Insurance Industry And Country Risk Assessment:

Israel: Life

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Overview

Strengths	Risks and weaknesses
Robust market growth prospects supported by resilient economy and mandatory pension savings.	Volatile profitability largely dependent on capital market performance and affected by prevailing low-interest-rate environment.
High barriers to entry limit potential entrants to the market.	Fierce competition, especially in the pension and provident funds lines.
Fast economic recovery should support life insurance and long-term savings activity.	Often pro-consumer regulatory reforms affecting profitability.

Rationale

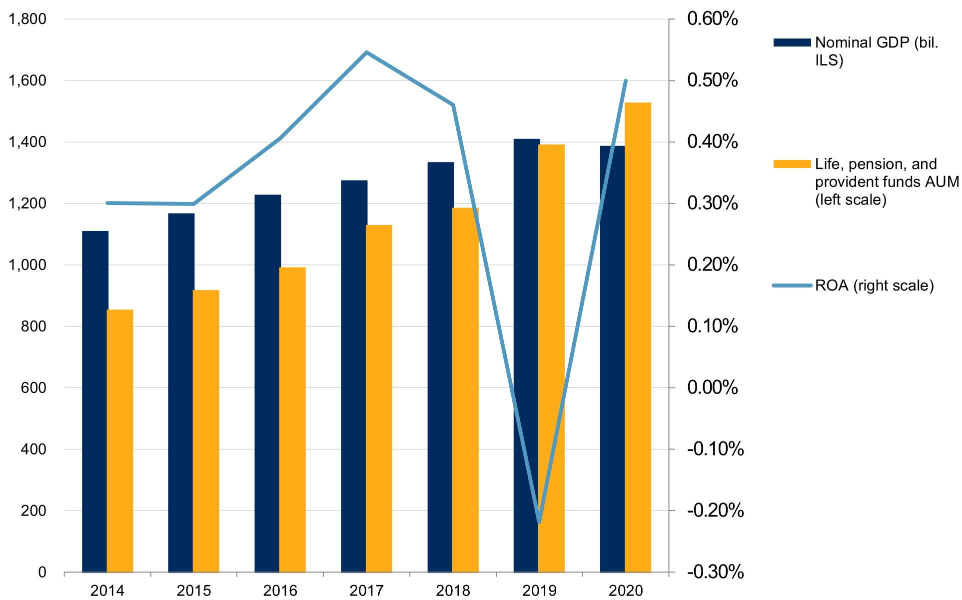
S&P Global Ratings assesses the industry and country risk of the Israeli life insurance sector as intermediate. Our assessment, which covers the overall Israeli long-term savings scheme, reflects our view of the diversified and resilient economy and robust market growth prospects, but also the volatile profitability which is largely driven by capital markets performance and somewhat hampered by the persisting low-interest-rate environment. The overall assessment is comparable with those of the Czech Republic, Italy, Belgium, and Spain.

Country Risk: Intermediate

Our view of Israel's intermediate country risk continues to be supported by its wealthy and resilient economy, alongside effective institutions, which should mitigate ongoing domestic and geopolitical volatility. The Israeli economy contracted by about 2.6% in 2020 because of the challenging pandemic-induced economic conditions. The strong macroeconomic fundamentals and high monetary flexibility should allow Israel to absorb the shock from the pandemic. We expect GDP to rebound in 2021 by 5%, based on an assumption of high and long-term vaccine efficiency. In 2022 and 2023, we assume that Israel's economy will expand by about 4% and 3.5%, respectively. We expect that the forecast recovery in economic conditions, particularly in terms of the unemployment rate and private consumption, will support premiums inflows to the life insurance sector. Pension saving is mandatory for all types of employees, which leads to continuous growth of assets under management in the long-term savings scheme, most of which is managed by the life insurance companies.

Chart 1

The Life, Pension, And Provident Funds Overtook Israel's Nominal GDP Level



AUM--Assets under management. ILS--Israeli new shekel. ROA--Return on assets. Source: S&P Global Ratings.

