Low Oil Prices and Political Instability Provide Testing Times for Middle East & North Africa Insurance Markets

A.M.Best

Once viewed as an economic powerhouse amongst emerging markets, with seemingly unstoppable growth prospects, the Middle East region has recently succumbed to a deterioration in medium-term economic forecasts, driven by unrelenting low oil prices and persisting regional instability. These two key challenges are likely to dictate the operating landscape of Middle East and North Africa (MENA) economies over the near to medium term, and will have repercussions for the insurance markets across the region.

Despite the substantial fall in the price of oil, there are further potential headwinds that can place greater pressure on the sector including reduced levels of demand from emerging economies, such as China, increased shale oil extraction mainly from the United States and the prospect of Iran reentering the market as a major supplier.

The impact and severity of a prolonged period of low hydrocarbon prices could be significantly more profound on these markets.

Political instability remains a further and somewhat interlinked challenge for the MENA. In the aftermath of the Arab Spring uprising, some of the countries affected have made positive strides from a political standpoint while others have seen a marked deterioration. Whilst the causes for political instability have not to date been directly linked to low hydrocarbon prices, there is a concern that heightened regional instability and political tensions over the longer term may exacerbate economic pressures on many MENA economies.

A.M. Best believes that the impact of these two key challenges on the insurance markets in the region is difficult to predict, but will undoubtedly hinge upon where the “new normal” oil price lands and how governments manage potential budgetary cuts and social unrest. In this report, A.M. Best examines the impact of oil prices, political instability and country risk on MENA insurance markets, and further notes the ability of those insurers in the region that it rates to absorb market deficiencies in the near to medium term.

Downward Trend in Economic, Political and Financial System Risks

A.M. Best’s approach to country risk analysis places countries into one of five tiers. Country Risk Tier 1 (CRT-1) denotes a stable environment with the least amount of risk, while Country Risk Tier 5 (CRT-5) countries pose the most risk and, therefore, the greatest challenge to an insurer’s financial stability. Country risk assessments form an integral part of A.M. Best’s rating process and in the determination of Financial Strength Ratings for insurers. Consideration is given to the impact of economic, political and financial system risks on a company’s operations, performance and capital adequacy, as well as the measures taken by companies to mitigate, manage and financially absorb country specific risks. It should be noted, however, that A.M. Best’s country risk evaluation does not impose a ceiling on ratings in a given domicile.

The general increase in regional instability and the persistence of low oil prices have resulted in elevated levels of country risk for many MENA countries, though A.M. Best notes that the manner in which these issues have manifested themselves has varied country by country.

Exhibit 2 shows the Country Risk Tiers (CRTs) for a selection of MENA countries as of Jan. 2016 and contrasts them against their position in 2011. The exhibit also illustrates the level of political, economic and financial system risks associated with each of these countries. Despite there being a heightened level of country risk within the region, over the last five years, only Bahrain and Egypt experienced negative movements in their CRT classifications.

Exhibit 2

A.M. Best Country Risk Tiers (Middle East and North Africa)

Country	A.M. Best Country Risk Tiers		Assessment of Country Risk Factors (as at Jan-16)		
	Jan-16	Jan-11	Political Risk	Economic Risk	Financial System Risk
Algeria	CRT-5	CRT-5	High	High	Very High
Egypt	CRT-5 ▼	CRT-4	High	High	Very High
Bahrain	CRT-4 ▼	CRT-3	High	Moderate	Moderate
Lebanon	CRT-5	CRT-5	High	High	Very High
Morocco	CRT-4	CRT-4	High	High	High
Tunisia	CRT-4	CRT-4	High	High	High
Turkey	CRT-4	CRT-4	High	Moderate	High
GCC Countries (excl. Bahrain)	CRT-3	CRT-3	Low - Moderate	Moderate	Low - Moderate

Source: A.M. Best research and data

Bahrain's re-classification to CRT-4 in the second half of 2015 principally reflected deterioration in both short and long-term trends for economic and political risks. In particular, fiscal pressure began to mount in the run-up to the re-classification and has persisted since, with falling oil prices and growth in social spending expected to lead to an increasing fiscal deficit over the medium term.
With oil and gas accounting for approximately 85% of total fiscal revenues and the government debt burden having doubled since 2009, the country's economic metrics moved into alignment with a CRT-4 classification. In addition, political division and governmental strain continue to be seen as a constraint on fiscal consolidation efforts in Bahrain over the medium term.
Egypt's re-classification to CRT-5 in 2011 related principally to an increase in political risk, which was viewed to also have negative repercussions for the economic environment. Social unrest had led to a political revolution with significant instability and uncertainty arising as a consequence. In addition, power sharing with the military and the development (and subsequent amendment) of a new constitution also applied significant pressure to the Egyptian economy. Given the continued unrest and economic uncertainty, Egypt's risk metrics remain in line with A.M. Best's CRT-5 classification.

