August 15, 2022

Shortcomings Still Present Despite Steady Improvements in ERM for MENA Insurers

Despite steady developments over the years, MENA insurance markets continue to lag more mature markets in terms of ERM capabilities

Principal Takeaways

- Insurers' risk profiles in the Middle East and North Africa (MENA) tend to be elevated due to higher economic, political and financial systems risks, which can drive greater volatility and uncertainty in some markets. In many cases, insurers' approach to risk management tends to be reactive rather than proactive
- ERM frameworks and capabilities can vary widely among market participants, with many insurers' approach to risk management limited to meeting regulatory requirements
- Silo approaches to enterprise risk management (ERM) are still prevalent in the MENA region, rather than enterprise-wide views of risk management
- ERM weaknesses for AM Best-rated entities include inadequacies in stress testing and embedding governance and risk culture practices
- The greatest risks to most insurers are associated with concentration, investment, and legislative/regulatory/judicial/economic risks

After experiencing several years of robust growth, insurance markets in the Middle East and North Africa (MENA) region faced wide-ranging challenges stemming from the COVID-19 pandemic, primarily due to the impact of the resultant global economic slowdown and an associated drop in the demand for oil and gas.

As economies emerged from pandemic restrictions through 2021, there was a significant increase in the demand for oil and gas, surpassing pre-pandemic levels. Then, following the sanctions imposed on Russia in the wake of its invasion of Ukraine in March 2022, the price of fossil fuels climbed to levels not seen before.

As part of its rating process, AM Best maintains a dialogue with the (re)insurers it rates in the MENA region and actively monitors how they might be affected by political and economic instability. In particular, AM Best notes that insurers in the region tend to have concentrated risk profiles.

While many companies write diversified portfolios by lines of business on a gross basis, retained underwriting portfolios tend to show greater concentration, with motor and/or medical business representing the majority of net business written. Additionally, locally domiciled insurers tend to be smaller in size by international comparison and source either all or the majority of their premiums from a single country, with limited geographical diversification.

Investment concentrations and high asset risk profiles are a common theme in the region, with companies often having greater exposure to real estate and equity investments, compared with peers in more mature markets. Nearly half of AM Best-rated MENA insurers held 40% or more of their investment portfolios in equity and real estate investments over

Analytical Contacts:
Romeo Berti, ACA CMA, London
Tel: +44 20 7397 0267
romeo.berti@ambest.com

Alex Rafferty, London
Tel: +44 20 7397 0312
alex.rafferty@ambest.com

Editorial Managers:
Richard Banks, London
Tel: +44 20 7397 0322
richard.banks@ambest.com

Richard Hayes, London
Tel: +44 20 7397 0326
richard.hayes@ambest.com

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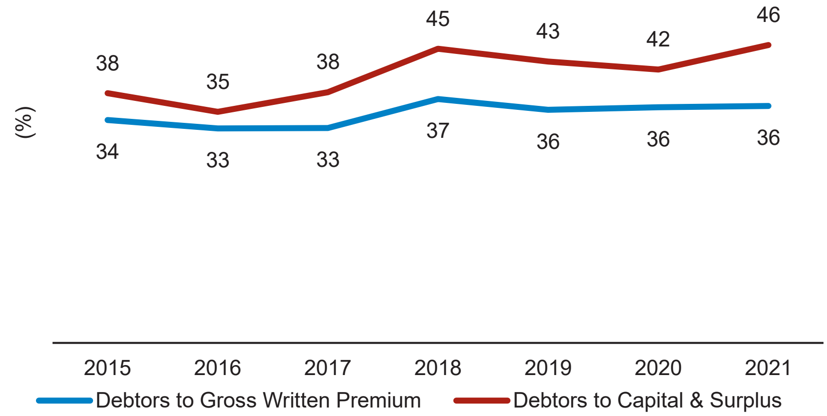
the five-year period to 2021, with instances of companies holding more than 80% of their total investments in these higher risk asset classes. Additionally, in part due to regulatory constraints on the movement of capital and the limited availability of investment opportunities in some countries, insurers tend to have significant exposure to single issuers, contributing to their concentration risk.

