Market Review
September 28, 2016

GCC insurance market regulatory developments promise greater stability and confidence

"Over the longer term, improvements in insurance regulation within the GCC should result in greater stability and confidence"

A.M. Best has observed a marked deterioration in the performance of a number of insurance companies in the markets of the Gulf Cooperation Council (GCC) as they adjust to more disciplined regulatory environments. Recent developments in Saudi Arabia and the United Arab Emirates (UAE) serve to illustrate the painful journey many insurers must endure as they move in line with the new requirements, with significant impact on the financial health of many insurers arising mainly from the adoption of prudent reserving practices. Actuarial based pricing and reserving has further emphasised the intense competition and pricing pressures that are inherent within these markets, in addition to the weak approach to reserving for many market participants.

Many markets across the GCC still harbour companies with traits of limited sophistication, poor underwriting discipline and cut-throat competition. Whilst many insurers have historically benefitted from strong balance sheets and sound operating performance, others have struggled as a result of poor data quality, lack of technical expertise, inadequate accounting and actuarial practices, and volatility arising from poor risk management and governance. The newly introduced regulations in the region have been designed to address these issues.

The GCC's insurance markets are generally characterised as fragmented, with a small number of larger insurers dominating their local markets, leaving numerous small to medium-sized insurers to compete for the remaining market share. Insurers typically have low premium retention with larger commercial risks being heavily ceded into the international reinsurance market. As a result, insurers depend on investment income and inward reinsurance commissions to generate earnings rather than 'pure' underwriting income.

Recent developments in regulation in a number of GCC markets have emphasised A.M. Best's concerns surrounding the inherent weaknesses in these markets. As result of new regulations strengthening minimum capital and solvency requirements, and incorporating actuarial pricing, a number of insurance companies have experienced a drastic decline in operating performance and risk-adjusted capitalisation. Despite the immediate adverse impact, A.M. Best believes these necessary regulatory changes place the markets on the right trajectory for greater financial stability in the future.

While the GCC markets are awash with capital, recent years have seen a decline in the appetite of insurers' shareholders to inject capital as return on equities has waned in recent years, with margins becoming pressured for both underwriting and investment activities. As a result, the imposition of minimum capital and risk-based solvency requirements could encourage greater impetus for merger and acquisition (M&A) activity, particularly for small to medium-sized insurers, which may result in larger, better-capitalised companies (though as A.M. Best has previously noted, barriers to M&A still remain in most GCC markets). However, financial flexibility and access to additional funds from capital markets may further reduce, should oil prices continue to remain depressed. In turn, this has the potential to make insurers more

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amenable to consolidation rather than seeking to perform rights issues to bolster capital positions.

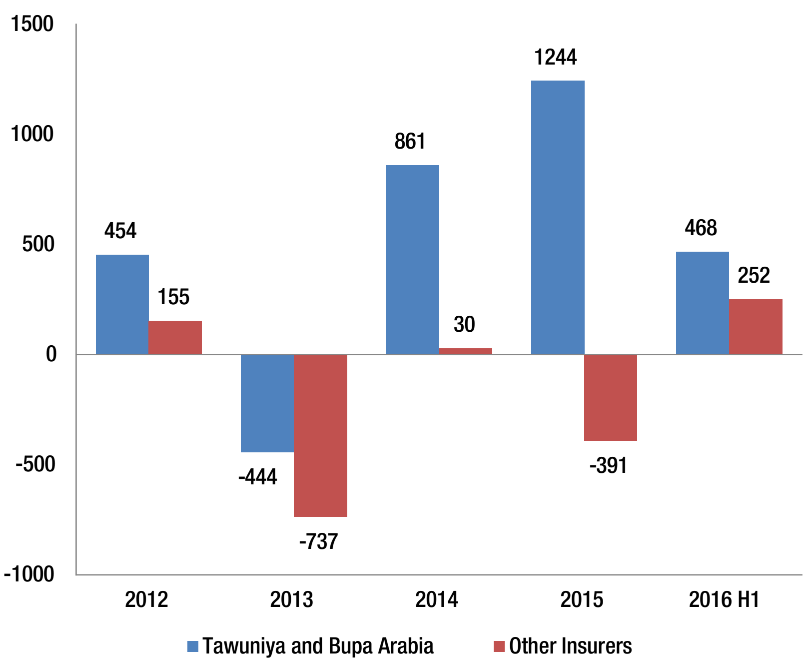
As A.M. Best notes in its briefing *"Middle Eastern Insurance Market Conditions Set Scene for Mergers and Stakebuilding Activity"* (May 2015), regulation is a potential driver for M&A as increases in minimum capital requirements or moves towards risk-based solvency capital impose higher barriers to entry and make it harder for companies to justify establishing new entities.

