Understanding the Realities for Insurers Operating in Oil Rich Emerging Markets

A.M.Best

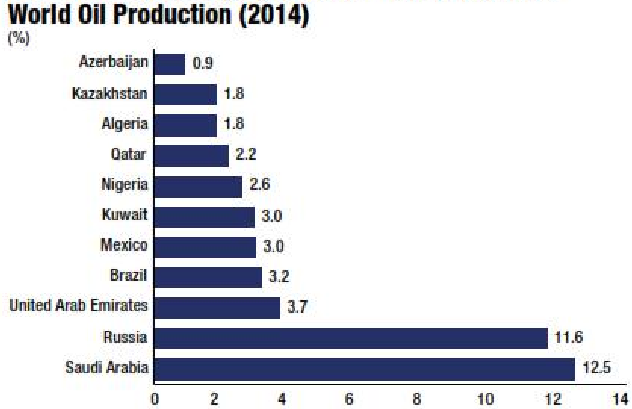
In early 2014, crude oil traded at a high of USD 110 per barrel, and it would have been hard to comprehend that two years later oil prices would fall to almost a quarter of this value, reaching the lowest price since 2003. With the price of this commodity set to remain under pressure for an extended period of time, though at higher levels than those seen in December, 1998 (when prices dropped as low as USD 9 per barrel), further weakness would have severe repercussions on the global economy, and in particular on the oil-dependent emerging markets.
A further reduction in demand and/or increased supply could be triggered by reduced demand from oil-importing emerging economies, such as China, increased shale oil extraction – mainly from the United States and the prospect of Iran re-entering the market as a major supplier following the lifting of certain oil-related sanctions.

The extent to which oil-rich emerging economies will respond to low oil prices is primarily driven by dependence on oil revenues relative to total GDP, the breakeven oil price required to support existing fiscal budgets, the existence of current account surpluses/deficits and the impact of local currency exchange rate movements relative to the global trading currency of oil (U.S. dollars).

Exhibits 2 and 3 illustrate the importance of oil production for emerging countries and the relative break-even price required to sustain their economies. It is clear that Saudi Arabia and Russia are the most significant contributors to global oil production and will be hard hit by falling oil prices.
While other countries have relatively lower contributions to world oil production, their economies are still dependent on oil revenues to stimulate growth. This includes Bahrain, Brazil, Kazakhstan, Nigeria and Oman.

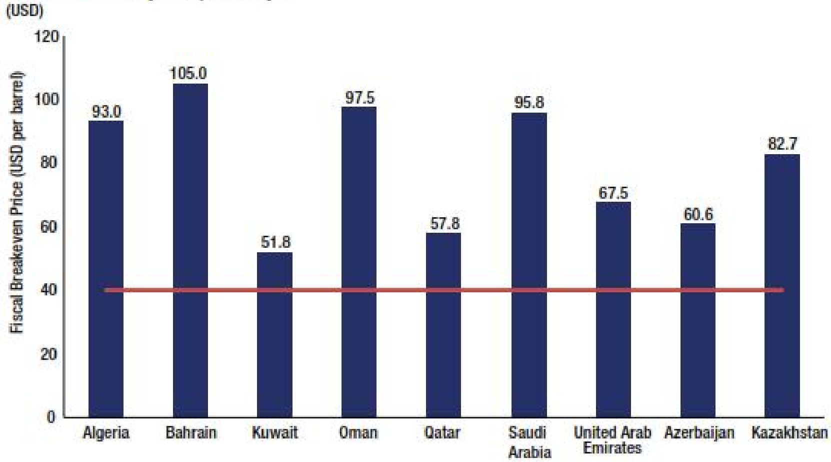
By contrast, some oil-rich emerging economies are much better positioned to weather the low oil price environment.
Countries such as Kuwait, Qatar and the United Arab Emirates have lower break-even points as well as more diverse income streams, making their economies better equipped to handle the difficult operating environment Of the insurance markets covered in this report, A.M.

Exhibit 2
Oil Prices and Emerging Markets – Contribution to World Oil Production (2014)



Source: United States Energy Information Administration

Exhibit 3
Oil Prices and Emerging Markets – Fiscal Breakeven Price for Oil Rich Emerging Economies (2016 Forecasts) and Monthly Average Price of Brent Crude (Feb., 2016)



Source: International Monetary Fund, IMF Regional Economic Outlook Middle East and Central Asia, October 2015, and A.M. Best data and research.

Best believes that Russia and Nigeria currently show more vulnerability than others. However, in a globalised world, strains in one market can impact a whole region and even beyond, as noted in A.M. Best's recent report "Low Oil Prices and Political Instability Provide Testing Times for Middle East And North Africa Insurance Markets".