Exhibit 1
MENA – Average Debtor Balances in the Region, 2015-2021



Sources: BESTLINK *Best's Financial Suite – Global*, AM Best data and research

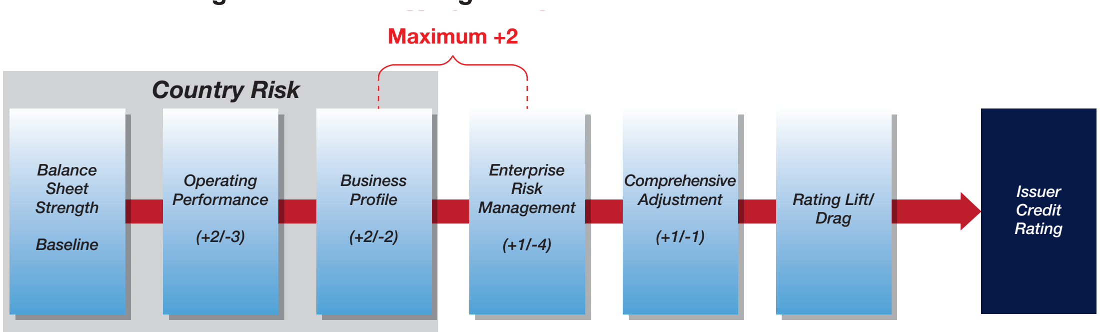
The relative illiquidity of some of these investments, coupled with generally high debtor balances across the region (see **Exhibit 1**), further increases risk profiles in terms of liquidity and capital management, and highlights deficiencies in managing these risks. While most AM-Best rated entities in the region are well capitalised according to AM Best's proprietary Best's Capital Adequacy Ratio (BCAR), many insurers remain unsophisticated when it comes to managing capital. It is common for companies to manage their capital levels only on regulatory requirements, which themselves can often be at an early stage of development and based on simplistic formulas. In this context, AM Best views the adoption of (or intent to adopt) risk-based regulatory solvency approaches in several countries as a positive development for the region.

AM Best notes that Enterprise Risk Management (ERM) practices in the region have shown steady improvement over recent years, in part driven by strengthening regulatory oversight and the increasing maturity of the region's insurance markets. Despite these developments, ERM frameworks and capabilities of the region's insurers vary significantly, and analysis from AM Best shows that certain shortcomings remain.

Enterprise Risk Management in the MENA Region

ERM is defined by AM Best's Credit Rating Methodology as "…establishing a risk-aware culture, using tools to consistently identify and manage, as well as measure, risk and risk correlations". The assessment of a company's ERM is a key rating factor in the assignment of a credit rating using AM

Exhibit 2a
AM Best's Rating Process – Building Blocks



Source: Best's Credit Rating Methodology

Exhibit 2b

AM Best's Rating Process – Enterprise Risk Management Assessment

Assessment	Notches	Key Characteristics
Very Strong	+1	The insurer's ERM framework is embedded. The insurer demonstrates market best practice techniques. The results are evident in a prudent and stable level of net required capital and successful performance over the long term. Risk management capabilities are very strong and are suitable for the risk profile of the company.
Appropriate	0	The insurer's ERM framework is developed. Risk management capabilities are well aligned with the risk profile of the company.
Marginal	-1	The insurer's ERM framework is evolving. Risk management capabilities show some weakness in key risk areas.
Weak	-2	The insurer's ERM framework contains some nascent elements. Risk management capabilities are largely not aligned with the risk profile of the company.
Very Weak	-3/4	The insurer's ERM framework is unrecognized. Risk management capabilities relative to the risk profile of the company are not aligned.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Source: Best's Credit Rating Methodology

Best's building block approach (see **Exhibit 2a**). For further information, please read *"Best's Credit Rating Methodology (BCRM)".*

According to its BCRM, AM Best's assessment of a company's ERM framework can range from 'Very Strong' to 'Very Weak', each with their own characteristics (see **Exhibit 2b)**. The exhibit also highlights how the ERM assessment can increase a company's Issuer Credit Rating (ICR) by a maximum of one notch or else decrease it by up to four notches. This downside spread in notching reflects AM Best's view that truly weak levels of ERM can disproportionately affect the future performance and financial strength of insurers.

Importantly, AM Best applies the proportionality principle in its assessment of ERM frameworks, and considers the nature, scale and complexity of the company and its activities. The idea being that a small or medium-sized insurer with a consistent track record of stable performance may have less complex ERM processes, but still function effectively. This is particularly applicable to companies in the MENA region, who tend to be smaller and have less complex operations than, for example, large international players.

Yet, regardless of the level of complexity, it is critical that a company can demonstrate that the ERM framework in place facilitates the identification, measurement, monitoring and active management of the risks faced.

