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M&A outlook for insurers in KSA: 2021

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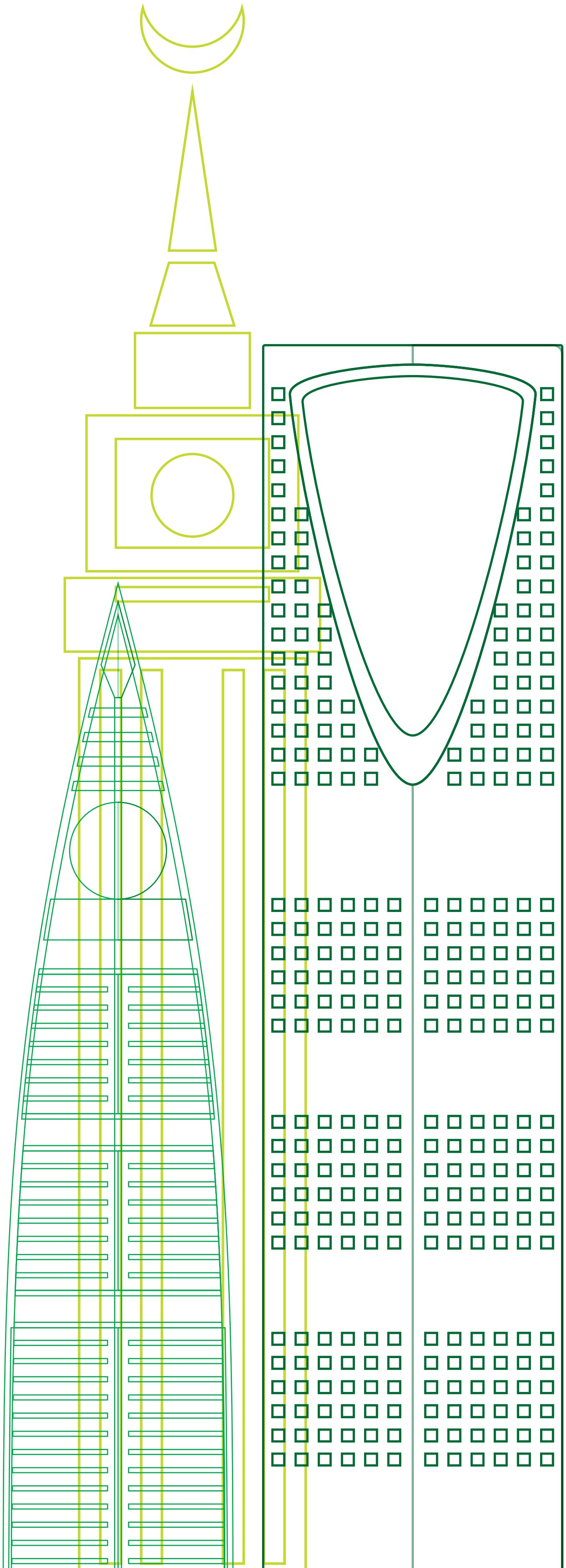
Introduction



This publication on the M&A outlook for insurers in the Kingdom of Saudi Arabia (KSA) explores the evolution of regulatory landscapes, the industry's response and challenges as well as the Mergers and Acquisitions (M&A) activity and consolidation which has emerged in 2019 and 2020. There are several themes that will drive M&A in 2021 including the desire of regulators to see more consolidation, an increase in minimum capital requirements in KSA, the need for scale and diversification, distress sales and digitisation. This paper also discusses the organic strategies which are important for insurers to focus on in order to effectively react and respond to the pandemic and thrive as market leaders.

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Evolution and stability in regulation has resulted in the emergence of M&A activity in 2019 and 2020

2015

Mandatory health insurance was implemented for private employees.

Introduction of insurance corporate governance regulations.

2017

The expansion of compulsory health benefits was added to include wider benefits.

Unified compulsory motor insurance policy was implemented.

2018

Mandatory no-claims motor discounts were introduced.

