Turkish Insurance: Ratings Under Pressure Despite Manageable Pandemic Impact

Sector Shows Technical Resilience amid Economic Pressures and Despite Health Crisis

Turkish Insurance Sector – Non-Life

(TRYbn)	1H20	2019	2018
Gross written premiums (GWP)	33	58	48
Total assets	87	77	61
Combined ratio (%)	95[a]	107[a]	111
Return on equity (annualised, %)[a]	35	21	19

[a] Fitch-calculated
Source: Fitch Ratings

Turkish Insurance Sector – Life & Pensions Market

(TRYbn)	1H20	2019	2018
Gross written premiums (GWP)	7	11	7
Total assets	180	154	114
Return on equity (annualised, %)[a]	41	41	36

[a] Fitch-calculated
Source: Fitch Ratings, TSB

The credit quality of Turkish insurers is highly sensitive to the challenges affecting the Turkish economy, and their ratings are pressured by Fitch Ratings' Negative Outlooks on the Turkish sovereign and Turkish banks' ratings. These Negative Outlooks weigh on insurers' investment quality and business profiles, the two main drivers for our credit assessment of Turkish insurers.

Pandemic Benefits Technical Results

We expect Turkish insurers' technical results to improve in 2020, driven by a coronavirus pandemic-induced lower claims frequency in motor and health lines, and adequate premium growth despite the pandemic.

Pressures on earnings will mostly stem from the negative 'real' interest rate environment, while exposure to equity markets remains low. Currency risks are manageable for insurers due to the nature of their business and investment profile, despite historic lows on the Turkish lira.

We expect the sector's capitalisation to remain adequate in 2020, benefitting from higher retained earnings and lower dividends to shareholders.

Operating Environment Evolving Fast

The new Turkish insurance independent regulator started operating in 2020, in lieu of the Directorate of Insurance of the Ministry of Treasury and Finance. We believe this could improve regulatory oversight in the sector.

The Turkish operating environment is highly volatile, with high macro-economic risks and high competition, pressuring Turkish insurers' business profiles. Recent actions and announcements by authorities aim to boost industry growth and market expertise, which we view as potentially favourable for the sector.

Life and Pensions Could Grow

Life and pension insurance is still underdeveloped in Turkey, with very low penetration and a basic product offering compared with more developed markets. High growth rates and profitability despite the economic downturn, and recent regulatory incentives, could help the sector develop in the medium term. A stronger life franchise would be positive for Turkish insurers' credit profiles.

Franchise, Ownership Drive National Ratings

Turkish insurers' national ratings are mostly driven by business profiles and potential support from their parent. Asset risks and, to a lesser extent, reinsurance and catastrophe risks, are of a lower importance given the similarities amongst insurers in those areas.

Related Research

Fitch Revises Outlook on Turkey to Negative; Affirms at 'BB-' (August 2020)

Fitch Revises Turkish Banks' Outlooks to Negative on Sovereign Outlook Change (September 2020)

Insurance Rating Criteria (August 2020)

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Sovereign Risks Pressure Investments

Pressures on Investments Drive Negative Outlooks

The Negative Outlooks on the Turkish sovereign and Turkish banks' ratings directly feed into our assessment of Turkish insurers' asset quality and liquidity profile, as most of their investments are placed with domestic counterparties. Consequently, the Outlooks on our Insurer Financial Strength (IFS) ratings on Turkish insurers are also Negative, as 'Investment and Liquidity Risk' is a key rating driver in our analysis.

The Outlook on the Turkish sovereign rating of 'BB-' was revised to Negative from Stable by Fitch in August 2020, largely driven by lower foreign-exchange (FX) reserves, a weak monetary policy credibility, negative real interest rates, and a sizeable current account deficit. Subsequently, the Outlooks on most Turkish banks' ratings were also revised to Negative.