Approximately two thirds of AM Best-rated entities in the region have an 'Appropriate' ERM assessment as at 30 June 2022, with the remaining third mostly assessed as 'Marginal'. By contrast, when considering AM Best-rated entities in domiciles such as the US or UK, approximately 90% of ERM assessments are 'Appropriate'.

In AM Best's opinion, the spread of ERM assessments across the region demonstrates that while many companies have developed sound ERM practices for their operations, shortcomings remain.

AM Best's analysis also indicates a correlation between the relative maturity of individual insurance markets and their regulatory bodies, and the strength of ERM practices. Notably, companies operating in jurisdictions where regulation is at a relatively more advanced stage of development, such as in several Gulf Cooperation Council (GCC) countries, are more likely to have an

'Appropriate' ERM assessment, compared with those operating in the wider region (see **Exhibit 3**). Economies in the GCC tend also to benefit from greater stability when considering economic, political and financial systems risks, compared to regional peers. In AM Best's view, operating in higher country risk environments often elevates a company's risk profile to such an extent that it can be challenging to adequately mitigate and manage all risks. Despite the best efforts to control these risks, this ultimately has on impact on AM Best's overall view of the insurer's ERM.

When evaluating a company's ERM framework, AM Best assesses three components: the risk management framework, the company's risk profile in light of its risk management capabilities, and the overall ERM assessment.

Risk Management Framework Evaluation

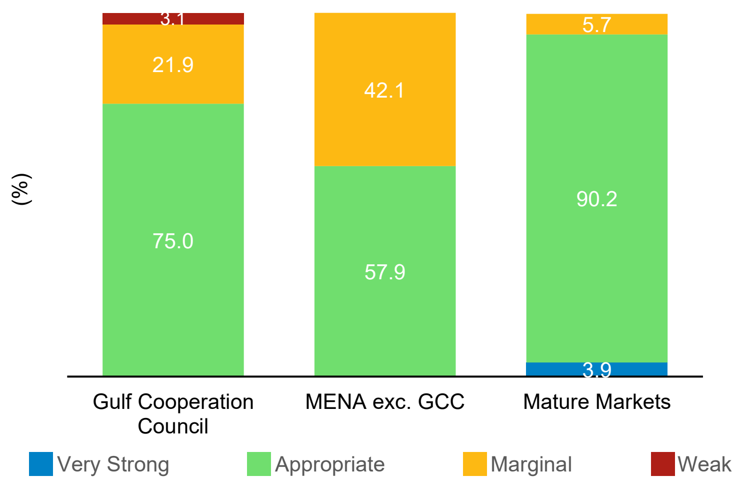
AM Best's risk framework evaluation focuses on five core areas:

- risk appetite and tolerance
- stress testing and non-modelled risks
- risk identification and reporting
- risk management and controls, and
- governance and risk culture

For each of these five categories, the rated company's ERM framework is assessed and placed in a category ranging from 'Embedded' on the higher end of the scale to 'Unrecognised' on the lower end.

Exhibit 3

Enterprise Risk Management – Overall ERM Assessment by Region

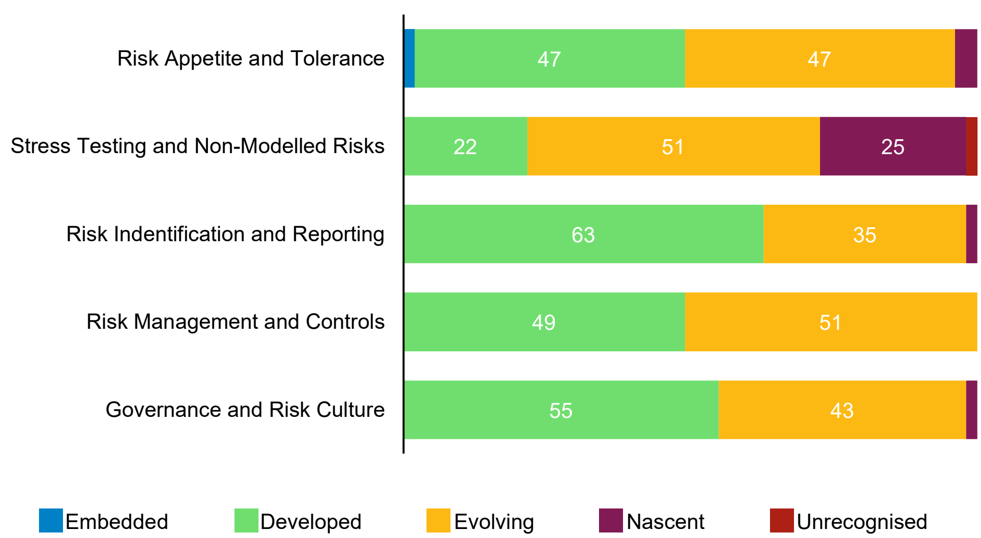


Sources: *Best's Financial Suite – Global*, AM Best data and research

Exhibit 4

MENA – Framework Evaluation

(%)