A further consideration is that whilst country specific risks vary from country to country, there are also clear contagion or crossover effects, with developments in economic, political and financial system risks typically spreading across borders to neighboring countries.

Low Oil Prices

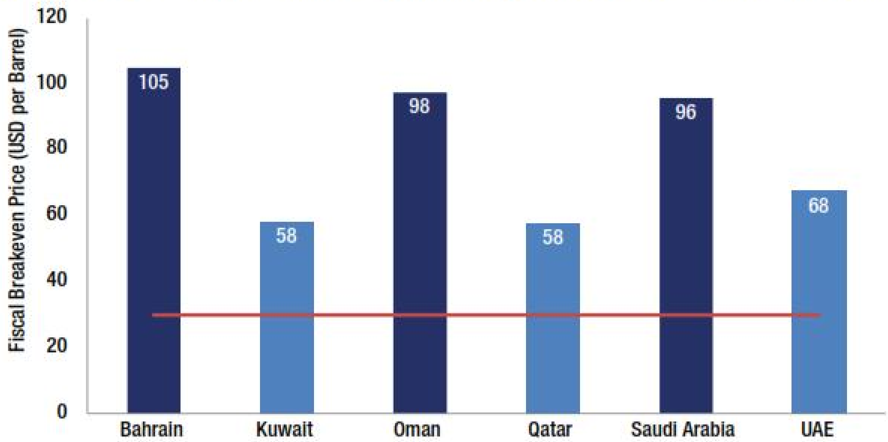
Significant growth in gross premium revenues in the region over the last decade has stemmed from an increase in insurable risk, mainly fuelled by the introduction of mandatory covers, but also driven by government and private sector investment in energy, infrastructure and industrial development projects. High oil prices combined with stable global demand in the years leading up to 2014 supported significant government expenditure by oil-rich countries, particularly those of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). Furthermore, as well as enabling strong domestic investment, significant budget surpluses allowed cash-rich governments to invest and support neighbouring economies.
As well as the widespread geographical benefit, the prosperity has spread across multiple sectors, including energy, finance, tourism and construction.

Qatar and the UAE, whilst not immune to the effect of low oil prices, are less susceptible to the long-term impact. Qatar has substantial natural gas reserves and is one of the world's largest exporters of liquid natural gas, prices of which have not fallen as much as oil over the past year. As a result of the country's lower fiscal breakeven point and substantial oil and gas reserves, there is expected to be significant prospective investment in non-oil related sectors.
Furthermore, despite the UAE having relatively limited oil production, the country maintains a much more diverse economy. As a consequence, these two countries are perceived to have the greatest level of long-term

economic stability in the region. Individuals and companies from across the region are more likely to find these markets attractive for investment, given that prospects for future growth are deemed stronger.

Exhibit 3

Gulf Cooperation Council (GCC) Fiscal Breakeven Price (2016 Projections) and Jan. 2016 Monthly Average Price of Brent Crude



Sources: International Monetary Fund "Regional Economic Outlook - Middle East and Central Asia" October 2015 and A.M. Best research.

For non-oil producing nations outside of the GCC, such as Egypt and Jordan, their economies may initially be considered immune from the effects of the decline in oil prices and may in fact prosper from lower energy costs. However, their economies have historically benefitted from notable public and private foreign investment from their oil-rich neighbours, and may be exposed to the contagion effects of lower economic activity within the GCC.

Furthermore, changes in the economic landscape may encourage the development of stronger capital markets, reduced social security benefits and changes in taxation regimes. There is also the real prospect of some GCC economies implementing a Value-Added Tax, which could change the dynamics of the markets. Also, should the GCC economies decide to reduce social care and medical healthcare benefits for their local populations, A.M. Best believes that this would provide a real opportunity for insurers to expand existing life and health operations.

While local insurers often only have profiles and balance sheets which support them taking a small net share on large property and engineering risks, they have benefited from strong inward commissions from regional and global reinsurers that bear the majority of these risks. Consequently, whilst a slowdown in new energy, property and construction risks may not impact the net written premium base of most domestic insurers, given their extremely low retention levels on these risks, technical profitability may be subject to deterioration. In A.M. Best's opinion, the technical profitability of local and regional insurers has been buoyed by the level of inwards reinsurance commissions which have been a key feature of earnings over the last five years. However, as many local insurers' underwriting performance has trended negatively over the last three years, driven largely by intensifying market competition, a drop in inwards commissions is likely to lead to further pressure on earnings.