Industry Risk: Moderately Low

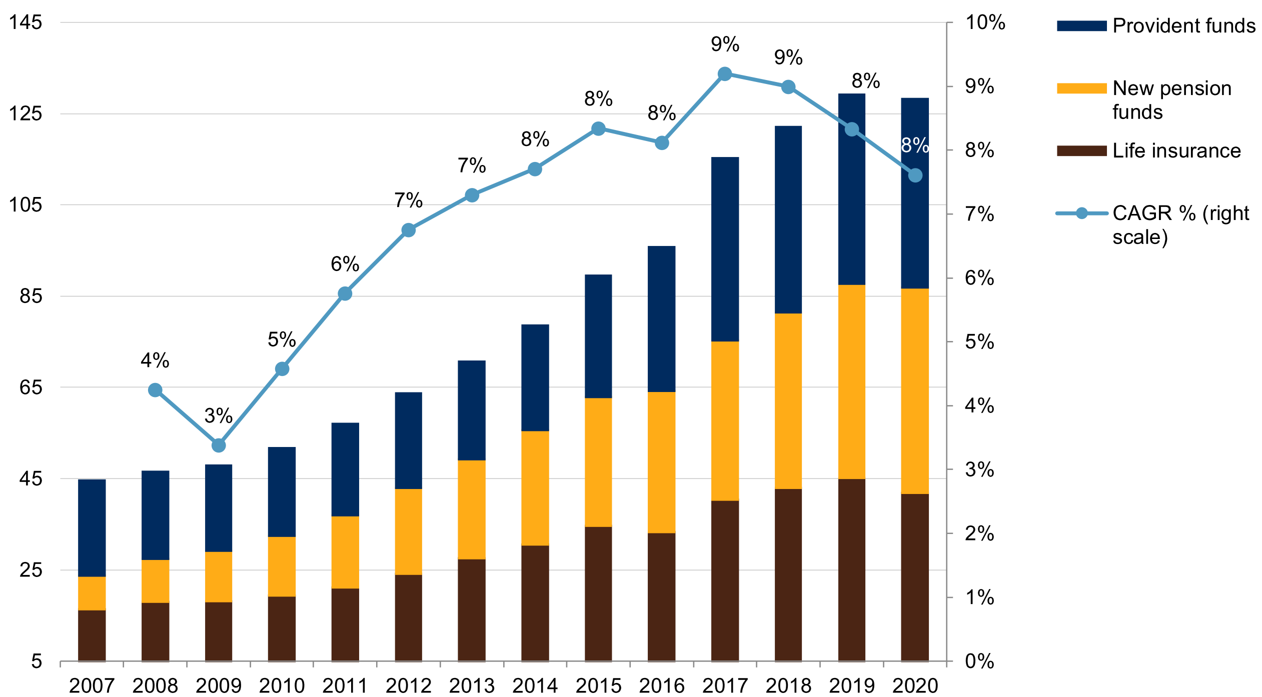
Our assessment of Israel's life insurance industry risk reflects the current and prospective sufficient level of profitability, as the five-year weighted average return on assets (ROA) is 0.3%. In 2020, the life insurer's profitability benefited from strong capital markets performance and reserves release on liability adequacy test (LAT) calculation methodology revision, driving 0.5% weighted average ROA. Looking ahead, we expect ROA to hover around 0.3%-0.4% in the next two years. This is supported by the high barriers to entry and relatively high expected growth rates of life insurance premiums, pension, and provident funds deposits. However, we consider the sector's profitability to be volatile, dependent on investment income, and subject to risk free interest rate yield curve fluctuations. Regulation also has a significant impact on the sector's profitability, mainly through enhancing competition by increasing transparency and comparability requirements.

Factors supporting profitability

- High barriers to entry. Our view stems from the more complex nature of long-term savings and pension products, which require individual adjustment in most cases to reflect personal needs. Hence, establishing a distribution network is crucial and considered extremely difficult for potential new entrants, in a sector where distribution is controlled mainly by insurance agents.

Chart 2

Life And Long-Term Savings Premiums And Deposits Remained Stable Amid The Pandemic



CAGR--Compound annual growth rate. Source: S&P Global Ratings.

