financial reporting and generally with the start of accession negotiations with the EU.

With respect to the harmonization of Turkish insurance legislation and supervision to the EU's, latest developments are positive but not enough. With the accession, all of the primary and secondary legislation, the Community's international agreements with third countries and jurisdictions of the European Court of Justice will be binding for Turkey. However the current negotiation process will determine the scope of national legislation to be transposed and the time scale of the transposition. A critical point in this process is the preparation of Turkey's "position paper" which determines these subjects. Therefore a hard work is needed by all actors in order to provide the best interest of the sector. With respect to regulation, some of the current Turkish legislation and the drafts of the main legislation are mainly compliant to existing EU rules. It can be concluded that insurance, generally financial sector, is not one of the most problematic and challenging areas of integration like agriculture, environment and regional policy. Also, from the sectoral point of view, relations between Turkish and European insurance markets have already been developed and there are many common applications because of the reinsurance business.

However, in order to benefit from integration to the Single Market and to have a competitive and functioning insurance market, only adopting laws and regulations will not be enough. Effective implication of the legislation by adequate institutional structure, fair legal system and a change in government and business philosophy is also needed. Regulatory and supervisory authorities' capacity and independency should also be increased. Moreover, EU rules regarding insurance regulation and supervision are not constant and with Solvency II, which seems to be in force when Turkey becomes a full member, the market and supervisory system will possibly be different. Therefore, Turkey needs to follow both European and other international developments in order to be sufficiently ready.

The effects of Solvency II on insurance companies in Turkey will be considerable. Firstly, Solvency II will possibly mean increased capital requirements. Secondly, companies will have to develop models for calculation of their regulatory capital; effective risk management and internal control systems which mean increased expenditure and on human resources and information systems. All of the above may result in survival and competitive problems for companies in Turkey; mergers and acquisitions of small ones which fail to respond the demands from regulators / supervisors.

Finally, it should be noted that, adequate preparation in both legislative and supervisory aspects to be a part of Single Insurance Market by all participants of insurance sector (not only public / government but also sectoral / civil institutions) through the process of negotiations will mean lesser problems and greater opportunities at the point of membership.

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