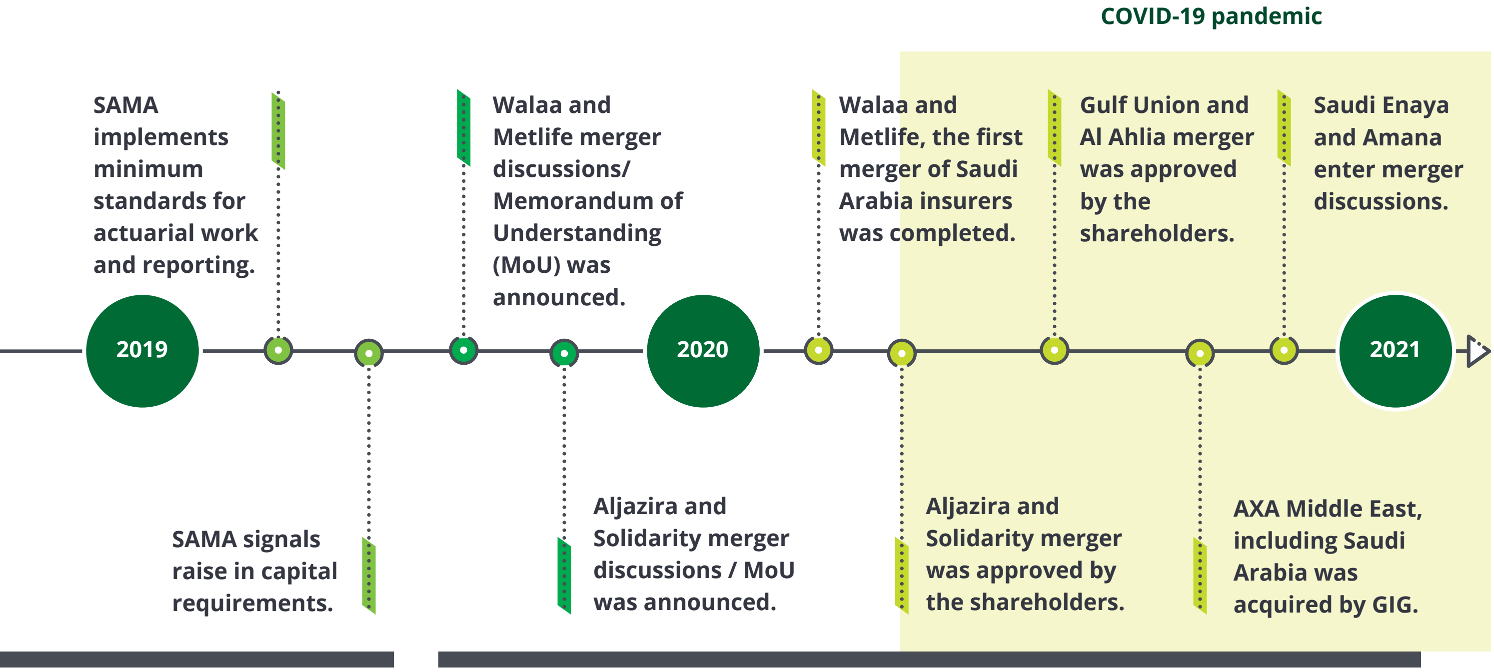
Collapse in insurance profits (80% decrease).

SAMA issued wider rules on foreign owners and control to attract investors.

Evolution of regulatory landscape

- The implementation of mandatory health insurance for private employees and the unified motor insurance policy were key growth drivers.
- Insurance penetration in the Kingdom of Saudi Arabia (KSA) increased from 0.9% in 2013 to 1.54% in 2016, albeit this was still lower than the UAE (3.2%) and the GCC average (2.0%)[1].
- Consumer-centric regulation was enacted including the expansion of compulsory health benefits and mandatory no-claims discount on motor policies.
- Insurance products and pricing slowly started to react to these changes, price competition increased, and actuarial pricing became more prevalent.

