

A.M. Best Comments on the New UAE Insurance Authority Financial Regulations

The Insurance Authority (IA) of the United Arab Emirates (UAE) has recently issued its new 'Financial Regulations to Traditional and Takaful Insurance Companies'.

These new rules promise to improve the risk profile and policyholder security of UAE insurers by placing limits on higher-risk investments, introducing risk-based solvency calculations and standardising reporting and actuarial practices. The IA has given a grace period of one to three years for all domestic and foreign insurers that operate in the market (outside of the Dubai International Financial Centre) to update their practices and move in line with the new requirements.

Whilst many UAE insurers have strong risk-adjusted capitalisation accompanied by unleveraged balance sheets and sound underwriting performance, there are a number of common issues. These include insurers with significant exposure to high-risk assets, inadequate and varied treatment of accounting principles, unsophisticated measurement of technical reserves and weak (although developing) Enterprise Risk Management (ERM) practices. The new rules are well placed to address these issues.

This report explores some of the potential outcomes of the new regulations.

Changes to Investment Allocation

High-risk Investment Profiles

The asset composition of most insurers' investment profile is currently highly weighted towards real estate and equity assets. While there has been a trend since the global financial crisis for insurers to move towards a more conservative investment profile, exposure to these asset classes remains high. Furthermore, the investment decisions of many insurers are made by their boards of directors, with limited involvement from the senior management team in many companies.

Investment allocation to higher-risk assets has historically driven volatility in the level of shareholders' equity of UAE insurers (see Exhibit 1). The global financial crisis and resultant fall in

asset prices demonstrated the exposure created by insurers' aggressive investment strategies. Insurers' balance sheets remain vulnerable to market shocks, particularly given that assets are concentrated in the UAE, and benefit from little geographical diversification.

The Insurance Authority's Response

The new investment rules are designed to improve the asset profile of insurers by reducing insurance companies' exposure to higher-risk assets. This should provide greater stability of returns to insurers' investment profiles and thereby reduce volatility arising from fluctuating asset prices on their operations and balance sheets. Given that capital requirements of domestic insurers are largely driven by investment risk, de-risking of the asset base should improve the financial strength of companies.

Consistent with the goal of improving the financial strength of market participants, the regulator is placing a limit of investment allocation of 30% to equities and the same amount to real estate assets within the UAE. A second purpose of the investment rules is to maintain a high proportion of investments within the UAE; this is achieved by requiring foreign equity holdings to be kept below 20% of insurers' investment allocations. While it is encouraging that these ceilings limit an insurer's asset risk, the combined exposure to equities and real estate can still be deemed high (up to 80% of an insurer's asset allocation), with many insurers likely to maintain an aggressive investment mix. However, it should be noted that the solvency requirements may impose a higher charge for holding these assets.

Additionally, the rules require that insurers have an independent, board-level investment committee to encourage better investment strategies; taking into consideration liquidity requirements, counterparty limits and stress-testing of the investment portfolio.

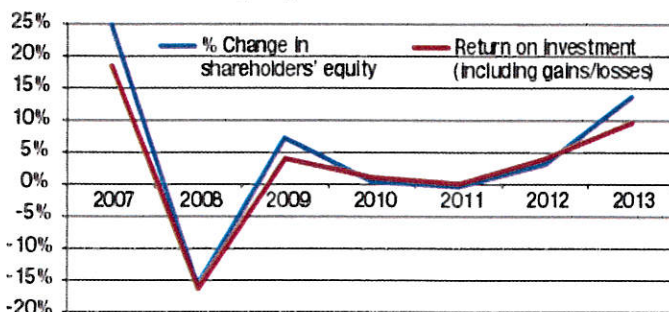
Effect on the Market

A.M. Best's analysis of over thirty insurers domiciled within the UAE indicates that approximately 19% of companies had a greater real estate allocation than permitted by the new regulations and 48% had a greater equity allocation at year-end 2013. This analysis is based on the value of assets reported in the companies' financial statements and therefore a number of companies could have greater exposure given the propensity for property assets to be held at historic book values far below their open market valuations. Which measure of value will be used is not made clear by the regulations at this stage.

