Economic hurdles: 2014

By Maroun Mourad

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Before moving to Dubai, Maroun spent four years working for AIG as Vice President, as well as a Financial Lines Profit Centre Manager and COO for Continental Europe. Maroun began his insurance career with Gen Re, a Berkshire Hathaway company, as an underwriter in the San Francisco office. He subsequently worked for Gen Re in its Paris and London offices. Maroun holds both a BA in Political Science and Juris Doctor (law) degrees from the University of California, Berkeley. He is currently on sabbatical writing an insurance management book, which will be published in early 2014.

The mid-September to mid-October period was a busy one for insurers and reinsurers. Budgeting, capacity, pricing, and terms and condition decisions are sandwiched between two tentpole meetings on the insurance calendar. First, the Rendez-vous de Septembre (Monte Carlo), where insurers, reinsurers and brokers met in September to exchange ideas; and second, Baden-Baden, which is almost exclusively a reinsurers and brokers meeting taking place in mid-October.

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Alternative risk transfer . . .

As reinsurance capacity remains a driving force behind the Middle East region's market dynamics, I think that Monte Carlo and Baden Baden are good places for us to kick off with the 2014 insurance market predictions. The dominant topic at both events in late 2013 was the influx of alternative capital into the reinsurance market. Executives, with very few exceptions, seemed laser-focused on the $40 billion to $45bn of fresh alternative capital that is said to have targeted the industry. Alternative capital comes in the form of cat bonds and sidecars, as well as collateralised reinsurance deals. Although the amount is not a game changer given the global industry capitalisation, it is not insignificant either. Approximately $40bn to $45bn of fresh alternative capital is equivalent to four to five new reinsurance players capitalised at $10bn each. Among alternative risk transfers and financing mechanisms, cat bonds are of particular concern to global players, as they bypass the traditional reinsurance market and access investors directly. This fresh capacity is said to take premiums away from traditional reinsurance deals and, consequently, puts more pressure on reinsurers to grow, with the ultimate effect of driving rates down due to increased competition. This new capital is particularly targeted towards the US nat cat and liability markets, as well as European and Asian nat cats (particularly Thailand and Japan) to a certain extent.

. . . And its effect on the Middle East region

I expect the Middle East reinsurance renewals to remain flat in 2014, while the direct insurance market rates are expected to suffer due to increased competition in the non-complex and non-large risks arena. Large complex commercial risks require global facultative reinsurance capacity and tend to be underwritten according to global standards and pricing. Their capacity remains driven by multinational insurers operating in the region, as well as reinsurers from Europe, London, the US, and Bermuda. commercial risks require global facultative reinsurance capacity and tend to be underwritten according to global standards and pricing. Their capacity remains driven by multinational insurers operating in the region, as well as reinsurers from Europe, London, the US, and Bermuda.

Oversupply and price wars

Downward pressure on rates in the primary general insurance market is expected to continue building in the lines that comprise the bulk of the market in our region – motor and medical. These two lines represent 50 per cent and 75 per cent of the UAE and Saudi Arabia markets, respectively. Multinationals have been making a push into these lines of business in order to gain a bigger share of the pie from local and regional players. The multinationals have invested heavily and need to grow, and thus drove prices down. The local and regional companies, feeling the onslaught on their home turf, react pretty much the same way. Setting more competitive rates they fight for market share and, consequently, make less technical profits. A phenomenon explained simply as supply exceeding demand. Most reinsurance capacity in the motor and medical lines is deployed on an excess of loss basis, so the reinsurers really have little leverage in dictating prices and pushing the market to be more disciplined.

I believe that the downward pressure on pricing is a phenomenon that is not only limited to the medical and motor lines. It is welcome news to see more underwriting capabilities and capacity being deployed in the specialty lines, such as excess casualty, professional liability, financial lines, energy, construction and complex high value operational property. The available premium universe, however, has not kept pace with the arrival of new capacity, therefore supply has also outstripped demand in this specialty insurance space. Prices, terms and conditions, and margins in these historically lucrative specialty segments are now also heading south due to increased capacity supply, which heightens competition. One would expect the pressure on margins to fuel M&A activity, but this does not seem to be the case.