Note 1: SAMA Insurance Market Report



Industry response and challenges

- Net profits for the top 20 insurers declined by 80% between 2016 and 2018[1] and several large insurers recorded significant losses.
- SAMA encouraged M&A and signaled its desire to drive consolidation towards a smaller number of larger, more stable players.
- Wider rules on foreign shareholders were announced to attract investors and SAMA discussed raising minimum capital requirements as a catalyst to increase M&A activity.

M&A activity and consolidation

- M&A activity starts to emerge, as Walaa and Metlife as well as Aljazira and Solidarity announce discussions in 2019 and completing their mergers in 2020.
- By December 2020, AXA Middle East, including the KSA listed business, was acquired by Gulf Insulation Group (GIG). In addition, Gulf Union and Al Ahlia also completed their merger.

- The COVID-19 pandemic brought strategic direction into focus as diversification and digital strategies become paramount.
- Capital requirements are expected to increase from SAR 100m to SAR 500m, driving a wave of further M&A in 2021.
- We believe consolidation will benefit all industry stakeholders.

Several themes will drive M&A activity in 2021

Increase in minimum capital requirements

SAMA has been in discussions with insurance companies over raising the minimum capital requirements since 2019. A decision was anticipated in 2020 but was deferred partly as a result of the COVID-19 pandemic. Market participants expect this to be announced in 2021, with an extended period for compliance in order to allow insurers enough time to restructure their capital if needed.

Currently, insurers must hold minimum capital of SAR 100m and companies with reinsurance activities must hold SAR 200m. These minimum requirements are predicted to rise to SAR 500m and SAR 1bn, respectively. The thresholds are yet to be confirmed but are expected to materially increase above current levels.

Based on the reported share capital as of December 2019, only seven out of 32 listed insurers in KSA had equity of over SAR 500m[1]. Participants will need to undergo rights issues or M&A in order to comply with the forecasted increase in minimum capital requirements.

Scale and diversification

In 2019, the top five insurers generated 66% of GWP with the bottom 25 insurers generating only 28%[2], illustrating the level of fragmentation and the large number of sub-scale insurers competing on price and unable to acquire meaningful scale.

Diversification of product and risk will be key differentiators for smaller players to create stronger product portfolios and balance sheets capable of competing. Although historically, insurers in KSA have preferred to raise capital to fund growth through rights issues and other means instead of undergoing M&A, mergers of companies with comparative advantages would provide more sustainable solutions.

Distress sales

KSA insurers made material net losses in the first half of 2020. A number of these including Saudi Enaya, Amana, MedGulf, Salama, Malath, Wataniya and Wafa were required to execute rights issues historically in order to meet solvency requirements.

Investor appetite to fund capital raises for consistently loss-making business has waned and these companies will need to look for alternative solutions. A sale or merger in these scenarios is often the most desirable outcome for shareholders.

Digitisation

The COVID-19 pandemic has forced insurers, along with other industries, to become early adopters of digital solutions. Customers increasingly expect transparent, easy to use and automated solutions from the point of purchasing a policy to claims handling.

From a cost perspective, digital end-to-end solutions incorporating Artificial Intelligence (AI) can generate efficiencies in the claims management process by reducing claims losses, preventing fraud and allowing insurers to reduce headcount.

Data-centric products such as Beema's pay-per-mile motor insurance and Bupa's partnership with Well.Me on a digital healthcare tracking tool provide competitive advantages in a market which had become increasingly commoditised.

Developing and implementing a successful digital strategy will be essential to achieve growth in the future. Larger insurers with greater resources are more likely to become pioneers in these areas and widen the gap with the long tail of sub-scale players.

IFRS17 implementation

IFRS17 was issued in May 2017 and will replace IFRS4 on accounting for insurance contracts for insurers globally with an effective date of 1 January 2023.

To ensure compliance, insurers need more granular data going significantly beyond current accounting requirements. Investment required to achieve compliance includes enhanced technology and systems upgrades, specialist talent and greater collaboration between the finance, actuarial and other departments.