Turkish Sovereign Ratings

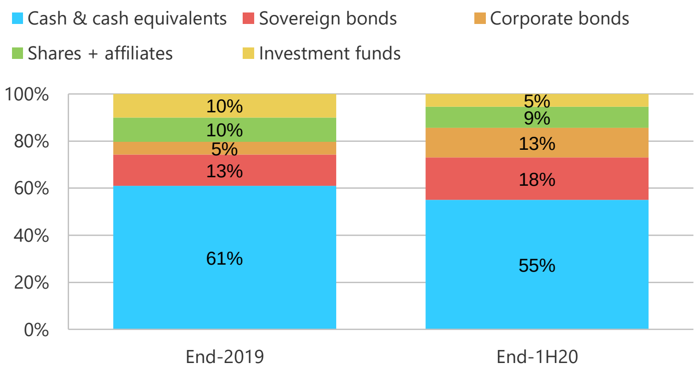
Long-Term Local-Currency Issuer Default Rating (LC IDR)	BB-
Long-Term Foreign-Currency Issuer Default Rating (FC IDR)	BB-
Outlooks	
LC IDR	Negative
FC IDR	Negative

Investment Strategies Driven by Market Volatility

Turkish insurers operate in a highly volatile macro-economic environment, and thus variations in asset allocations are more frequent and sharper than in other EMEA markets. This was reflected in a material shift towards bonds in 1H20 as a reaction to the negative real interest rates in the country. Fitch believes such proactive balance sheet management indicates that conditions for investment remain adequate despite increased systemic and liquidity crises in the country.

Investment portfolios of Turkish insurers generally lack diversification and sophistication compared to more developed insurance markets, although Fitch views Turkey's domestic debt and equity capital markets as developed compared with peer countries. Investment portfolios remain skewed towards deposits in Turkish banks and domestic sovereign bonds.

Investment Portfolio Allocation - Turkish insurers



Source: Fitch ratings, TSB, Selected companies

Sovereign Concentration Risks Could Increase

Asset risks remain a key rating weakness for Turkish insurers, and their 'Investment and Liquidity Risk' scores are primarily driven by their exposure to the banking sector, whose credit quality is highly correlated to the sovereign. However, ample cash investments are positive for the companies' liquidity profiles.

Turkish insurers are also exposed to sovereign concentration risk on their balance sheets, which Fitch quantitatively assesses by looking at the ratio of sovereign investments to capital. The ratio was at a manageable level for the sector according to our estimates at 1H20, but is volatile by nature given the frequent investment shifts.

We also apply extra add-ons to our risky assets to capital ratios for sovereigns rated in the 'B' category or below. This means that should Turkey be downgraded to the 'B' category, according to our estimates at 1H20, risky assets ratios, which are core ratios in our criteria, would fall into the 'bb' category from their current 'bbb' category levels. This would further affect our view of insurers' asset risks.

Operating Environment Evolving Fast

Regulatory Environment Could Improve

The Turkish insurance sector is now regulated by an independent regulator, which Fitch views as positive for its assessment of regulatory oversight. The Insurance and Private Pension Regulation and Supervision Agency (IRSA) was established by presidential decree in 2019, and started its activity in June 2020. Previously, the Turkish insurance sector was supervised by the Directorate of Insurance of the Ministry of Treasury and Finance.

We believe this development could improve the clarity and consistency of regulation and oversight in the sector, although such developments usually take time to materialise. Turkish insurers typically had frequent legislation changes in the past, often resulting in complexity, inconsistencies, and difficulties enforcing regulations.

The IRSA is an independent public administrator operating in Istanbul, which means it is close to the market. Its decisions won't be monitored by the state except from a legality standpoint. It will take over regulation and supervision of insurance branches in Turkey, including motor third-party liability (MTPL) business, which was the main source of technical losses and regulatory burdens for Turkish insurers in recent years. This could improve technical soundness in the market.

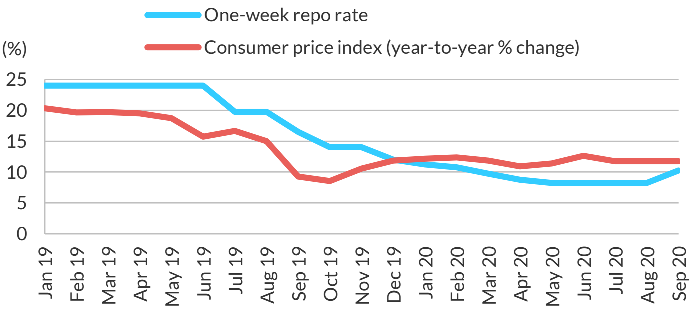
Technical Sophistication to Develop; Penetration Is Low

Low Insurance Penetration

Insurance penetration is very low in Turkey compared to more developed European jurisdictions, with insurance premiums accounting for 1.5% of GDP. This suggests that the insurance sector has strong room for growth in all business lines, including mandatory lines such as MTPL (20% of vehicles are uninsured) or earthquake insurance (around 50% coverage). There are also significant coverage gaps in non-compulsory lines such as motor own-damage (MOD) and property.