To assess the overall impact of the new regulations on insurers and how this affects the rating fundamentals over the short-to-medium term, A.M. Best has taken an in-depth look at recent regulatory developments in Saudi Arabia and the UAE. Whilst there are differences in how the regulators have undertaken regulatory reform, both markets are going through a similar process, with Saudi Arabia further along on the journey.

Saudi Arabia: intense competition sparks clampdown on cash-flow underwriting

Saudi Arabia's insurance market is the second-largest in the GCC, representing 33.5% of GCC gross written premium (GWP) in 2015. There are currently 34 licensed insurance companies in the market. The Saudi Arabian market is closed with only companies established in the country allowed to transact direct insurance business, and foreign participation either allowed through reinsurance or partnering with a local insurer. Most insurers have similar product mix, which results in high levels of competition and consequent pricing pressure, particularly in the compulsory lines of medical and motor insurance. Following the introduction of the Law on Supervision of Cooperative Insurance Companies and a number of structural reforms implemented by the government in 2005, the insurance sector has seen steady growth. During that time, the insurance market regulator, the Saudi Arabian Monetary Agency (SAMA), has taken a number of steps to improve market discipline.

Exhibit 1
GCC Regulations - Saudi Arabia - Profit Distribution (2014-2016 H1)
(SAR millions)



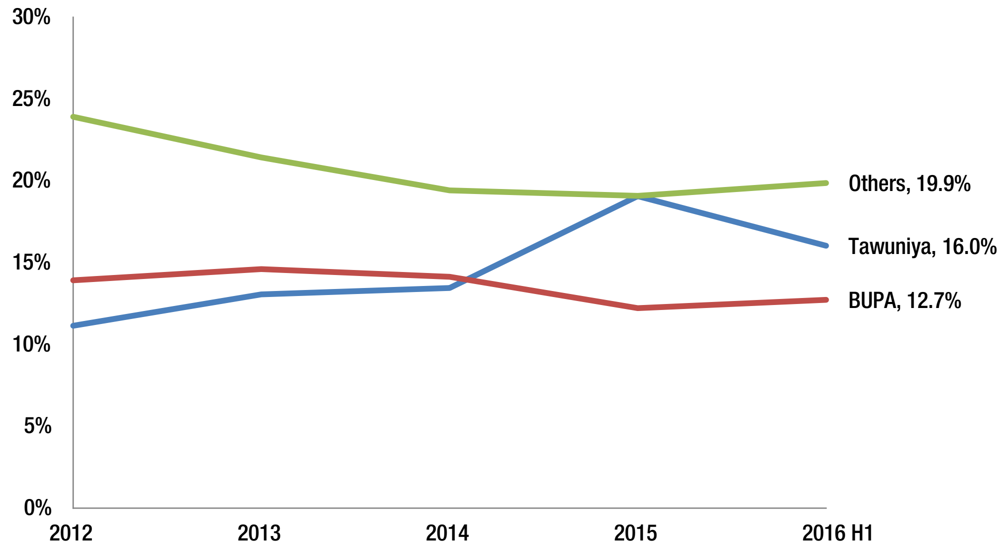
Source: BESTLINK *Best's Statement File – Global*

The top two insurers - the government-owned The Company for Cooperative Insurance (Tawuniya), and Bupa Arabia - represent 42% of GWP and have enjoyed the lion's share of profits over the period 2012 to the first half of 2016 (see **Exhibit 1**). In contrast, small and medium-sized insurers have experienced significantly weaker levels of performance.