Values less than 4.0 not labelled.

Sources: *Best's Financial Suite – Global*, AM Best data and research

Exhibit 4 summarises the ERM framework evaluations of the AM Best-rated companies in the MENA region. The vast majority of AM Best-rated entities are assessed as having ‘Evolving’ or ‘Developed’ risk management frameworks, with the population distributed relatively evenly between the two categories. The prevalence of the ‘Evolving’ framework assessment for the region is indicative of the relatively early stage of development of the insurance sector. Additionally, the prevalence of silo, rather than enterprise-wide, approaches to risk management is a limiting factor to a greater number of insurers achieving a ‘Developed’ or ‘Embedded’ ERM framework assessment.

AM Best notes that many insurers in the region have engaged with third parties to provide solutions to strengthen and improve their risk management frameworks over recent years. While this may be a step in the right direction, it is AM Best’s view that the development of effective ERM frameworks is a process that takes time to integrate, and the embedding of risk management principles can be limited to some extent for many insurers.

Stress Testing a Framework Weakness

While AM Best has observed deficiencies across all ERM framework components, the clearest weaknesses relate to stress testing. Over a quarter of AM Best-rated insurers in the region are deemed to have ‘Nascent’ or even ‘Unrecognised’ stress testing capabilities (see **Exhibit 4**).

One reason for this is the relatively low exposure to natural catastrophe perils in certain countries, notably among the GCC member states, which may result in a lower perceived importance or engagement on the subject. However, AM Best notes that even in those countries that carry greater natural peril exposure, a lack of robust historical natural catastrophe exposure data impacts the accuracy of the available catastrophe models and ultimately their output. Generally, insurers in the region lack the capability to perform natural catastrophe modelling in-house and tend to outsource the function to international brokers or reinsurance partners, on which they rely to quantify exposure and purchase adequate levels of reinsurance protection.

AM Best expects companies to stress test their operations, using infrastructure that is robust and comprehensive and that extends beyond basic regulatory requirements. While to some extent, exposure to natural catastrophes may be low for a number of insurers in the region, other stress tests may be of greater importance relative to their risk profiles. These could include stress or scenario testing of performance and solvency in relation to investment stresses, given the generally high exposure to potentially volatile equity and real estate markets, or to the write-off of irrecoverable debtor balances that may have accumulated over many years of operating. Furthermore, as many insurers in the region carry a high dependence on reinsurance, stressing the resilience of the organisation to counterparty credit stresses or to the impact of a reinsurance dispute on a single large loss, may be more appropriate.

In general, AM Best takes the view that comprehensive stress testing approaches—that show how a company would perform under more severe events, and how these relate to risk appetites and tolerances, as well as contingency and recovery plans to restore capital should such events occur—as lacking in the MENA region.

Application of Risk Appetites and Tolerances is Still Evolving

The establishment of appropriate risk appetites and tolerances is another important area for development in the region. Approximately half of AM Best-rated entities are assessed as ‘Evolving’ in this category. This is because while many companies may be able to demonstrate defined risk appetites and tolerances on paper, the application of and adherence to these policies, and the implementation of the controls around them, often remains untested. In AM Best’s view, this is in part attributable to persistent limitations when it comes to governance and risk culture.

Weaker Governance Frameworks Influence Risk Taking

It is noted that while over half of AM Best-rated insurers have 'Developed' governance and risk culture assessments, 45% are deemed to be 'Evolving' or lower. AM Best has observed several governance incidents in recent periods that have adversely affected insurers' financial strength or their ability to operate. Independence of the board of directors remains an area of weakness in several companies and countries. This is reflected particularly when it comes to investment decisions, which are often concentrated at board level rather than with management. A result of this dynamic is investment decisions being made with limited consideration of risk appetite and tolerances and the impact on risk-adjusted capitalisation, regulatory solvency, or asset liability management.

