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Israeli Property/Casualty Insurance Sector Carries An Intermediate Industry And Country Risk

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Israeli Property/Casualty Insurance Sector Carries An Intermediate Industry And Country Risk

Rationale

Standard & Poor's Ratings Services continues to assess industry and country risk for the Israeli property/casualty (P/C) insurance sector as intermediate. Our Insurance Industry And Country Risk Assessment (IICRA) addresses the risk factors that Israeli insurers are facing, and reflects our view of intermediate country risk and intermediate industry risk.

Israel's growing economy, in which there is a relatively high level of wealth and a low unemployment rate, supports stable P/C premium inflows and moderate growth in new business. In our view, the financial system benefits from a stable banking sector; the effective and active capital market offers insurers a supportive investment universe. The Israeli P/C insurance sector is less concentrated and more competitive than the life segment. Therefore, the underwriting profitability is often marginal, although it recently began to improve. The P/C sector is less sensitive to low interest rates than the life sector and recent reserve adjustments have been minor. In our opinion, it is easier to enter the Israeli P/C sector than the life sector, because new entrants do not necessarily need to establish a viable network of agents; distribution can be done directly to the end customer.

Our assessment of the Israeli P/C industry risk is on par with countries such as Austria, Poland, the Czech Republic, and Slovenia, however, it compares favorably with the U.K. and poorly with Germany. The differences are mainly driven by the barriers to entry and level of competition and their implications on profitability. Growth prospects in Israel and in its European peers are limited, but insurers in European markets report stronger average net combined ratios than those operating in Israel, usually below 100%. Lower combined ratios indicate better profitability.

In our view, in the past, Israeli insurers have relied on investment gains and their profitable life products, while compromising their underwriting performance in the commoditized P/C market. This is gradually changing, as profitability in the life and health sectors comes under increased pressure.

In Israel, as in similar markets, we view barriers to entry as neutral, which indicates it is typically not difficult to establish insurance operations. Barriers to entry are higher in countries such as Germany and Austria, where substantial investments are required to gain access to distribution channels. As a result, we assess barriers to entry as favorable in these markets. In addition, insurers in these markets are not usually exposed to a high risk of volatility because of product features. By contrast, although the Israeli market is less exposed to natural catastrophes such as snow or flood, its effective exposure is to destructive earthquakes.

Country risk in Western European countries is usually lower than it is in Israel. The positive macroeconomic factors supporting our assessment of Israel's country risk are overshadowed by its high geopolitical risks.

Table 1

Peer Property/Casualty Insurance Industry And Country Risk Assessment

Country	Israel	U.K	Czech Republic	Germany	Austria	Poland	Slovenia
IICRA	Intermediate Risk	Intermediate Risk	Intermediate Risk	Low Risk	Low Risk	Moderate Risk	Moderate Risk
Country risk	Intermediate Risk	Very Low Risk	Intermediate Risk	Very Low Risk	Low Risk	Moderate Risk	Moderate Risk
Industry risk	Intermediate Risk	Moderate Risk	Intermediate Risk	Low Risk	Intermediate Risk	Intermediate Risk	Intermediate Risk
Industry Risk Components							
Profitability	Neutral	Neutral	Positive	Neutral	Neutral	Neutral	Positive
Product risk	Neutral	Negative	Neutral	Neutral	Neutral	Neutral	Negative
Barriers to entry	Neutral	Negative	Neutral	Positive	Positive	Neutral	Neutral
Growth prospects	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral
Institutional framework	Moderately Strong	Very Strong	Moderately Strong	Strong	Moderately Strong	Moderately Strong	Moderately Strong

Country Risk: Intermediate

We assess country risk as intermediate. The positive economic conditions and a supportive and developed financial system are mitigated by unfavorable political risk.

Israel enjoys a prosperous and well-diversified economy; its estimated GDP per capita was $38,000 in 2015. In 2014, the economy grew by 2.8%, despite the military action in Gaza during the middle of the year, which depressed GDP growth slightly. We anticipate that GDP growth will recover to average 3%, or 1.5% in per capita terms, over 2015-2018, boosted by robust private consumption, continued corporate investment activity, and healthy exports. In recent years, P/C premium growth has been lower than GDP growth, and we anticipate that this trend will continue.