The Turkish insurance industry has positive structural features for development, with a young, fast-growing population compared to most European countries, and a well-established insurance sector dating back to the 1800s. However, low disposable income and high macro-economic risks, with high inflation and negative real interest rates at times, have constrained insurance development in recent years. Total insured values increased slower than GDP in 2014–2018.

Interest Rates and Inflation in Turkey



Source: Fitch Ratings, Turkish Central Bank

As part of its recent economic reforms, Turkish authorities deemed insurance as a 'strategic sector', with the aim of boosting premium growth and penetration, which we view as a positive development. The recent establishments of new local market participants (see *New Participants to Build Market Expertise*) are part of this trend. However, we believe penetration will evolve slowly given the economic volatility in Turkey, and the magnitude of the targeted structural reforms.

New Participants to Build Market Expertise

Some new insurance participants were recently established by the Turkish authorities with the aim of building capacity and expertise in the market. New companies include Turkiye Sigorta AS, Turk Reasurans AS (Turk Re) and Turk P ve I Sigorta AS (Turk P&I; rated IFS BB-/Negative by Fitch). We believe these developments could enhance our assessment of market technical sophistication and diversity.

Turk Re was established in 2019 in order to increase domestic reinsurance capacity, and we believe this could allow better access to affordable reinsurance protection for Turkish insurers, particularly those that are domestically owned because they can't rely on parent reinsurance arrangements. Around 75% of ceded business in Turkey is with foreign-owned reinsurers, and Turkey's only active domestic reinsurer (Milli Reassurans TAS) has limited capacity. Turk Re will also provide coverage for more sophisticated risks, and help the Turkish catastrophe regime through earthquake risk modelling.

Turk Sigorta, established in 2020 as a merger of three government-owned bancassurers and now Turkey's largest insurer, aims to accelerate sector growth and operate on specialised, underpenetrated risks such as construction, credit and surety. Turk P&I was established in 2014 as a marine insurance specialist in order to build domestic protection and indemnity (P&I) capacity.

The Turkish Wealth Fund (TWF) consolidated the shares of three major state-owned bancassurers in 2020, each of which was previously amongst the ten largest Turkish insurers. These mergers resulted in the establishment of Turk Sigorta, non-life market leader, and Türkiye Hayat ve Emeklilik, life and pensions market leader. Both are owned and controlled by TWF.

TWF was established in 2016 by the state and acts as the strategic long-term investment arm of Turkey, with major stakes in numerous economic sectors across the country. It is rated BB-/Negative by Fitch.

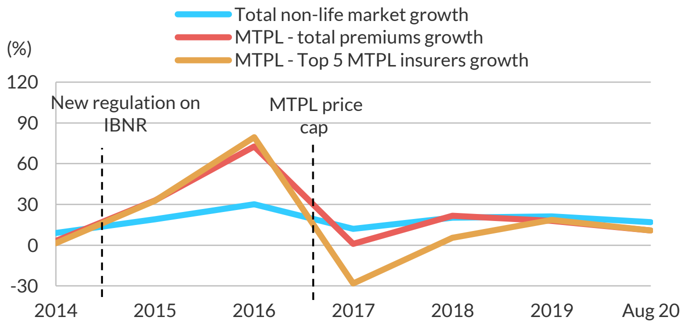
MTPL Business Environment Becoming Less Challenging

We view the MTPL regulatory price cap, introduced in 2017, as detrimental to the Turkish insurance sector's technical soundness because it compels insurers to underwrite business at a loss and introduced some irrational competition in the market. The additional allowance for inflation in the price cap is not sufficient to structurally generate gains, particularly as it was reduced by the government to a monthly 1% (from 1.5%) in light of the pandemic.

We believe, however, that the MTPL business environment is in a slightly better condition than in 2018. After some strategic divestments, large MTPL underwriters slightly stabilised their market positions in 2019 and early 2020. In addition, lower interest rates – as well as some stricter control by the regulator – could deter new entrants from aggressive underwriting strategies. These trends could enhance our assessment of the competitive profile in Turkey should they continue into 2021.

Year-on-Year GWP Growth Rates

MTPL top-five growth back at market levels in 2019



Source: Fitch Ratings, TSB

In addition, we believe most insurers that underwent adverse MTPL reserving experience in recent years, resulting from the reserving regulation change in 2015, are in a better position after several years of reserve strengthening. This enhances our view of the sector's reserve adequacy.