A.M. Best notes that the larger market participants have also benefited from economies of scale, which is reflected in lower expense ratios (see **Exhibit 2**). As a result, these companies are better placed to take advantage of the requirement for actuarial pricing. Given their cost efficiency, their technical price is likely to be competitively lower (and therefore more attractive to consumers) than a competitor with a higher relative cost base. This impact can be seen in **Exhibit 1**, which shows the top two companies (Tawuniya and Bupa Arabia) are able to competitively price their products, achieve strong premium production and thereby consistently generate good margins above other market participants.

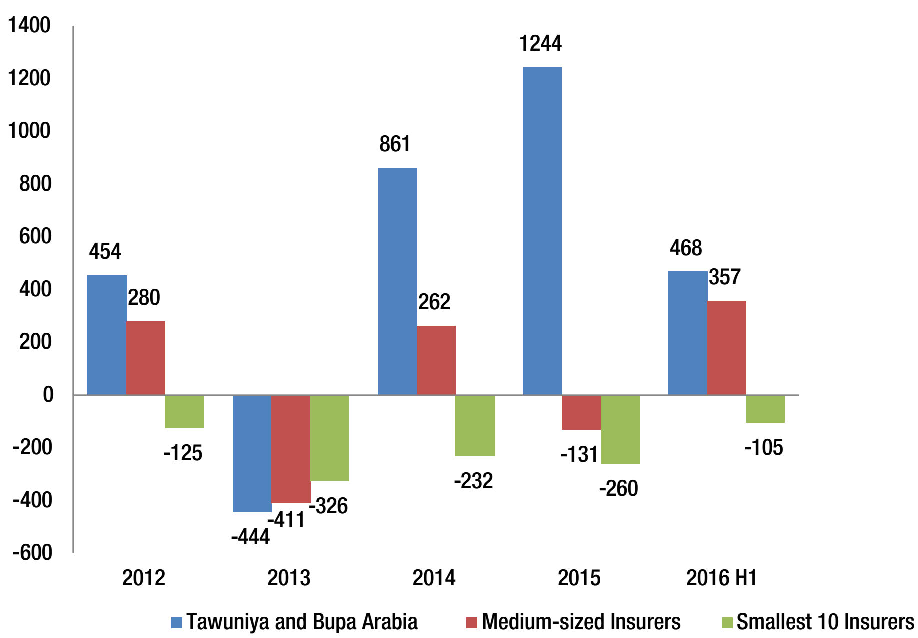
Additionally, from a profitability perspective, whilst all companies saw an increase in the

Exhibit 2
GCC Regulations - Saudi Arabia - Expense Ratios (2012-16)



Source: BESTLINK *Best's Statement File – Global*, Tadawul

Exhibit 3
GCC Regulations - Saudi Arabia - Profit and Loss (2014-2016 H1)
(SAR millions)



Source: BESTLINK *Best's Statement File – Global*, Tadawul frequency of both attritional and large loss experience in 2013, Tawuniya, and Bupa Arabia have recovered strongly to record resilient profits post-2013 (see **Exhibit 3**). In contrast, whilst the medium-sized insurers experienced a recovery in 2014, they recorded overall losses in the following year. This highlights that, despite the actuarial reviews, insurers are still under pressure to find ways to achieve greater scale and compete within the market.

The regulator's intervention in 2013 signified that the market had reached a crossroad. Capital requirements, claims inflation, price competition and lower investment returns were forcing insurers to reassess their business models. At the same time, reinsurers (impacted by an increased frequency of losses in the market) were pushing for more restrictive proportional reinsurance terms.

Previously, insurers were permitted the use of internal pricing mechanisms, but SAMA insisted on the use of independent actuaries to determine whether risk was being adequately priced. This was prompted, in particular, by severe price competition among insurers on medical and motor business lines, which had caused a sharp deterioration in loss ratios and technical profitability. According to regulatory requirements, all companies must hold minimum capital of SAR 100 million for insurers and statutory reserves of no less than 20% of profits. The minimum capital requirements are further raised to SAR 200 million for those insurers choosing to transact reinsurance (inward facultative) business from the local market.