Israel's institutional and governance structures are generally considered effective and transparent. However, the lack of political stability weighs on policy predictability. The Commissioner of Capital Markets, Insurance and Savings operates under the Ministry of Finance.

Israeli insurance companies enjoy a diversified and active capital market, where they can invest in a wide variety of assets. Israel's corporates benefit from developed corporate debt markets, where they issue a significant amount of debt. Although insurers tend to prefer to invest in the local market, in recent years we have seen a growth in investments overseas, both in equities and real estate.

The Israeli banking system also benefits from a supportive economy. Domestic credit growth is in line with GDP growth and displays a low level of loan-loss provisions and nonperforming loans. Nevertheless, Israeli banks are exposed to elevated housing prices and high single-name corporate concentration, reflecting the small, concentrated local economy. Overall, we expect the banking industry to remain solid, and consider the government to be supportive toward its systemic banks. The stability of the banking sector enhances the stability of the financial system, which is crucial for the insurance sector.

We view the payment culture and rule of law in Israel as neutral to our country risk assessment. According to the latest World Bank governance indicators, Israel was in the top 20% countries worldwide for rule of law and control of corruption in 2013.

Table 2

Israel Country Risk: Selected Economic Data And Projections						
	2012	**2013**	**2014**	**2015f**	**2016f**	**2017f**
Nominal GDP (bil. $)	257	291	304	300	325	343
Real GDP growth (%)	3.0	3.2	2.8	2.9	3.3	3.2
Real GDP per capita growth (%)	1.6	2.1	1.6	1.4	1.6	1.5
Inflation rate (%)	1.7	1.5	0.5	0.1	1.4	2.3

f--Forecast.

Industry Risk: Intermediate

We continue to assess industry risk for the Israeli P/C insurance sector as intermediate, based on our evaluation of five industry-related factors. We see profitability, barriers to entry, product risk and market growth prospects as neutral factors and the institutional framework as intermediate.

Profitability (neutral)

We view the profitability of the Israeli P/C sector as a neutral factor in our industry assessment. According to our estimates, the sector's five-year weighted-average return on revenue (ROR) was approximately 9% in 2010-2014, and the combined ratio was about 103%. (The combined ratio is the industry's leading underwriting profitability metric. The lower the combined ratio, the more profitable the underwriting. A ratio of more than 100% indicates an underwriting loss). The industry's combined ratio has improved slightly over the past few years as some industry players have acted to improve profitability. As a result, the year-end combined ratio for 2014 fell below 100%.

The high combined ratio is affected, in our view, by historically high loss ratios caused by competitive industry conditions. Distribution fees are also high because the sector mostly relies on insurance agents for distribution. The combined ratio is also affected to some extent by the sizable proportion of long-tail business in the insurance portfolio. This includes motor third-party liability (MTPL) and other third-party or professional liability insurance, for example, medical malpractice. Reserves for such products are held for longer periods, making investment gains integral to core profitability. Although loss and combined ratios have decreased, the high proportion of long-tail business is likely to restrict the overall combined ratio to around 100%.

Pricing for some P/C products is affected by regulation. MTPL tariffs are regulated and capped, and we expect them to be further squeezed by new regulations that will lower the caps on tariffs and offer policyholders that have a clear track record the opportunity to claim premium refunds. In our view, this may cause the overall premium level to fall and may also hit profitability.

Similar to the life sector, Israeli P/C insurers rely on investment returns to support their profitability, and embed investment returns in their pricing. As a result, overall profitability is less stable and less predictable.

Historically, an increase in market share in the highly competitive P/C sector has eroded insurers' loss and combined ratios. Insurers offset this by making gains in other lines of business, and supported profitability with capital markets gains. This practice is gradually changing as some of the players start to focus on improving core profitability; as a result, we are seeing an improvement in the sector's average combined ratio.

