KPMG

The Insurance Authority Financial Regulations: A platform for growth in the UAE

CLIFFORD CHANCE

Introduction

In light of the new insurance regulations (the Financial Regulations) introduced by the UAE Insurance Authority, sections of which come into force this year (2016), this briefing highlights key themes and potential impact areas for insurers, both foreign and local, operating (or wishing to operate) in the UAE.

This briefing has been prepared jointly by KPMG and Clifford Chance, both leading advisory firms specializing in insurance globally.

The Financial Regulations are a positive step forward and could provide a platform for further growth. They should stimulate a prudential regime which requires insurers to invest reserves in a manner appropriate for the evolving risks in their operations and capital positions, but without inhibiting growth. The regulations include:

- Risk-based solvency capital requirements
- Technical provisioning based on actuarial calculations
- Defined investment policies and enterprise risk management requirements
- Enhancement of governance and controls to match the supervisory expectations of the new regime.

H. E. Eng. Sultan bin Saeed Al Mansouri, the UAE's Minister of Economy and Chairman of the Insurance Authority, has commented that the new Financial Regulations establish prudential risk requirements similar to those of the European Solvency II model, putting the UAE at the forefront of the Middle East. We would agree. The new Financial Regulations avoid certain of the complexities behind Solvency II whilst introducing many of its core principles.

In order to comply with the Financial Regulations, insurers will need to introduce or modify a significant amount of policies, systems, governance and controls, and comply with detailed – and frequent – new actuarial and financial reporting requirements. For smaller insurers, the new requirements may be demanding and costly. As a result, the Financial Regulations may trigger a wave of consolidation across the fragmented UAE insurance market by, amongst other things, supporting the diversification of risks and requiring the creation of systems and controls adapted to manage more complex organisations.

In this briefing:

- We compare the Financial Regulations with the European Solvency II framework.
- We highlight the potential impact of the Financial Regulations on insurers operating in the UAE, including compliance costs and potential consolidation opportunities.

Key investment restrictions

Whilst the Financial Regulations provide a period of two to three years for implementation, there are material changes which may have more pressing implications on current investment strategy decisions, including:

- **Real estate**: Notwithstanding the specified maximum exposure of 30% of investments in real estate, firms may, with the prior special approval of the Investment Authority, invest up to 40% in real estate (the firm would need to explain why it requires a higher maximum limit). The changes may prompt some rebalancing of portfolios - firms' exposure to real estate is understood to have been a concern of the Insurance Authority in preparing the Financial Regulations, given the historical volatility in prices.
- **Derivatives**: Financial derivatives which do not serve a hedging purpose must be closed out. The remainder can only make up 1% of a company's total investment output. However, the Financial Regulations clarify that a company may exceed the stated 1% if the additional derivatives are solely to hedge against currency fluctuation.

Certain market participants caution that the restrictive approach to admissible assets could have negative consequences. Emmanuel Deschamps, Head of Risk Management at Oman Insurance has commented that "*the restrictions could undermine policyholder protection by limiting the flexibility of insurers to diversify investments and take management decisions which, whilst attracting appropriate higher costs under Solvency II according to their risks, are simply not admissible under the Regulations.*"

The Financial Regulations – contrasts with Europe

The key tenets of the solvency capital requirement (SCR), and indeed the wider Financial Regulations, follow the basic principles of the Solvency II model with a risk-based (underwriting, market, liquidity, credit and operational risk) capital requirement calculated to ensure an insurer is able to meet its obligations over the next 12 months with a probability of 99.5%.

Insurers are required to maintain the higher of the:

- SCR – a risk-based requirement using solvency template prescribed by the Insurance Authority
- Minimum guarantee fund (MGF) – the higher of:
  - (i) not less than one third of the SCR; or
  - (ii) the higher of a minimum amount to be specified by the Investment Authority for each type of business and a specified percentage of the net earned premium for each type of business
- Minimum capital requirement (MCR) – AED100 million for direct insurers and AED250 million for reinsurers (this remains unchanged from previous requirements).

Notwithstanding these requirements, the UAE regime adopts a similar approach to Solvency II in a simplified and more standardised and streamlined manner[1]. This, hopefully, provides many of the benefits of a risk-based regime without certain of the regulatory burdens under Solvency II which could inhibit growth:

- **There is no requirement to conduct an own risk and solvency assessment (ORSA).** Instead, the Financial Regulations include the internal supervision principles necessary to comply with the new UAE regime and a requirement to submit, at the request of the Insurance Authority, a financial condition report (FCR) which includes a risk-based analysis of the solvency-related aspects of the firm[2].
- **The underwriting risk module in the Financial Regulations does not contain the detailed sub-categories of Solvency II**. Additional detail may be provided by the Insurance Authority in future, but for now the simpler approach in the Financial Regulations respects the evolving nature of the UAE insurance market.
- **There is no concept of tiered capital under the Financial Regulations**. A key growth issue for European insurers is the requirement that increased capital often needs to be met by issuing subordinated capital instruments that meet tiered capital tests. These instruments require investor appetite and often offer unattractive interest rates (given their subordination). The Financial Regulations include simply that (basic) own funds requirements are met by admissible assets in excess of liabilities. This is positive for both growth and consolidation in the UAE insurance sector, as growth can be backed by admissible investments without the need to raise equity capital or subordinated debt from the capital markets.