Moreover, given the exposure most local insurers have to equity and real estate assets, it is highly conceivable that investment markets, and consequently the non-technical performance of these insurers, may be further impacted. With the expectation that business prosperity and economic indicators are set to weaken, this is likely to result in a fall in investor confidence and may lead to deterioration or fluctuations in market performance of equity and real estate assets. However, A.M. Best believes that this impact is not expected to be as severe as that experienced over the last few years.

Furthermore, with all of the GCC economies having longstanding currency pegs to the U.S. Dollar, the sustainability of the exchange rate may become pressured for some countries as a result of low oil prices. In particular, Oman and Bahrain may be subject to increased pressure to free float their currencies, due to reduced foreign exchange reserves. Such a situation could create significant challenges for the economy and insurance sector over the medium term.

Political Instability

Political instability in the region has existed for some time, but over the last five years has become a heightened issue. For insurers operating in the region, the implications have been varied. Whilst some countries, such as those that form the GCC, have remained relatively immune to long-term political instability, other countries including Algeria, Egypt, Lebanon and Tunisia have experienced significant political instability, reform and social unrest.

For most local insurance companies, political instability and social unrest has not directly impacted their operations or performance over the short term. For instance, A.M. Best rated insurers with operations in CRT-5 countries (such as Algeria, Egypt and Lebanon), that have experienced significant social unrest and political instability in the last five years, have in most cases continued operating profitably and without significant hindrance. However, the political strains that have arisen in these countries have resulted in heightened economic issues as well as financial market volatility.

Economic factors, such as inflation and foreign exchange movements are also critical to insurance operations, and in countries with increased political instability such factors often experience volatility. Inflation assumptions are essential when setting premium rates for longterm policies and can also affect sum assured values over time. Additionally, claim and expense costs are often very sensitive to movements in inflation, with a shift outside of an insurer's expectation easily able to move technical operations from a profit to loss position.

Furthermore, this type of environment creates additional risk and challenges for insurers when attempting to determine effective investment strategies. For example, an insurance company operating in a CRT-5 economy with a high level of inflation may be able to generate a seemingly strong investment return of between 5-10%. However, in real terms (adjusting for inflation) the return would be significantly lower. In addition, the risk of a suspension of financial markets, as occurred in 2011 in Egypt, can introduce not only fluctuations in the value of assets, but also create liquidity issues for insurers.

The scope for significant foreign exchange movements outside of the GCC is also increased in CRT 4/5 countries, adding a further challenge for insurance companies. For local insurers operating in a single market, foreign exchange movements may not be an issue as assets and liabilities would be matched in the same currency. However, in most cases, domestic writers purchase reinsurance protection from the global markets, with volatility in exchange rates creating variations in reinsurance cost. To combat this risk, some local and regional insurers look to write risks in a non-domestic currency, often choosing an international currency such the U.S. Dollar.

Some insurance companies have benefited from the regional unrest, taking advantage of opportunities such as an increasing demand for political violence cover offered as riders for existing policies. These risks tend to be underwritten on a selective basis where risk mitigation measures are in place and are generally priced by the international market, with local insurers typically fronting these risks with small net participations.

Summary

Whilst the short-term impact of political instability and related economic and financial systems risks can be absorbed by most insurers in the region, longer-term exposure ultimately requires enhanced enterprise risk management capabilities and practices. Many insurers in the region that are rated by A.M. Best have successfully navigated these issues to date and have a proactive and constantly evolving risk management approach.

In A.M. Best's opinion, understanding the risks of operating in countries with higher CRT tiers exhibiting currency fluctuations, illiquid asset classes, investment market volatility, high inflation and business interruption is only one part of the challenge. The real test for an insurers' risk management approach is the strength and agility of the controls, practices and measures that it puts in place to prevent issues triggering earnings and capital volatility. And as well as having adequate measures and controls in place, the strongest insurers are those that go one step further and consider “what if” scenarios and create contingency plans that target the unexpected. Determining the extent to which the profile, performance and balance sheet strength of local and regional insurers is likely to be impacted by low oil prices and continued political instability in the region over the medium term is not easy. So far, those insurers rated by A.M.Best have displayed resilience to these challenging market conditions. Looking ahead, should the environment of low oil prices persist, it may put a dampener on insurance growth and pressure earnings. A.M. Best believes the impact of these testing market conditions is unlikely to result in a sudden deterioration in market performance and as such will enable insurers to adapt their strategies as necessary. A.M. Best has also noted that largely, its rated insurers across the MENA region have good balance sheet strength, which enables them to absorb market deficiencies at least over the near to medium term.