Implications for domestic insurers
In general, insurers in oil-rich emerging countries have seen notable growth in gross premium revenues over the last few decades, stemming from increased insurable risks.
These have been fuelled to varying degrees by government and private sector investments in energy, infrastructure and industrial development projects, and the introduction of mandatory covers, mainly on motor, medical and liability classes. However, there is concern that in the face of plummeting oil prices, investment will slow down considerably. As such, domestic risk carriers may no longer be able to achieve top-line premium growth at levels previously experienced.

Just as the effect of low oil prices is likely to be varied among oil-rich emerging economies, the impact on domestic insurance companies operating in these markets is likely to be mixed. 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 and high dependence on inward reinsurance commission on these risks, technical profitability may be subject to deterioration.

The underwriting performance of domestic insurers in many emerging markets has trended negatively over the last five years, driven by intensifying market competition, weak technical discipline and worsening claims experience.

The report covers the implication of Oil prices on several countries including Russia, Brazil, Nigeria & Kazakhstan and finally on GCC Countries, we will review only the implications on GCC countries which is more relevant from General regional perspectives.

GCC Countries: A mixed bag
High oil prices, combined with stable global demand in the years leading up to 2014, supported significant government expenditure by the GCC countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the

United Arab Emirates (UAE). There was widespread regional benefit and this prosperity spread across multiple sectors, including energy, finance, tourism and construction.

Some GCC member countries have entered the next phase of growth, diversifying their economies away from a dependence on oil and gas. The UAE stands out, with Dubai developing as an international tourism, trade and finance hub, and Abu Dhabi emerging as a centre for renewable energy. Qatar is also less susceptible as it 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 consequence, the UAE and Qatar 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.

Other markets retain a higher level of dependence on oil and gas revenues and are therefore more vulnerable. A.M. Best notes that some countries, including Saudi Arabia - the world's biggest oil producer - are running existing budgets on accrued cash reserves, a clearly unsustainable approach over the medium term. Additionally, for those GCC countries that have not accrued the same level of surpluses, such as Bahrain and Oman, the negative impact of low hydrocarbon prices is even more immediate.

Domestic insurers in the region often only have profiles and balance sheets that support them taking a small net share on large property and engineering risks. Nevertheless they have benefited from strong inward commissions from regional and global reinsurers that bear the majority of these risks, and profitability over the last five years has been buoyed by these commissions. Consequently, whilst a slowdown in new energy, property and construction risks may not impact the net written premium base of most domestic insurers, technical profitability may be subject to deterioration.

Moreover, A.M. Best notes that 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 economic indicators are set to weaken, a fall in investor confidence may lead to deterioration or fluctuations in asset values. However, A.M. Best believes that this impact is not expected to be as severe as that experienced over the last few years.

So far, those insurers rated by A.M. Best in the region 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-rated insurers across the GCC region have good balance sheet strength, and this should enable them to absorb market deficiencies, at least over the short-to-medium term.

Conclusion

With oil prices remaining low and volatile, global repercussions are inevitable and their effects will be felt particularly keenly in oil-dependent emerging markets. In A.M. Best's opinion, of those markets in which it rates domestic insurers, companies in Russia and Nigeria could be the first to experience deterioration in their operating fundamentals. This is particularly reflected in the current negative outlooks on Russia's (re)insurance companies.

Nevertheless, A.M. Best maintains that the extent to which the profile, performance and balance sheet strengths of insurers operating in oil-rich emerging markets will be impacted over the medium to long term will be more nuanced, and, inevitably, there will be variations between countries, and also between companies.

A.M. Best believes that markets with more diversified economies will be somewhat cushioned from the impact, while insurers with stringent underwriting frameworks, sufficient reserves and investments in foreign currencies should also be buffered. Many insurers in oil-rich emerging markets that are rated by A.M. Best have successfully navigated these issues to date.

It is worth noting that, due to the limited retentions of insurers in most emerging markets, the impact of declining oil prices on insurers' balance sheets is most likely to come about as a result of worsening economic climates in addition to, in some instances, a reduction in inward reinsurance commissions. Where balance sheets are already under pressure, as a result of competitive market conditions, these oil price-related strains could tip the balance.

A.M. Best believes the impact of these market conditions is unlikely to result in a sudden deterioration in market performance and as such, this will enable insurers to adapt their strategies as necessary. A.M. Best has also noted that largely, its rated insurers within oil-rich emerging markets possess good balance sheet strengths that will enable them to absorb market deficiencies at least over the near term.