Product risk (neutral)

We continue to assess the potential for product risk to trigger volatility in returns as neutral. This is supported by our view of the sector's exposure to natural catastrophes as intermediate and the risk of unpredictable settlement as low.

Israeli insurers are exposed to damaging earthquakes, but risks from other natural catastrophes--such as floods or windstorms--are lower than those at their European peers. The industrywide exposure is adequately covered by reinsurance contracts, in our view.

We assess the risk of unpredictable settlement of claims as low. In our view, claims in short-tail policies, which comprise about 60% of the business, are settled in the short term and are predictable. Settlement of claims in long-tail business, such as third-party damages, are naturally less predictable, but this risk is moderated by lower retention levels.

Barriers to entry (neutral)

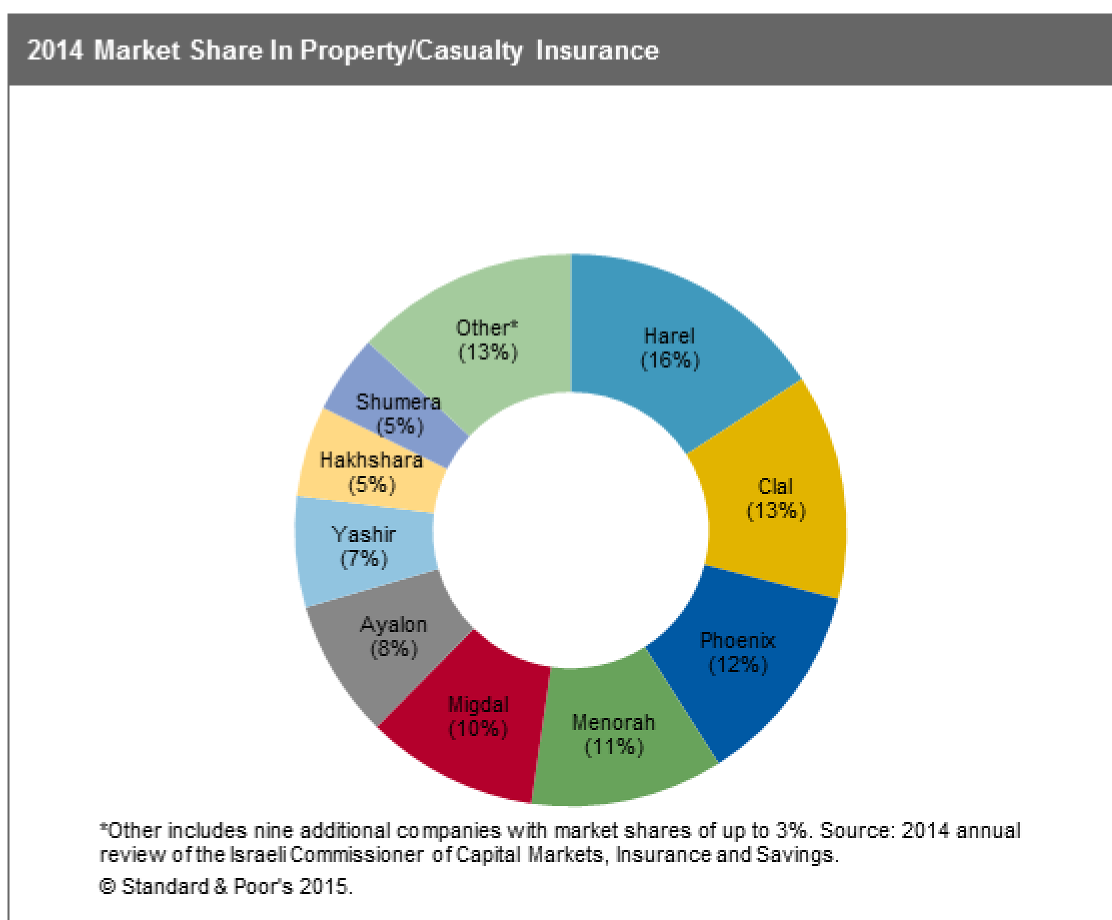
We consider the barriers to entry for the Israeli P/C insurance market as neutral to our assessment. We base our view on our assessment of both regulatory and operational barriers as moderate.