Investment by UAE insurers is generally limited to domestic assets, driven by shareholder connections and greater knowledge of the local market. Given the nature of the new rules, insurers wishing to maintain higher equity allocations (and therefore the potential for a higher return on invested assets) can use their 20% foreign equity allocation to invest abroad.

As a result, these regulations could increase insurers' participa-

Exhibit 1 Investment volatility has historically driven shareholders' equity of UAE insurers



Source: A.M. Best research. Based on 27 UAE Insurers with sufficient reporting history



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tion in foreign equities, potentially increasing overall equity exposure in some instances. Insurers are able to invest in neighbouring Bahrain, Oman, Qatar and Saudi Arabia without taking significant currency risks as these countries all have dollar-pegged currencies.

It is foreseeable that some companies, enjoying high dividend incomes on their equity portfolios, will make the case that their balance sheets are large enough to provide sufficient liquidity to support policyholder obligations, whilst at the same time allocating a significant proportion of high-risk assets for maximum return. Given the strong risk-adjusted capitalisation of many UAE insurers (as measured by Best's Capital Adequacy Ratio (BCAR)), such an argument would carry some weight.

As insurers are obliged to comply with these new rules, they will be forced to liquidate large real estate and equity holdings. Insurers would be wise to plan ahead in order to achieve the right price for these assets, particularly during a period when insurers will be selling in large volumes which may depress real estate and share prices. This may be especially problematic for those insurers with large positions in thinly-traded stocks. Notably, the IA has afforded insurers a two year grace period to comply with the new investment guidelines, whilst affording three years for real estate. This allows insurers longer to divest their larger, less liquid assets.

A.M. Best expects that the resulting more conservative investment allocations will improve risk-adjusted capitalisation across the market as capital is less exposed to investment risk.

Capital requirements are currently unduly balanced towards investments as compared to underwriting risk. De-risking investment portfolios will result in more balanced risk profiles, reflecting a stronger emphasis on insurance activities. Moreover, companies will be able to achieve a higher level of underwriting leverage, supporting larger volumes of insurance business with the same amounts of available capital.

The new rules requiring board level investment committees and strategy are viewed positively and should enhance the governance framework and understanding of investment decisions that the company is undertaking. It is vital for policyholder protection that an insurer's investment strategy can support its insurance activities by adopting prudent asset-liability matching practices to ensure that there is sufficient liquidity within the operation to cover policyholder obligations at any given point in time.

Capital Adequacy and Solvency Margin

Knowledge and ability to assess capital requirements varies widely in the UAE market, with many insurers having a weak understanding of the key risk drivers that affect their balance sheet strength. Without quantitative measures, managers are unable to gauge how much capital is necessary to support their current and prospective level of underwriting and investment activity. Over recent years, many insurers have adopted aggressive growth strategies, sometimes coupled with high dividend distributions (over and above earnings) which have resulted in a deterioration in risk-adjusted capitalisation.

Some companies, particularly larger players who are better able to invest in the necessary expertise have developed capital-modelling capabilities. This puts them in a better position to understand and control their respective risks.

Until now, the UAE has not had any risk-based solvency regulations in place and has simply required primary insurers to hold a minimum of AED 100 million and reinsurers AED 250 million in paid-up capital. A fixed level of minimum capital for all companies is insufficient, given the variation in insurers' scale and their risk profiles. The market risk-adjusted capitalisation for most insurers operating in the UAE indicate that capital requirements are well in excess of these minimum levels, demonstrating the inadequacy of the current rules. In this respect, the IA's regulation has lagged behind other regimes, such as that of the Central

Bank of Bahrain which already enforces a risk-based solvency test for insurers.

The new solvency margin regulations are designed to improve the financial strength of UAE insurers by measuring their solvency using a risk-based measure according to the key principles of Solvency II. Management will need to calculate capital requirements for their companies, taking into account underwriting, market, credit and operational risks. The requirements will be compared to adjusted capital to produce margins over Minimum and Solvency Capital Requirements. The new metrics will give the regulator a tool to measure companies' solvency levels and will provide a warning sign that risk-adjusted capitalisation is deteriorating.

The solvency measures should enable management to better understand their company's operations by identifying which risks are most significant and consume the most capital.