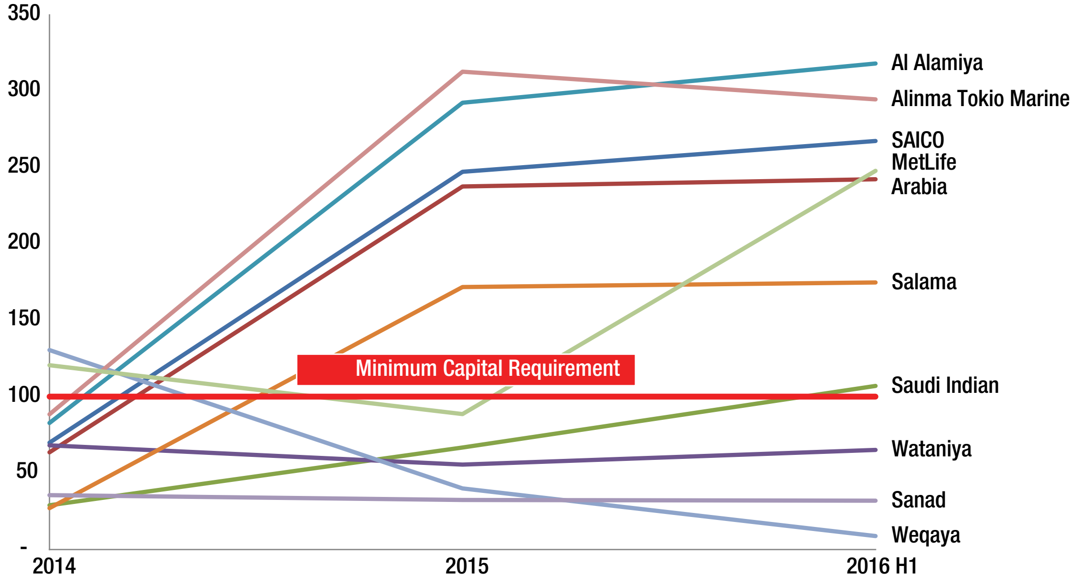
SAMA also carries out quarterly checks to ensure that insurers' premium pricing is in line with these actuarial recommendations. These in-depth reviews are compulsory for all Saudi Arabia-based insurance companies. As a result of these reviews on motor, medical and other classes (with SAMA setting out risk and pricing requirements for property underwriters in October 2015), there has been a significant negative impact on insurers' operating performance. The initial reserve strengthening in 2013 was expected to be short lived. However, after some actuaries' calculations were shown to be more relaxed than others, SAMA reinforced its guidance and called for market-wide prudence. As a result, further spells of reserve strengthening followed in 2014 and 2015, with signs that further adjustments may still need to be made.

As a result of the increased level of reserving and high level of losses experienced in 2013, the risk-adjusted capitalisation of insurers in Saudi Arabia came under substantial pressure. Eleven insurance companies have lost a significant amount of shareholders' equity over the past four years, with some falling below regulatory minimum requirements (see **Exhibit 4**).

While SAMA had initially indicated it would welcome consolidation in the market, it has also signed off on a number of recapitalisations, allowing companies to bolster their balance sheets rather than pursue M&A solutions. So far, seven companies have sought to raise capital in order to meet minimum capital requirements through rights issues. The impact of the rights issues on capital adequacy can also be seen in **Exhibit 4**.

At year-end 2015, five companies remained below minimum solvency requirements. One of the five (Saudi Indian) was able to increase its capital from increased profits, whilst another two (Metlife and Watania) underwent rights issues to bolster capitalisation, leaving Weqaya and Sanad as the only companies currently below the minimum capital requirement. SAMA has also given those insurers with losses exceeding 50% of their capital a year to improve performance and reassess and restructure their business models, or face liquidation or run-off. While consolidation is an option, A.M. Best notes that finding prospective buyers for loss-making companies could prove challenging.

Exhibit 4
GCC Regulations - Saudi Arabia - Shareholder Equity (2014-2016 H1)
(SAR millions)



Source: BESTLINK *Best's Statement File – Global*, Tadawul

In spite of these painful short-term corrections and the growing likelihood that some of the weaker players could exit the market, the longer-term prospects for the Saudi Arabian insurance industry will likely yield greater stability and profitability. A.M. Best has observed that companies are steadily becoming more disciplined as they follow the stricter rules surrounding actuarial pricing and reserving. The introduction of compulsory covers has also contributed to steady double-digit premium growth, to the benefit of all market participants.