Overall, we believe that the UAE regime adopts many of Solvency II's benefits whilst encouraging both growth and consolidation across the insurance sector.

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1 Without having the scope of application and level of complexity required for a regime to fit across the European Economic Area (EEA) – the 28 EU countries and Iceland, Norway and Liechtenstein.

2 The FCR would include risk-based analyses of investment portfolio, strategy and management, SCR, reinsurance structure, underwriting policies and procedures, and the evaluation of enterprise risk management policies and procedures.

The potential impact of the Financial Regulations

The Financial Regulations are likely to have a significant impact on the business models of UAE insurers as well as the sector as a whole, both in the short and longer term.

Solvency and capital requirements

The new solvency and capital requirements are more sophisticated, moving from a "one-model-fits-all" approach to a more entity-specific risk assessment.

Oman Insurance suggests that the Financial Regulations will offer positive changes to the UAE insurance market for key players. Mr Deschamps commented that he believed "*the regulations will bring more sustainable growth within the insurance industry along with stronger balance sheets".* However, Mr Deschamps noted that the Insurance Authority should make sure the initiative is not mainly consultant driven and should continue to drive the evolution of the regulations as they become embedded within the UAE insurance sector.

We believe the ability, or even appetite, to raise additional capital to meet the requirements of the relevant new regulations may force smaller players to exit the market or merge with larger competitors. Reorganisation, portfolio sales or run-offs and restructuring opportunities may arise as underwriters, in an attempt to preserve existing capital, look to segregate profitable and unprofitable lines of business. However, in the short-term, M&A activity in the sector may remain subdued due to continued expectation gaps between sellers and buyers.

UAE insurers may end up following the same path as Saudi Arabian insurers. Similar solvency and capital requirements implemented by the Saudi Arabian Monetary Agency (SAMA) in 2014 have not, as yet, led to an increase in M&A activity. Instead, capital has been injected by existing shareholders through various rights issues.

Actuarial reserving and financial reporting

All insurers are required to appoint an actuary, registered with the Insurance Authority, to review and approve technical provisions on a quarterly basis. In addition, the actuary is required to submit an annual report to the Insurance Authority detailing technical reserves and key risks going forward for a period of 12 months. The prominent role of actuaries is a welcome addition to the industry. They can support the development of in-house technical skills and help to stabilise premium pricing in the industry.

The impact of similar actuarial reserving and pricing in KSA has controlled the severe price wars prevalent in 2012 and 2013, driving the strong rebound underwriting performance for many KSA insurers in FY14 and H1'15.

Within the UAE, we would expect the impact of actuarial reserving requirements to largely reflect the KSA experience. This includes some hardening of premium rates in the long-term, particularly across motor and general insurance, two lines of business which have experienced fierce pricing competition in recent years, leading to deteriorating loss ratios across the sector. Drawing parallels with the KSA experience, we expect short-term pressure on underwriting performance as UAE insurers increase technical reserves in order to comply with actuarial reserving methodologies. 13 out of 29 listed UAE insurers posted underwriting deficits in the first nine months of 2015, a signal perhaps that insurers have already begun to align their technical reserving methodologies with the new requirements.

Hari Prasad, Chief Financial Officer, Union Insurance comments that the new Financial Regulations will create a "*level playing field in the UAE insurance sector, allowing for accurate financial reporting and greater transparency which in turn will lead to greater stakeholder confidence*". Mr Prasad believes the new actuarial reserving guidelines will not only ensure reserve adequacy but also improve underlying profitability, as insurers will be forced to reassess the type of risks they underwrite as well the level of associated premia.

Similar sentiments were expressed by Dr. Abdul Zahra, Chief Executive Officer, National General Insurance, who views the new regulations, particularly the technical reserving requirements, as a positive step to "*increase shareholder and investor confidence in the sector, through stronger balance sheets and a tighter risk management framework*".

Investment policies, asset allocation and risk management

Diversification of investments, and systems and controls for prudent investment management, are also important concepts under the Financial Regulations:

- Investments should be adequately diversified to avoid excessive risk concentrations and to allow firms to respond adequately to changing economic circumstances. Firms must comply with new asset distribution and allocation limits, revised valuation requirements and the "prudent person principle" when making any investments (see right). Insurers may be required to significantly restructure their current portfolios and overhaul existing investment policies and procedures.
- The Insurance Authority can force discrepant insurers to invest in a specified manner and prohibit specified entities from investing in certain asset classes or individual assets.
- Enterprise risk management (ERM) policies and procedures should be enhanced. ERM should support a firm's investment policy, adequately monitor and stress test investments on a regular basis, and identify risks and weaknesses in the firm's controls and operations. The Financial Regulations also allocate responsibilities within firms and require the board to approve risk appetites, review polices annually, and institute an investment committee with guidelines. The investment committee has its own minimum level of responsibilities, including making, reviewing and monitoring investments. Finally there are several responsibilities allocated to "senior management" in the governance and controls process.