Our view of regulatory barriers to entry as moderate reflects the lengthy regulatory process for approving new licenses for insurers. This is relevant both to change in ownership for existing companies and to new entrants.

Operational barriers in the P/C sector are moderate, although they are high for life business. This reflects the role of distribution. In the life sector, distribution is mostly done through agents, because most products are sophisticated and require proper consulting. By contrast, most P/C products are simple and commoditized and can be acquired over the Internet or by telephone. Accordingly, direct insurance players have recently become more active in the P/C sector.

We believe that moderate operational barriers support the reduced concentration in the P/C segment, compared with the life sector. There are 20 players engaged in P/C insurance, and the top five insurance groups have a combined share of about 62% of total premiums. By contrast there are only 10 players in the life segment, and the top five largest companies hold 92% of the deposits.

Chart 1



Market growth prospects (neutral)

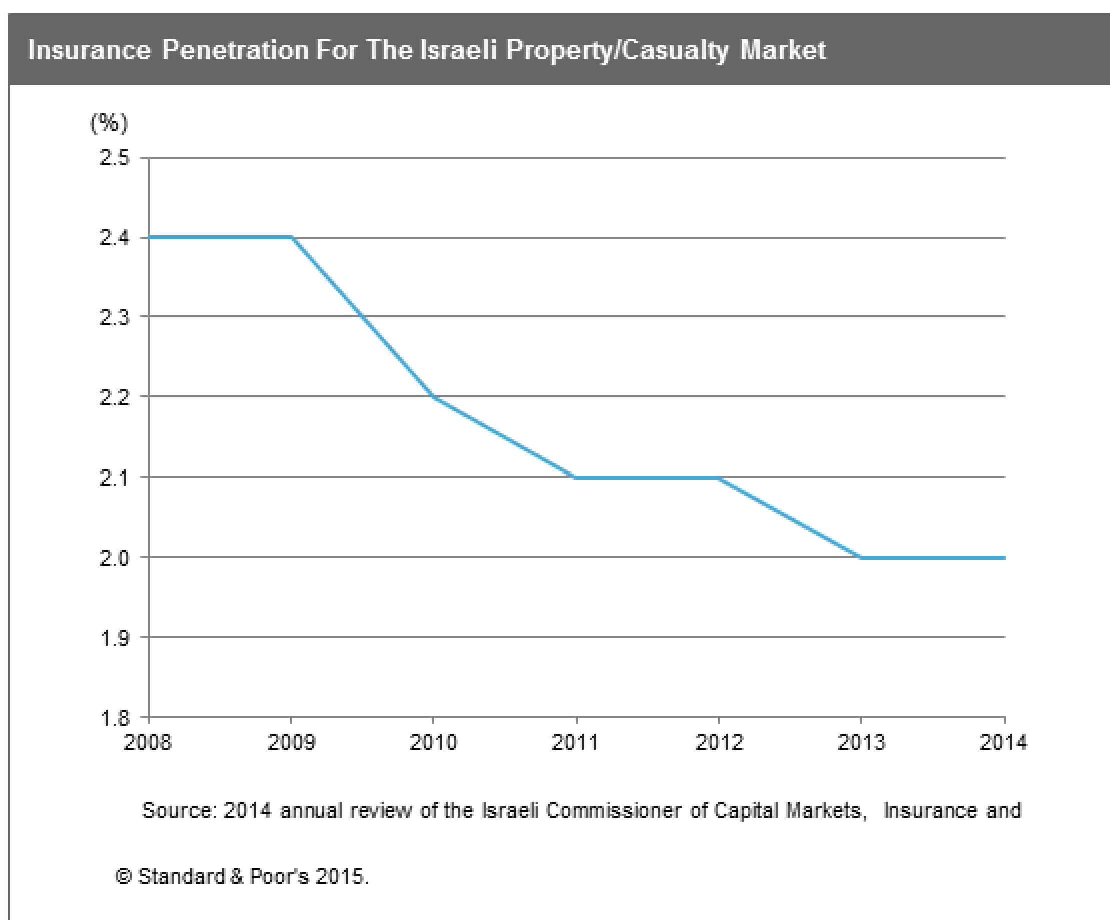
We view growth prospects for the Israeli P/C insurance market as neutral. Despite the positive GDP growth and relatively high level of wealth in the economy, we see relative stagnation in P/C premiums. We anticipate that this trend will continue for the next two-to-three years.