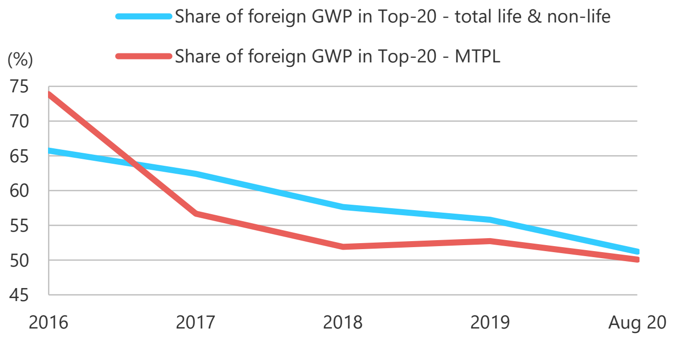
Locally-Owned Insurers Gaining Market Share

In the past five years, locally-owned insurers consistently gained market share in the highly competitive Turkish insurance market, particularly in MTPL and some other non-life lines. This partly reflects the underwriting caution exercised by many foreign-owned insurers amid market volatility, and also reflects the authorities' will to retain more premiums in Turkey.

We believe Turkish-owned insurers will typically remain more committed to the market than foreign participants, and favour long-term strategies, which is positive for the sector's business prospects. However, foreign parent companies often have a stronger credit profile and higher levels of expertise than Turkish peers, which typically leads to higher ratings and better technical sophistication within the sector.

We believe foreign-owned insurers will remain active in Turkey despite lower market shares, continued volatility and the economic downturn, given the long-term potential of the sector.

Foreign-Owned Companies in Top-20 Turkish Insurers



Source: Fitch Ratings, TSB

Business Profile Scores under Pressure

Fitch scores the Turkish Industry Profile and Operating Environment (IPOE) for insurance between 'bbb-' and 'b' with a Negative Outlook, which reflects Turkey's deteriorated economic prospects. We view the operating environment as a constraint on the Turkish insurers' credit profiles, in addition to investment risks. The worsening IPOE is also likely to have a detrimental impact on Turkish insurers' business profiles.

Pandemic Benefits Technical Results

Pandemic Will Slow Market Growth

The Turkish non-life market showed good growth in 2019 after two years of close to nil 'real' growth, but the pandemic and its economic consequences could result in lower growth for the market than initially expected in 2020. We also expect life real premium growth rates to be lower in 2020 than in 2019. Difficult economic conditions, with continuously high inflation, could result in loss of purchasing power and thereby deter customers from buying insurance or renewing their policy.

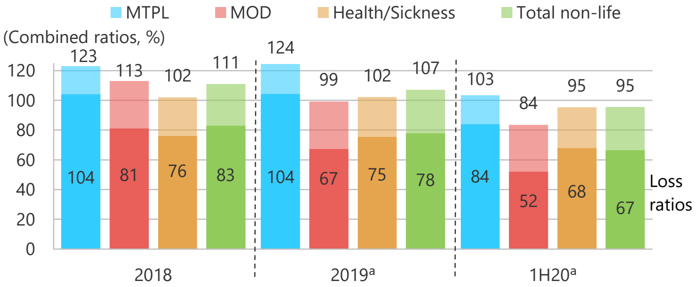
We believe, however, that this will not impair sector fundamentals, given the resilience at 9M20. Market premiums real growth in 9M20 was higher than in 2018 and 2017, although lower than in 2019. Similar to other countries, premiums recovered during the summer after a slowdown in spring 2020 due to the lockdown. Turkish authorities made recommendations to insurers in the midst of the pandemic to extend premium payment delays, in order to limit sector premium losses.

Technical Results Higher amid Lower Claims Frequency

The industry's technical profitability sharply improved at 1H20, with loss ratios down by over 10 percentage points compared to 2019, and combined ratios below 100% – indicating a technical profit – as per our estimates. It is unclear whether this positive profitability will carry on through 4Q20 and into 2021, given the uncertainty around the pandemic and the rapid changes in the industry.

The sharp loss ratio improvements largely reflect lower claims frequency in motor and health lines due to the lockdown in spring 2020. In addition, Turkish insurers have very low exposure to business interruption lines, which are typically exposed to pandemic-related pressures in other countries, with very low coverage on SMEs in Turkey in particular.