A strong case for M&A, but . . .

M&A activity in the region, if we exclude some large bank assurance and alternative distribution deals, seems to have halted In 2013 and we should not expect this to change dramatically in 2014. This is definitely going against the global trend where there is quite a bit of M&A activity in emerging markets, such as Asia and Latin America, while the pace is picking up in the US and Europe. Activity in mature markets is expected to gain more steam in 2014.

Deals are driven by a variety of factors – tough economic conditions, coupled with a desire to lower expense ratios, are fuelling M&A activity in order to realise economies of scale and operational efficiencies In Europe and North America. Investment income remains at historically low levels at best and volatile at worst. Interest rates on investment grade 'safer' government bonds remain at all-time low levels and capital market returns are still unpredictable.

Cash needs to be deployed elsewhere, that's why more hedge and pension funds, as well as private equity dollars, are pouring into the industry. Furthermore, the post-2005 KRW (Katrina, Rita and Wilma hurricanes) capital that flooded the industry is looking for an exit, driving sell-side activism globally. Lastly, valuations, particularly in the reinsurance sector, are attractive, with several players trading at 80 per cent of book value. Who wouldn't want to buy a dollar for 80 cents? I believe that family owned structures, restrictions on foreign direct investment, as well as regulatory complexities, are the main hurdles behind the low level of M&A activity in the Middle East insurance industry. On paper the time seems perfect for an avalanche of M&A activity:

- The market is overcrowded with more than 330 insurers writing less than $20bn in 2011. The operational efficiencies alone would create enormous shareholder value, reducing invested capital and increasing ROEs.
- Capital structures are inefficient and the market is overcapitalised for the size of retentions companies keep.
- The market is balkanised and fragmented. Very few insurers, especially indigenous ones, operate beyond the borders of their home markets.
- The penetration is under one per cent. The opportunity for growth is immense and the upside is high. The Middle East insurance sector would need to triple its size to be on par with other emerging markets' penetration, such as Eastern Europe, Latin America and Southeast Asia.

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• Valuations are on the rise, but remain reasonable (1.5 to two times book value) compared to other emerging markets and I expect the next wave of M&A activity, when it comes, to drive valuations upwards.

However, other factors continue to hinder growth in the Middle East insurance sector, making it less appealing to investors in general. The shortage of local talent, low levels of awareness and lack of regulatory activism are impediments to growth. I expect them to either improve at a snail's pace or not improve at all in 2014.

Severe talent shortage

The local market, particularly among GCC nationals, remains heavily underdeveloped in terms of talent readiness for technical and mid to senior level managerial insurance jobs. Indigenous talent interested in working in insurance is quite scarce and the industry as a whole does not seem to be attractive enough for locals. The reasons stated are: 1) Lack of industry visibility – with a penetration of less than one per cent of GDP that is a fair challenge, although our industry is growing at nearly 10 per cent CAGR; 2) Lack of competitive salaries – at entry, junior and mid-level jobs, the banks and other financial institutions pay higher salaries, not to mention the governmental public sector; and 3) Lack of enough locals and role models in the industry, especially in the UAE. In comparison, Oman and Saudi Arabia have put in place effective localisation programs. We should note that even in the Omani insurance market where the local population comprises 65 per cent of the insurance industry workforce, there remains a severe shortage of specialised underwriting, risk engineering, legal, finance, and actuarial talent. The picture is even starker in the UAE and other Middle Eastern markets with a few exceptions such as Egypt, Jordan, and Lebanon whose nationals still supply the bulk of the Arab insurance talent to the region's players.

Unacceptably low awareness and penetration

Low awareness of everyday risks and the benefits of insurance protection among our region's population is another inhibitor to growth. Take Dubai's JLT Tamweel Tower fire in 2013, for example. Most, if not all, of the tower's residents, irrespective of nationality, did not carry homeowners' insurance and were left to bear the brunt of the financial loss personally. I had recommended to several regulatory bodies to partner with the private sector to launch insurance products and services awareness campaigns over the past few years; the idea was welcomed, but not acted upon.