Risk Profile Evaluation

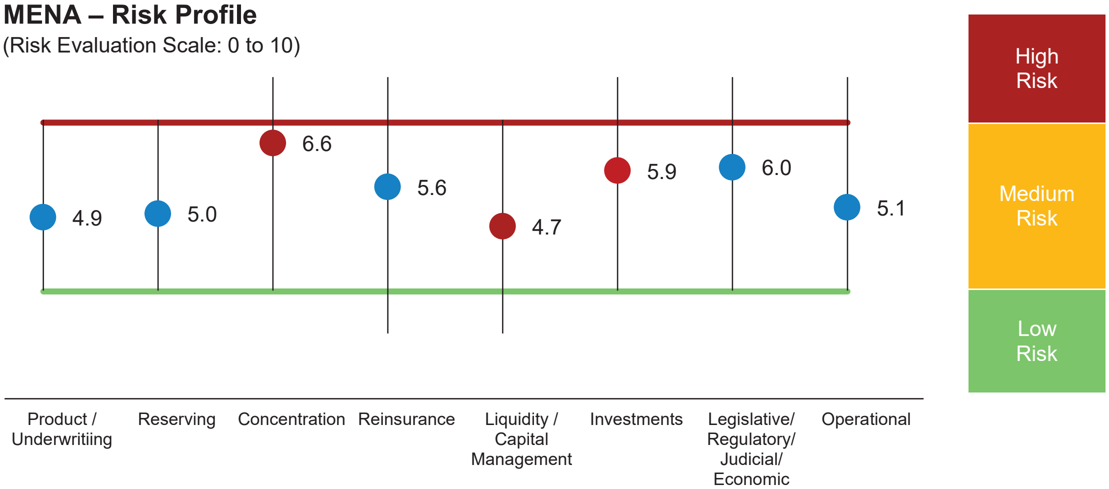
AM Best's ERM risk profile evaluation is based on eight components and assesses a company's risk management capability relative to its risk profile. These are related to product and underwriting, reserving, concentration, reinsurance, liquidity and capital management, investments, legislative/regulatory/judicial/economic, and operational risks.

More diverse, complex, and higher-risk companies—such as global insurance and reinsurance groups, and companies that have substantial catastrophe exposures, long-tailed business, or high embedded life guarantees—are generally viewed as having higher risk profiles. These companies need more robust tools and mechanisms in place to manage their exposures, as well as a sufficient framework in place to support these risks.

The risk profile evaluation of AM Best-rated insurers in the region is shown in **Exhibit 5**. The vertical lines indicate the spread of minimum to maximum risk profile assessments, while the dots represent the average risk profile for the risk category. The risks with the highest average risk profile (most significant to the market) are concentration, investment, and legislative/regulatory/judicial/economic risks.

In many cases insurers have risk management capabilities that are deemed appropriate for the risk profile faced. This is shown by the blue dots in **Exhibit 5**, which indicate that the relevant risks are managed appropriately for most companies. However, the red dots indicate that there are still

Exhibit 5
MENA – Risk Profile
(Risk Evaluation Scale: 0 to 10)