Market Combined Ratios and Loss Ratios Sharply Improve Amid Pandemic



[a] Fitch-calculated
Source: Fitch Ratings, TSB

We believe private health insurance profitability will improve in 2020, despite Turkish health insurers' decision to cover all coronavirus testing and treatment costs for their policyholders. This is driven by lower medical activity during the pandemic, and continued strong premium growth compared to other non-life lines, despite comprehensive social security coverage in Turkey. We believe some health consumption catch-up could occur from 2021, which could pressure profitability in health lines.

While in recent years investment income drove insurers' profitability, we expect a more balanced earnings profile in the sector between technical and investment results in 2020. A balanced earnings profile is positive from a credit perspective, although underlying volatility remains.

Improved combined ratios and adequate premium growth will lead to higher technical results, while lower interest on deposits will pressure investment results. Insurers' exposure to equity markets is low, and thus the impact of the pandemic on investment results will mostly materialise through yields on bonds and FX results, in addition to interest income.

Capitalisation Will Remain Adequate

We believe Turkish insurers' capital positions will remain adequate and supportive of their credit profiles in 2020. Our assessment of capitalisation primarily relies on the output of our Prism Factor-Based Capital Model (Prism FBM), and we also monitor regulatory solvency positions, which are risk-based, in the market.

We expect the sector's capitalisation will benefit in 2020 from higher retained earnings, as well as dividend limitations to shareholders, according to a presidential decree. However, Prism FBM scores could be under pressure by higher balance-sheet exposure to bonds compared to 2019. This is due to higher model charges for bonds below 'BBB' compared to cash. We also expect most regulatory solvency ratios will be above 115% at end-2020 in the sector, which is the threshold for a first query from the regulator.

Currency Risks Are Manageable

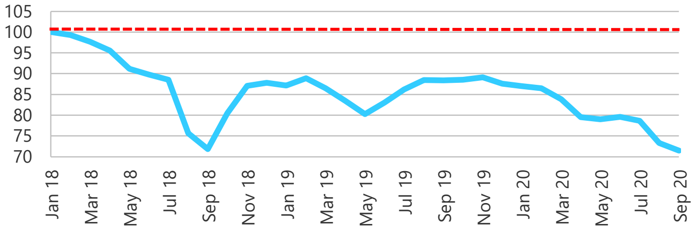
We believe FX risks remain manageable for Turkish insurers despite a continuously weak Turkish lira through 2020. Insurers in Turkey are typically less exposed to currency risk than other financial institutions, such as banks, mostly because policyholder liabilities are mainly denominated in local currency. The Turkish lira is a very volatile currency, and reached a historic low point at 9M20 compared to 'hard' currencies.

We believe Turkish insurers' FX risk management is adequate, with higher foreign-currency (FC) asset levels compared to FC liabilities on the balance sheet, although the gap is small. Some insurers have embedded protection features against FX volatility to some of their reinsurance treaties, or use derivatives in order to hedge FX risk. Fitch believes foreign-owned Turkish insurers have better access to FC assets than their domestically owned peers.

Turkish insurers are mainly exposed to lira depreciation on the P&L through higher claims costs on motor lines – auto spare parts are usually imported – and through their use of international reinsurance coverage with the requirement to pay reinsurance premiums in 'hard' currencies. Their balance sheet position is positive should the lira depreciate further, with FC asset levels greater than FC liabilities.

Turkish Lira - Effective Exchange Rate[a]

(01 Jan 18 = 100)



[a] Effective exchange rate is the weighted average value of the Turkish lira relative to the basket of the countries' currencies that have a significant share in Turkey's foreign trade

Source: Fitch Ratings, Turkish Central Bank

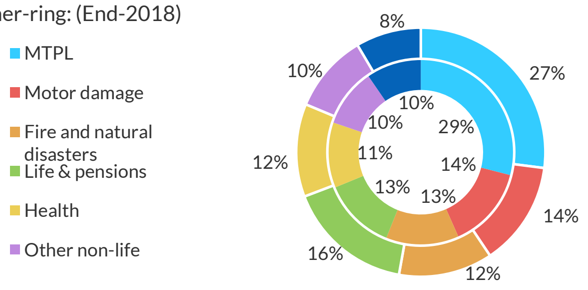
Life and Pensions Business Could Grow

Low Life and Pension Penetration

Life and pensions insurance products in Turkey are still in their early stages of development, with very low penetration rates. Despite very strong growth rates in 2019 and 9M20, life premiums are still marginal compared to non-life in Turkey. In 2019, only 16% of total market premiums were life and pensions. Continued growth in those lines would be positive for Turkish insurers' business diversification and profitability, and for our view of the sector as a whole.