Regulatory inactivism and much needed reform

On the regulatory front, besides the DFSA in Dubai and QFCRA in Qatar, Saudi Arabia's SAMA has been one of the most active regulators in recent times on both the regulation issuance as well as

enforcement fronts. Many have argued that SAMA's approach was premature given the Saudi market conditions, but I believe that this is what it takes to bring a previously unregulated market in line with modern regulatory standards. However, I think that regulators still have a long way to go in many areas. Below are some change recommendations that I believe could help the market maturity and development:

• Adequately staffing the enforcement divisions and stepping up enforcement activity of market conduct violations.
• Enacting and enforcing stricter consumer protection laws to prevent miss-selling.
• A review of minimum capital requirements, which would lead to fewer but stronger market players and a surplus building for the population.
• Tighter investment guidelines to increase the probability of balance sheet survival in turbulent times.
• Moving from capital markets and other speculative investments towards sovereign debt and strongly rated corporate bonds, to bring regional investment portfolios in line with those in well-regulated global markets.
• A regulatory push towards pension reform and safer bond investments, which will kick-start a vibrant bond market in the region, as insurance companies and pension funds have historically been significant consumers of such investment instruments.
• Higher local GCC nationals hiring quotas at junior, middle, as well as senior, C-suite levels.

Change will require a black swan

Overall, I do not expect any earth-shattering changes to occur in 2014, unless we experience a 'black swan' event. It can take the shape of:

• Massive earthquakes off the southern coast of Iran affecting the UAE and Oman, or in western Saudi Arabia affecting the Jeddah region.
• Destructive typhoons hitting Oman.
• Nuclear or biological attacks in the region, or in a heavily-populated western urban zone.
• Mega mergers such as Swiss Re/Munich Re, AXA/AIG, or Zurich/Allianz.
• A repetition of the financial meltdown we experienced five years ago.

Otherwise, reinsurers will probably renew at expiring or lower prices, terms and conditions, and reinsurance capacity will keep growing in the region. The local reinsurance market, with DIFC-based players in particular, will continue to be the first port of call for regional risks placement. We also see broker activity from Africa, the 'Stans', and some Asian risks accessing the DIFC reinsurance market in the financial lines, as well as complex operational property and energy spaces. Reinsurers, as well as brokers, continue to add depth and breadth to the regional capabilities in the form of capacity and human capital. I expect this growth to be sustained as the DIFC, and to some extent the QFC, grow into a global reinsurance placement hubs over time.

I remain bullishly confident in the market, especially for the UAE, KSA, and Oman. We should expect the insurance market to surpass its expected 9 to 10 percent CARG over the next five years. The growth will be driven by:

• Rising overall inflation, especially in medical insurance.
• Compulsory medical legislation in Dubai and Qatar, as well as the mortgage law in Saudi Arabia.
• Infrastructure investments in the GCC, with $1trn worth of assets expected to be built and deployed in the region over the next 10 years.
• Higher penetration driven by more acceptance of the concept of insurance, as well as greater risk awareness among the local and expat population.

The opportunity remains strong

It is also a matter of time before Syria, Libya and, to a certain extent, Egypt, will further drive these growth figures into the mid-to-high teens. The growth will come as the countries rebuild and spend billions on construction, energy, marine, workers' compensation and property insurance.

Back to where we started in Monte Carlo, Lloyd's chairman, John Nelson, predicted that the commercial insurance market will grow from $600bn to $2trn by 2025. Most of the growth, Nelson claimed, will come from emerging markets. As such, I believe that the Middle East insurance sector is well positioned vis-à-vis its global peers to grow and prosper. In the absence of a black swan event causing reinsurers to drastically change their approach to the 2014 renewals, we in the Middle East insurance community just have to collectively keep moving at a faster pace in order to claim our spot as a significant economic player.

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