As premium rates reflect the companies' underwriting performance and cost bases, A.M. Best believes that there will be less reliance on cash-flow underwriting and more focus on underwriting profitability. Risk management remains high on the agenda, with encouraging signs that Enterprise Risk Management (ERM) practices are becoming more embedded. In general, larger carriers in particular are taking more expert approaches to risk analysis, pricing and managing their capital resources, developments that have been assisted by the appointment of in-house actuaries.

In January 2016, SAMA introduced new regulations detailing the role, responsibilities and required professional qualifications of company actuaries. This followed the introduction of new rules in October 2015 regarding the composition and role of audit committees within the corporate governance structure of insurers and reinsurers. In A.M. Best's view, these are all positive developments that should result in a more mature insurance market that comprises sophisticated and financially strong insurers.

United Arab Emirates: the impact of new risk-based regulations will be felt most keenly by small and medium-sized insurers

The UAE, with a near 40% share of total insurance premiums in the region, has taken a similar road to regulatory reform as Saudi Arabia but is at an earlier stage of the journey. A.M. Best believes that the UAE can expect an adjustment period of at least two years before its market begins to stabilise, during which there will be an impact on solvency, reserving and operating performance, as well as reinsurance utilisation.

The approach to capital modelling under the new regulations in the UAE has been more comprehensive than in Saudi Arabia, with a risk-based capital model that takes into account all classes of business and addresses the asset side of an insurer's balance sheet in addition to its underwriting activity. Historically, insurers in Saudi Arabia have adopted, in line with investment limits imposed by SAMA, more conservative investment policies. This has resulted in lower volatility in risk-adjusted capitalisation and operating performance arising from investment risk and therefore less need to address investment in a capital model.

The UAE solvency margin calculation takes into account insurers' invested assets through charges associated with market and liquidity risks forming part of the solvency capital requirement. Additionally, the regulator, the Insurance Authority (IA), has deemed certain categories of assets inadmissible and therefore excluded from insurers' basic own funds (which must cover the minimum capital requirement (MCR), solvency capital requirement (SCR) and minimum guarantee fund (MGF) measures).

These rules force insurers to consider the impact of their investment portfolio allocation on solvency, incorporating the risk of investment volatility into strategy. Large asset allocations to real estate (above 30%) and UAE equity (above 30%) are deemed inadmissible. However, the 30% restriction on non-sovereign fixed income might result in insurers reducing diversification in their investment portfolios.

The new rules represent a move towards a more complex and risk-based approach to prudential regulation in the market, with insurers given a coming-into-line period of between one and three years to comply with the new requirements.

A.M. Best notes that six companies maintain total capital and surplus below the regulatory minimum of AED 100 million, with five of the six losing further capital in the first half of 2016. Due to the rules concerning admissible assets, even companies with healthy capital and surplus can find that they have own funds below the regulatory minimum. The regulator requires these companies to formulate a plan to bring their levels of capital back above the minimum, but so far, the IA has not taken steps to intervene in operations or force into run-off the companies that are below this threshold.

Following the introduction of the new regulations, insurers have been required to improve and standardise the way they calculate and report unearned premium reserve, incurred but not reported claims, unexpired risk reserves, unallocated loss adjustment expenses and outstanding claims recoveries. A.M. Best expects this change to improve the quality of insurers' reserving over the medium term. However, in the short term, reported capital positions have been eroded as a number of insurers have restated their technical reserves for prior years to reflect the new requirements. A.M. Best notes that six companies have already moved to strengthen reserves, restating figures for 2014 and reporting a decline in capital. Further companies may seek to delay implementation of the new rules to later in 2016, which could result in further adjustments to financial statements.

Unlike Saudi Arabia, the new regulations in the UAE do not yet enforce actuarial pricing for insurers, leaving market participants free to compete fiercely for business by lowering rates. However, A.M. Best notes that it is possible that the improved requirements for actuarial reserving will nonetheless concentrate management's attention on ensuring products are adequately priced and helping to improve market discipline.