We believe the Financial Regulations provide a framework for insurers to review their operations and risk profiles with a focus on profitability, whilst also safeguarding and protecting the rights of policyholders and shareholders. Larger players and those who have already adopted 'best in class' methodologies, governance and controls are most likely to benefit from growth opportunities. Less sophisticated players, who may have under-reserved historically or who have weaker risk management frameworks, may be impacted by higher losses and additional capital erosion.

Prudent person principle

- Only invest in assets and instruments whose risks can be properly identified, measured, monitored, managed, controlled and reported, and which are appropriately taken into account in the SCR calculations.
- Assets covering the SCR should be invested in such a manner to ensure the security, quality, liquidity and profitability of the portfolio as a whole.
- Cash flows from investments should match outflows from any corresponding liability, with an exception for policies where the investment risk is borne by the policyholder (in which case the firm must ensure the return from a unit-linked policy or the appropriate exposure to a reference value or index is passed on in policyholder returns).

Compliance and associated costs

The heavy costs of Solvency II compliance for insurers in Europe has been well documented. While the more standardised approach of the Financial Regulations should reduce compliance costs, they do require a fundamental shift in culture, governance and controls ("risk management should be well integrated into the organizational structure").

The list of new functions, policies, processes and procedures is extensive, along with potentially onerous new internal review requirements, such as a "detailed review of the claims handling practices". In addition, the enhanced, central role of the firm's actuary may require firms to draw more from this costly resource.

Costs should not be underestimated. Strategies should be prepared to ensure efficient implementation. The Insurance Authority expects reports during the alignment period that demonstrate progress[3]. These are an additional reporting requirement but may also, perhaps, be an opportunity to 'test the water' on new methods. Again, size may be positive, as larger players can devote manpower and import international practices.

[3] In addition to having published certain revised forms expected for reporting based on the Financial Regulations, such as pursuant to Circular No. 23 of 2015, concerning the adoption of the financial solvency form.

Merger and acquisition structures

The UAE insurance landscape remains highly fragmented, with around 60 different insurance companies serving a population of approximately 10 million. Certain legal structures for transactions could be considered as a result of the Financial Regulations.

Mergers of domestic insurers

Under a statutory merger between two domestic insurers, the merging insurer would be dissolved, and all of its assets and liabilities assumed by the surviving insurer, by operation of law (as opposed to an asset transfer or contractual assignment or novation). The merging insurer would be dissolved and its shareholders would be issued new shares in the combined entity at the effective time of the merger.

Mergers have traditionally been difficult to achieve in this region, as prospective merger counterparties fail to reach terms on matters such as ratios for the exchange of shares, co-branding, head office location, combined boards of directors and other shared systems. The merging of insurance platforms and IT systems can be particularly complex.

Aside from the need to secure shareholder and regulatory approvals, creditors, including policyholders, of the entity to be dissolved would also (based on the current rules) be entitled to raise objections during a period prior to the effective date of the merger. Depending on the creditor profile, this could generate uncertainty and delay.

There are also several regulatory and practical requirements to effect a statutory merger in the UAE, taking into account the revised Commercial Companies Law and the requirements of the Insurance Authority. However, the AED46bn Aldar/Sorouh merger in 2012 sets a helpful and important precedent (albeit in a different sector) for conducting statutory mergers in the UAE.

Acquisitions

An alternative structure could be an acquisition, whereby one insurer acquires another to obtain benefits of scale. Challenges would include the minimum free float requirement (recently reduced to 30% in the revised Commercial Companies Law) for insurers, and the lack of a codified UAE takeover regime. UAE law does not provide rules for the "squeeze out" of minority shareholders seen in other jurisdictions.

However, **an acquisition could relatively quickly result in a structure whereby the combined group can consolidate capital requirements and reporting. A combined group could also save from economies of scale when rolling out ERM and the other governance and controls required under the Financial Regulations. The subsidiary could remain independent in certain aspects, such as branding, and systems could be cost-effectively integrated over time. In addition, this structure could also encourage the separation of life and non-life businesses, in line with the recent requirements of the Insurance Authority. Founding shareholders of the acquired insurer could retain minority interests or shares in the parent entity if a share-for-share exchange was so structured.**

Sale of an insurance portfolio or business

The sale of an insurance business, outside of a transfer of a shareholding or a merger, could be structured as a portfolio transfer or a full business transfer. Depending on the structure, engagement with the Insurance Authority would be required at each stage. The transaction would also probably require its approval, with a likely policyholder/creditor objection period.

Value-in-force reinsurance arrangements

In many markets, portfolios of risks are transferred through VIF reinsurance arrangements which shift the economics of a particular line of business to a reinsurer and free up substantial capital and underwriting capacity. Under the Financial Regulations, an insurer which is struggling to meet its capital and operational requirements may not be helped by a VIF transfer as the regulations would require capital in respect of credit risk. Systems and controls requirements would still apply at the UAE level.

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