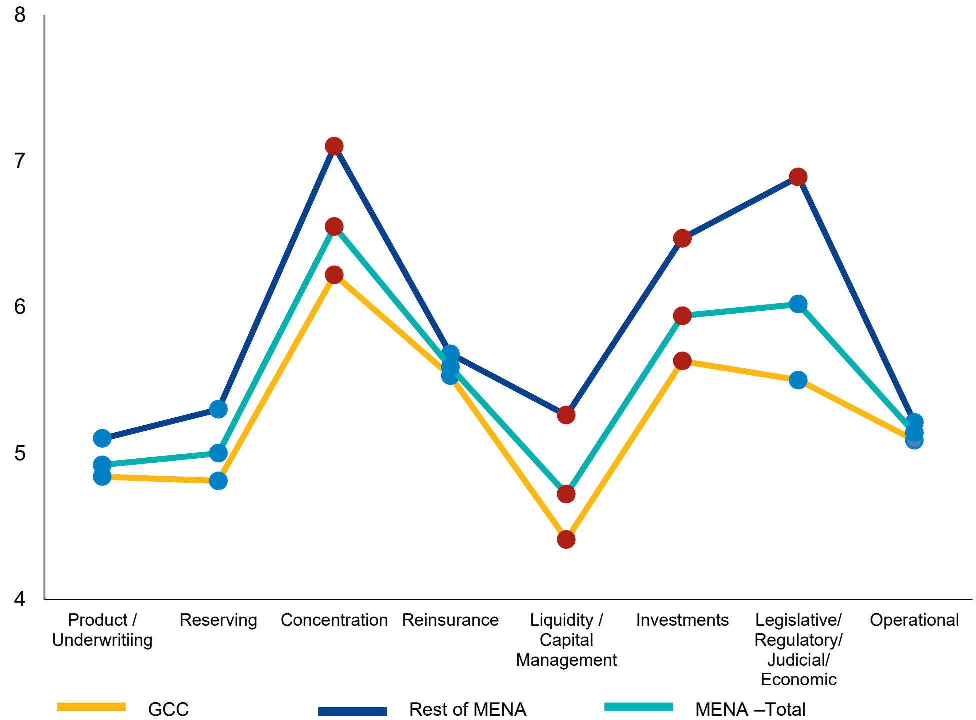


● Indicates that risk management capabilities are in line with the profile assessment.
● Indicates that risk management capabilities are deficient to the risk profile assessment.
Source: AM Best data and research

Exhibit 6

Risk Profile Average Assessments – GCC vs. Rest of MENA

(Risk Evaluation Scale: 0 to 10)



● Indicates that risk management capabilities are in line with the profile assessment.
● Indicates that risk management capabilities are deficient to the risk profile assessment.
Source: AM Best data and research.

weaknesses inherent in insurers' capabilities to manage the risks associated with concentration, investments, and liquidity and capital management.

GCC Fares Better Than the Rest of MENA in Terms of Risk Profiles

AM Best notes that the insurance markets in the region are not homogenous, with companies in the GCC countries having on average lower risk profiles than those operating in the rest of the region (see **Exhibit 6**). The differences are especially noticeable when it comes to concentration risk, investments, and liquidity and capital management.

Additionally, on average, companies domiciled outside the GCC face a higher risk profile, particularly in relation to legislative/regulatory/judicial/economic risks. Overall, AM Best assesses the risk management capabilities in this category to be 'Marginal'. The higher average risk profiles for these companies are in part attributable to the relatively more challenging business environments faced. AM Best deems many of these countries to have the highest levels of country risk, indicative of high or very high economic, political and financial system risk.

Another high-risk area identified in AM Best analysis is that of reinsurance. Companies in the region cede on average approximately 40% of their gross written premiums, with some ceding figures in excess of 70%, creating a dependence on reinsurance. These high cession levels are often driven by property, engineering and other specialty classes of business, where it is not uncommon for insurers in the region to cede almost all the risk to reinsurance partners. While this is a significant risk to be managed, AM Best is of the opinion that the insurers it rates are managing it appropriately. Risk management capabilities in light of this reinsurance dependence are supported by the general use of reinsurance panels of sound credit quality and reinsurance limits calibrated to sufficiently cover risk and modelled event exposures. AM Best also notes that the region has seen a shifting landscape of providers of reinsurance capacity over recent years. In light of this, AM Best continues to monitor the potential for a downward transition in the credit quality and concentration of the reinsurance panels used by the region's insurers.

ERM Frameworks and Capabilities Going Forward

Despite steady developments over the years, AM Best believes that the MENA insurance markets continue to lag more mature markets in terms of ERM capabilities. MENA insurers are more likely to be assessed as having lower risk management capabilities than their risk profiles. In AM Best's view, this is attributable to weaknesses in ERM frameworks, arising from silo approaches to ERM, the adoption of basic or minimum governance standards, and evolving ERM practices that are yet to be time tested and embedded. Furthermore, the regulatory frameworks in several countries are still in the early stages of development, with ERM developments often accompanying regulatory strengthening. In the past, AM Best has observed ERM shortcomings in the region as having led to the re-statement of financial statements, asset value write-downs, capital volatility, reserve strengthening, and incidents of fraud.

Going forward, AM Best expects companies in the region to continue to demonstrate improvements to their ERM frameworks and capabilities, particularly in terms of governance and risk culture. This will also be in part a consequence of a progressive strengthening of regulatory oversight, particularly with the take-over of the regulatory role by insurance-specialised departments within central banks in some countries, which AM Best views favourably.

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AMERICAS
WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)
LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best - MENA, South & Central Asia*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Representative Office

ASIA-PACIFIC
HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

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