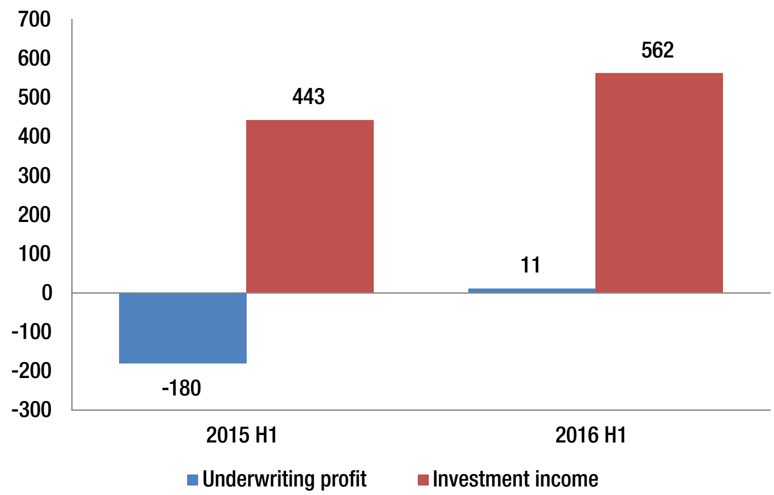
In the first half of 2016, underwriting profitability in the UAE improved considerably with the market's combined ratio falling to 96%, compared to 100.4% in the first half of 2015. However, this improvement has not been experienced by all market participants, with the majority of the smallest insurers still reporting an underwriting loss. In contrast, the top five companies all reported healthy underwriting profits. The improvement in the market's result was driven by a fall in the loss ratio from 80% to 74%, which A.M. Best believes may have been driven by a certain amount of price rationalisation.

As a next step, the IA announced in April 2016 that it intends to require all national and foreign insurers to employ an actuary to price policies, with this activity monitored by companies' boards and the regulator. The measure is not yet in place but could result in price increases for some lines of business. While underwriting performance has improved compared to the first half of 2015, the key driver of profit in the UAE market is not underwriting income, but investment income (see **Exhibit 5**).

Equally, despite an increase in profits in the first half of 2016, the total comprehensive income (TCI) of UAE insurers is down as a result of unrealised losses from their investment portfolios. One intention of the regulatory changes is to de-risk companies' balance sheets given that higher-risk assets have historically driven volatility in the level of shareholders' equity of UAE insurers. If the regulations are successful in achieving this aim, insurers will experience lower fluctuations in their investment portfolios, with a reduction in volatility in risk-adjusted capitalisation.

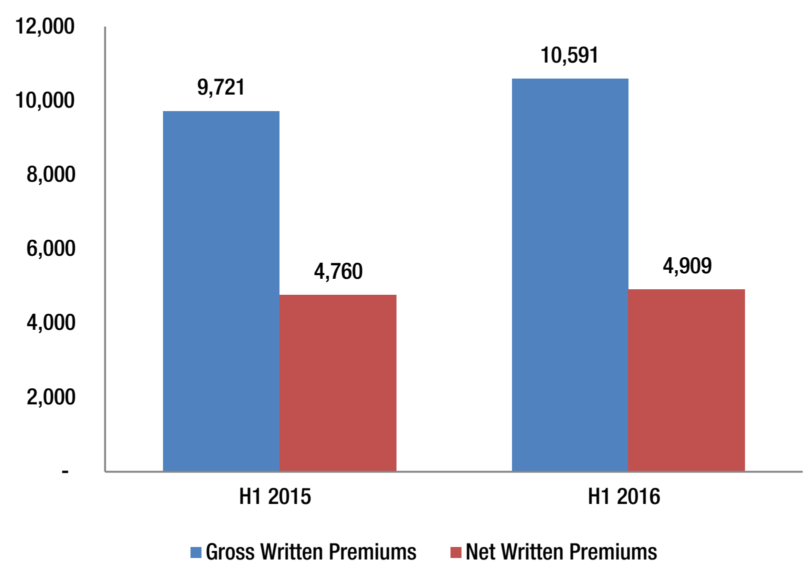
In terms of reinsurance utilisation in the UAE, developments in risk-based capital regulation may already be having an effect. In the first half of 2016, the GWP of listed national insurers grew by 9% compared to the first half of 2015. However, increased reinsurance purchase has resulted in

Exhibit 5
GCC Regulations - United Arab Emirates - Underwriting Profit and Investment Income (2015 H1 and 2016 H1)
(AED millions)



Source: BESTLINK *Best's Statement File – Global*

Exhibit 6
GCC Regulations - United Arab Emirates - Premiums Ceded (2015 H1 and 2016 H1)
(AED millions)



Source: BESTLINK *Best's Statement File – Global* a 15% increase in premiums ceded to reinsurers. Retained premiums for the market only grew by 3% compared to the first half of 2015 (see **Exhibit 6**).