Managers should be able to adjust capital requirements through measures such as changing their reinsurance programmes, adjusting investment allocation and adapting their underwriting profile. An understanding of risk-based solvency calculations should

allow insurers to better insulate themselves against financial shocks and limit volatility in their operations.

Financial Reporting and Technical Provisions

A.M. Best notes that there are currently inconsistencies in UAE insurers' financial reporting practices. Additionally, companies vary in the sophistication of their reserve calculations; in some cases, incurred but not reported (IBNR) claims are simply raised as a proportion of premiums written, whilst other companies are able to base reserving on historical loss experience. This can lead to a lack of comparability and uncertainty regarding the financial strength and operating performance for insurers.

The IA has stipulated that all UAE insurers must come into line with International Financial Reporting Standards (IFRS). Companies will need to conform to standardised actuarial practices and reserves will be subject to yearly actuarial reviews. A.M. Best views this positively as the regulation should result in greater consistency and transparency in financial disclosure, with the new regulations ultimately removing inconsistencies between companies and allowing the same basis for comparison.

Other requirements of the new rules, including having an audit committee, internal audit department and a compliance officer, should enhance the level of corporate governance in the market.

Risk Management

Standards of Enterprise Risk Management (ERM) differ significantly between insurers in the UAE. As with capital modelling (itself a component of ERM), some larger players have been able to invest the resources necessary to better understand and manage risks. On the other hand, less sophisticated insurers are unable to identify or monitor their risks. Given the high level of reinsurance cessions for complex risks and high-risk investment portfolios, reinsurance and investment management represent key risks to companies in the sector. At present, most insurers adopt a silo approach to risk management. While there have been significant improvements in recent years, further development is required.

The new regulations stipulate that companies must have a risk

management system, including strategy, policies and procedures. A risk appetite statement must be determined by a company's board of directors and companies must produce an assessment of all types of risks, including emerging risks. The regulation acknowledges that risk management should vary according to the size and nature of each company.

ERM allows companies to limit the potential risks to their operations from all sources. A.M.

Best's Credit Rating Methodology states that a company's risk control capability should be appropriate to its risk profile and it places greater emphasis on the practice rather than the form of risk management. The requirement of an ERM framework and policy represents a step towards effective risk management, but it must influence practice and strategy to effectively manage risk in regulated companies.

Conclusion

The new regulations represent a significant step forward for the UAE and promise to improve the insurance market and provide a higher level of financial strength and policyholder security.

A.M. Best believes they promote a better level of corporate governance and risk management, which should serve to reduce volatility in companies' operations.

However, there are caveats in terms of timeliness and effectiveness of the regulations. Given the substantial changes that many companies will need to make, there is the potential for deadlines to slip, as has happened with the separation of life and non-life activities.

Additionally, it will be important that the effectiveness of implementation and enforcement match the letter of the new rules. The IA will need the appropriate resources and expertise to actively police the market according to these new rules and must be prepared to take appropriate action in the case of breaches.

Exhibit 2

United Arab Emirates - A.M. Best-rated Companies

Ratings as of February 24, 2015.

AMB#	Company Name	ICR	Outlook/ Implication	FSR	Outlook/ Implication
085825	Abu Dhabi National Insurance Company	a	Stable	A	Stable
090708	Abu Dhabi National Takaful Company	bbb+	Stable	B++	Stable
090714	Al-Sagr National Insurance Company	bbb	Stable	B++	Stable
078732	Alliance Insurance	a-	Stable	A-	Stable
090584	Dubai Insurance Company	bbb+	Stable	B++	Stable
085401	Emirates Insurance Company	a-	Stable	A-	Stable
093190	Emirates Retakaful Limited*	bbb+	Stable	B++	Stable
088930	Gulf Reinsurance Limited*	a- u	Negative	A- u	Negative
090718	National General Insurance Company	bbb+	Positive	B++	Positive
092651	National Takaful Company (Watania)	bbb-	Stable	B+	Stable
078177	Oman Insurance Company	a	Stable	A	Stable
078593	Orient Insurance Company	a	Stable	A	Stable
090357	Union Insurance Company	bbb	Positive	B++	Stable