Business Mix - Turkish Insurance GWP

Outer ring: (End-2019)
Inner-ring: (End-2018)



Source: Fitch Ratings, TSB

Recent regulations in Turkey aim to develop the pensions sector – particularly the pension auto-enrolment system established in 2017, with a gradual perimeter extension to all companies. As many policyholders have dropped out of the system, authorities are setting up additional government and employer incentive features to pensions products in order to boost pension penetration.

Basic Life Product Offering

Life insurance products in Turkey are largely limited to mortgage-linked death products, as around two thirds of life products are credit-linked. We believe the regulatory focus on pension products, along with low household income, could impair the development of traditional savings products in the country.

The life and pensions sector's strong growth in 9M20 was partly helped by reduced interest rates, which boosted mortgage loans and thus credit-linked products. Continued regulatory incentives on the pensions side also helped growth. The sector was very profitable in recent years, despite high interest rate volatility.

Competitive Landscape Could Evolve

Unlike the non-life sector, the foreign-owned life insurers' market share has remained stable in the past several years, at around 55%. These companies usually have high levels of expertise as life providers in multiple countries, despite more difficult access to bank sales channels, which are the main distribution channels for life and pension. We believe the sector's focus on bancassurance channels is positive for client retention, but could result in difficulty reaching new customers.

The Turkish life market is dominated by newly established Türkiye Hayat ve Emeklilik (around 30% market share at 9M20). Most other life participants are foreign-owned and hold below 10% market share. We believe that further sector development could result in some M&A activity between foreign-owned insurers.

Business Profile and Ownership Drive National Ratings

Business Profile and Ownership are Main Drivers

Business profile is a main differentiator in national ratings. Stability in an insurer's business model and strategy, alongside a strong competitive position and a well-established franchise, are key rating strengths on the national scale. Access to bank distribution channels is an advantage, given the high profitability and retention prospects of products sold through banks. Business diversification could become increasingly important in our analysis, should the life sector continue to develop.

Potential shareholder support is increasingly important in our analysis, reflecting our view that the benefit of having a large international parent company increases in times of heightened domestic systemic stress. A majority of Turkish insurers are foreign-owned, despite some market share loss to local insurers.

Assets Risks and Reinsurance Have Lower Weightings

Other important credit factors, such as capitalisation and earnings, mirror those of an international credit assessment. Reinsurance and catastrophe risks are slightly less prominent in a local analysis, since most large Turkish insurers have adequate reinsurance practices with strong ties to international reinsurers. They also are exposed to the same catastrophe risks, largely earthquake, and operate under the same catastrophe regime.

Contrary to our international assessment, investment risks are of low importance on the national scale for Turkish insurers, because such risks are largely tied to the Turkish sovereign for all insurers, and investment portfolios are largely similar between insurers – although some have more sophistication than others.

In addition to IFS ratings, which are assigned to insurers globally, Fitch also assigns National Ratings in Turkey. National IFSs are an opinion of an insurer's creditworthiness relative to other insurers within Turkey. An insurer's National Rating is determined relatively to its international IDR[a] (private or public), and by subsequently assessing its credit profile relatively to other insurers with the same IDR level, using a National Ratings correspondence table.

Turkey National Ratings Correspondence Table

Updated: 4 June 2020

This table indicates the correspondence of Local Currency International to ratings that have been assigned on the Turkish National Scale where entities have both a Local Currency International and Turkish National Rating. The table considers Fitch's public and private IDR ratings[a] that existed as of 4 June 2020.

International scale	Turkey
BB and above	AAA
BB-	AAA to AA-
B+	AA- to A-
B	A- to BBB-
B-	BBB- to BB-
CCC	B+/B/B-
CC	CCC/CC
C	C
RC to D	RD to D
Date of last revision	4 June 2020

[a] IFS ratings in Turkey are one notch higher than IDRs, reflecting strong assumed recovery prospects for policyholder liabilities in a distressed scenario

Source: Fitch Ratings, National Scale Rating Criteria (June 2020)

Ratings of Turkish Insurers

	IFS Rating/Outlook	National IFS Rating/Outlook
Anadolu Anonim Turk Sigorta Sirketi	BB/Negative	AA+(tur)/Stable
MAPFRE Sigorta Anonim Sirketi	n.a.	AA+(tur)/Stable
Turk P ve I Sigorta A.S.	BB-/Negative	A+(tur)/Stable

Source: Fitch Ratings