The regulator's risk-adjusted solvency model incorporates charges associated with retained insurance risk. As a result, insurers reduce required capital and improve their reported solvency positions by ceding a higher proportion of business.

The key driver of reinsurance purchase remains overcapacity in the international reinsurance market resulting in competition and attractive pricing. While the primary market continues to benefit from attractive commissions, it is likely to pass on a large portion of assumed risk to reinsurers. However, a continued heavy reliance on proportional reinsurance could hinder the development of sophistication and technical expertise in the market.

Several of the UAE's larger insurance companies were already compliant with the new regulations (including reserving, reporting and solvency calculations) when they were introduced. As a result, they have had to make fewer changes in order to comply with the new framework. Therefore, A.M. Best notes that the regulatory reform is being felt most keenly by small to medium-sized insurers. These companies have higher expense bases and lack economies of scale. As a result, A.M. Best believes that it is likely that the gap between the largest and smallest insurers will widen.

The market's smaller scale participants face a number of options. Some may seek to exploit specialised niches and product lines away from the highly-competitive and saturated retail classes of business (such as motor and medical), while some may choose to consolidate. A.M. Best notes that the same barriers to M&A that exist in Saudi Arabia are even more prevalent in the UAE as shareholders have yet to experience the need for capital increases. However, it may be that UAE carriers are finding there is currently less appetite from investors for rights issues as a result of falling oil prices and depressed earnings. If capital raising does prove more of a challenge, it could encourage consolidation in a market that has so far seen little in the way of M&A activity. Others, particularly loss-making companies in breach of minimum capital requirements, may simply exit the market or enter run-off.

Regulation gains momentum

As Saudi Arabia and the UAE's insurance markets adopt more prudent regulatory environments, they are setting the pace for the wider region. In Qatar, the Central Bank introduced rules earlier in 2016 that define a broad range of regulatory and prudential requirements relating to licensing, regulation and controls, risk management, accounting and actuarial reports and capital requirements.

The new law stipulates that listed insurance companies must maintain capital above QAR 100 million or a minimum threshold defined by the company's modelled risks. While the market could see some adjustment to the new rules, with companies taking a varied approach to pricing, reserving and risk management, the reforms may not be as rigorous as those introduced in the Saudi Arabian and UAE markets. The Qatari insurance market is also less fragmented and capital adequacy remains strong amongst its participants, suggesting that any deficiencies should be absorbed by the market.

Kuwait would appear to have the weakest regulatory framework of the GCC insurance markets and there are few signs this position will change in the immediate future. A.M. Best notes that many companies take an inadequate approach to pricing, risk and capital management, which could result in significant one-off adjustments as and when new regulations are introduced.

Oman has adopted and strengthened practices in recent years following cyclone activity in the country. The Capital Markets Authority has introduced strict rules covering investment activities and prudent practices are adopted for reserving, with companies required to conduct actuarial reviews of their reserves every two years. A key challenge is meeting new capital requirements and listing on the Muscat Stock Exchange. A.M. Best notes that many of the smaller market participants may be left with no options but to consolidate or leave the market.

As insurance regulation continues to gain traction across the GCC, companies will experience adjustments of varying degrees depending on prior regulatory standards in their markets, their size and sophistication. These expected short-term corrections may be particularly painful for weaker, undercapitalised insurers. Some market exits are anticipated, particularly if regulators actively enforce new rules surrounding minimum capital requirements. Markets could also experience consolidation, although as mentioned, several barriers preventing widespread M&A remain across the region.

In A.M. Best's view, it is inevitable that there will be winners and losers, with the better capitalised, more sophisticated companies remaining and gaining market share and the gap between the larger and smaller carriers widening. While the jury is out on whether regional regulators will opt to actively police their respective markets, over the longer term, improvements in insurance regulation within the GCC should result in greater stability and confidence.

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