As we move closer to the implementation date, several insurers in KSA have struggled to maintain momentum and allocate the resources required to meet their implementation targets. The added costs and complexity of reporting requirements to continue to operate may crystallise more strategic decisions around the future.

Government objective

Strengthening the insurance sector is a key part of the KSA government's Financial Sector Development Program as part of Vision 2030. SAMA issued a statement in January 2021 encouraging insurers to consider M&A transactions to improve customer service and efficiency as well as reducing costs. The evolution and maturity of regulation achieved to date will support this consolidation activity, diversify competencies and create more financially solvent entities.

The COVID-19 pandemic has strengthened the focus on a number of M&A themes

	Increase in minimum capital requirements	Digitisation	Scale and diversification
Pre COVID-19 M&A drivers	• Material increases in regulatory capital requirements to SAR 500m. • Low capital buffers held historically, with majority of insurers at < SAR 500m. • Frequent rights issues.	• Investment in digital channels is key to customer experience. • Cost benefits of end-to-end digital solutions and systems. • Prevalence of data-centric products in the near-term future.	• Economies of scale are only available to the largest players. • Limited product diversification resulting in a race to the bottom. • Risk primarily held in motor and health lines.
Enhanced focus in a COVID-19 environment	• Increasingly challenged capital and solvency in a low growth environment. • Reduced shareholder appetite to fund rights issues in an economic downturn. • Short term relief from regulators and the government unlikely to recur if the pandemic lasts through 2021.	• Social distancing rules meant that online/digital mediums are the only viable form of direct distribution. • Customer appetite for digital solutions has accelerated to the norm. • The pandemic will increase demand for tailored data-centric products such as pay-per-mile motor insurance.	• The benefits of risk diversification are heightened in an uncertain environment. • Customers are likely to be more price-conscious in a downturn. • The gap between the largest players and sub-scale insurers is likely to increase during the pandemic and more clearly separate winners from laggards.

Organic strategies will remain important for insurers to emerge from the pandemic as market leaders

To provide more tailored advice compared to a traditional insurer, including advising businesses on how to claim compensation or access to relief measures from the government.

Revisit policy wording to better protect and serve customers.

Desired outcome

Customers consider their insurer as a trusted advisor leading to improved approval ratings and policy retention rates.

Put in place the right systems and tools to ensure the workforce is engaged, healthy, and can function effectively remotely.

Avoid mass redundancies under the cover of Covid-19.

Desired outcome

The workforce is engaged, resilient and agile. Employees are enabled by technology, policies, and leadership to work effectively.

Manage the regulator

- Treat customers fairly.
- Effectively manage and pay out claims.
- Meet cancellation/redemption requests.

- Ensure compliance requirements are met despite remote working, e.g. recording calls.
- Promote and ensure employee wellbeing.

3 Rebuild and grow the book of business

Identify opportunities by entering new segments and offering innovative products including parametric pandemic insurance and pay-per-mile motor insurance.

Invest in more advanced digital distribution channels.

Desired outcome

Each line of business offering has products that can grow profitably and meet customer needs in terms of structure and coverage.

4 Ensure the balance sheet is robust, capitalised and solvent

Utilise the benefit of a low claims environment in 2020 by building capital buffers.

Review reinsurance coverage and investment portfolio to ensure adequate coverage and liquidity.

Seek compensation offered by government schemes if necessary.

Desired outcome

Improves solvency and capital ratios despite the challenge to the top line and build resilience.

5 Coordinate the industry response

Be proactive and engage with governments to provide a coordinated resolution on response to current and future pandemics e.g. shaping new regulations and propose industry solutions.

Desired outcome

Ensure the insurance Industry's reputation is enhanced and consumer trust is largely positive.

Manage the regulator

- Continue to offer fairly priced products. Services with unusually high margins will attract suspicion.
- Ensure the appropriate level of regulatory rigor is applied to new and innovative products.

- Continue to meet solvency requirements.
- Notify regulator if liquidity issues arise e.g. in case of suspension of property funds.

- Lobby with caution on post COVID-19 regulation improvements such as excessive capital sensitivity to interest rates due to solvency requirements.

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