Nominal P/C premiums grew by an average of 3% a year for the past few years and penetration levels, measured as a percentage of GDP, have decreased.

The number of insured vehicles grew by less than the total number of vehicles in the economy over the past five years because of a growth in the number of vehicle fleets. These are mutually insured, which reduces demand for casualty and collision automobile insurance (CASCO). In addition, MTPL premiums are decreasing due to competition and transparency, supported by the regulator. They may decrease further when the new regulation affecting the segment comes into effect.

Some compensation is provided by the moderate increase in premiums for property insurance of apartments--these premiums have grown by about 11% since 2011. However, we assume that the overall premium growth level will be moderate and lower than GDP growth.

Chart 2



Institutional framework (moderately strong)

We regard Israel's institutional framework as moderately strong. This reflects our view of the industry's intermediate regulatory framework, intermediate track record of regulatory actions, and lack of evident deficiencies in governance and transparency. Israeli insurers are regulated by the Commissioner of Capital Markets, Insurance and Savings, within the Ministry of Finance, while the banking sector is regulated by the Bank Of Israel.

Regulatory framework. The Commissioner supervises Israeli insurance companies according to the Control of Financial Services (Insurance) Law, 1981, and directives issued thereunder. Insurance companies are also subject to the Insurance Contract Law and the Law of the Control of Financial Services. Moreover, similar to other companies, insurance companies are subject to the provisions of the Companies Act, and for public companies, the Securities Law.

Recently, the Commissioner introduced an updated policy of control for institutional entities, and the Law to Promote Competition and Reduce Concentration (The Concentration Law). Approval of the latter will trigger changes in ownership of two of the five largest insurance companies, which may occur by the end of 2015 through 2016. In our view, in future, the regulator may approve and regulate foreign-owned insurers (most likely China-based), rather than the local conglomerates it has previously regulated. We expect this to be more difficult and sensitive, because insurance companies manage a high proportion of the population's pension savings.

Regulatory oversight is based on international standards, including those of the International Association of Insurance Supervisors (IAIS), the Organization for Economic Cooperation and Development (OECD), and other foreign regulatory authorities. Notably, the Commissioner intends to implement the EU's Solvency II Directive in Israel to ensure insurers' solvency. This is expected to become effective in Israel on Jan. 1, 2017.

Regulatory track record. We assess the regulatory track record as intermediate. The regulatory supervision is proactive, as the regulator often provides ruling and guidance to the insurance companies. The regulation is also preventive, and concerned with the stability of the sector. For example, a few years ago, the regulator instructed insurers to increase life insurance reserves and banned the sale of policies which contain guaranteed life expectancy coefficients, to limit the exposure to longevity risk.

However, regulation is not always predictable and tends to be interventionist in terms of market dynamics. Techniques include enforcing pricing caps and standardizing basic policies. The regulator aims to increase transparency of the insurance products and their pricing, to promote comparability and competition.

Governance and transparency. We consider governance and transparency as adequate. All insurance companies in Israel disclose very detailed financial reports in accordance with International Financial Reporting Standards (IFRS), supporting cross-border comparisons and transparency. Financial statements of all the insurance companies have invariably been audited by the "Big Four" accounting firms: mainly Ernst & Young and KPMG. All public insurers disclose information on executive compensation, stock ownership, internal controls, and procedures, which further strengthens the governance framework. We are not aware of any material governance weaknesses.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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