- High growth rates are expected to persist. Life premiums, pension, and provident funds deposits remained stable in 2020. This is because of the relatively low share of deposits belonging to those employees who were worst hit by the pandemic--most of whom were employees of sectors such as leisure and hospitality, which also have lower wages. At the same time, the more productive industries that are characterized by higher wages demonstrated resiliency amid the pandemic. Therefore, premiums and deposits remained overall stable. However, 0% growth is much lower than the average compound annual growth rate of above 7% over the past eight years.
- We believe that growth rates of life and long-term savings premiums, as well as pension and provident fund deposits, will recover in 2021 but will slightly lag the multi-year average, depending on the labor market recovery. We expect average growth rates to return to 6%-7% on average in 2022 and thereafter. Our growth expectation is supported by expected economic

recovery, decline in unemployment, and overall improvement of the labor market conditions. The constant inflow of deposits due to mandatory pension law in Israel also support our view.

- We expect pension and provident funds deposits to dominate the premiums and deposits composition in the coming years, because of the recent regulatory change to the features of the life unit-linked policies, which made them less attractive.
- The Israeli institutional framework is robust, in our view, and we consider it supportive to the satisfactory level of profitability. The supervision standards of the Capital Markets, Insurance and Savings Authority are aligned with international standards. We view positively the amendment to the Solvency II capital regime framework in 2020, which will allow the sector to become more aligned with the European regime requirements. We also think it will provide more clarity to the market players, allowing them more time to build their capital, especially for the long-term risks. The multiline insurers, which are large life and health players, benefit from the new amendment, which allows them to gradually build their capital over 13 years, while the required capital for the old life and long-term health books is declining. Those companies therefore chose to adopt this proposal and the full implementation of the Solvency II regime will be in 2032. The weighted average of the Solvency II ratio with transitional relief, post amendment, is 159% as of Dec. 31, 2019. We believe that the post-amendment Solvency II regime will reduce the cost of capital, improve capital efficiency, and support overall profitability.

We also believe the revision of LAT calculation methodology in 2020 will positively affect accounting profitability in the life insurance sector. This is because it will eliminate volatility in the results, often due to reserves adjustments following changes in the interest rates yield curve. Life LAT reserves will be calculated per group of products and allowed to offset insufficient reserves from one product with other life products, rather than the previous approach of reserves adjustment per specific product without grouping. In our view, the revision of LAT calculation methodology and Solvency II regime amendment demonstrates the regulator's commitment to the long-term stability of the insurance sector.

However, we believe that the prudent and proactive regulation hampers the sector's profitability to some extent. The regulator often acts by changing the product features, which affects the product offering and the insurers' profitability. This was the case in 2019, where the regulator removed the pure risk coverage sold as part of long-term insurance and saving products.

The insurers included in the post-amendment average 159% of solvency capital requirement calculation--Clal, Migdal, Harel, and Phoenix--are those that chose the new option in the life unit-linked products, effectively leading to a massive reduction of the sale of those products. The insurers compensated for the loss of unit-linked products by introducing saving policies where the insurance feature can be acquired separately.

We recently observed higher involvement from the regulator with regards to the protection of corporate governance in disputes between the management and the board, or between the board and owners in a couple of cases. Although this involvement provided more confidence to the market, we would prospectively expect more stable internal processes in terms of dispute settling in such cases and generally more robust management and board governance frameworks, which would reduce the need for close regulatory involvement and enhance stability.

Factors limiting profitability

Prevailing low-interest-rate environment as well as dependency on investments returns continue to weigh on the life sector's profitability. We believe the low interest environment and resulting risk free yield curve fluctuation will continue to trigger reserves adjustments, despite its being reduced following the recent regulatory change to LAT calculation methodology and will affect mainly long-term care reserve. In addition, variable management fees, which are charged at about 43% of the life portfolio, are linked to investment returns and not collected in case of investment losses. This source of income is subject to investment income fluctuations and therefore creates constant volatility in the segment's profitability. We also view Israeli insurers as materially exposed to longevity risk, since they relate to the majority of insurers' life books, despite products containing longevity guarantees no longer being sold.

- The strong premiums and deposits growth rates have not always translated into insurers' profitability growth, which was driven more by the products' features. We believe this trend could gradually change when material asset accumulation, which generates fixed management fees, offsets the impact of variable fees volatility on profitability. We also expect the recent regulation changes to the accounting reserving requirements to reduce the profitability volatility, due to interest rate changes to reserving adjustments. Overall, over the longer term, the life insurance long-term saving products will more-closely resemble investment products, reducing the insurers' exposure to investment and longevity guarantees.

Related Criteria And Research

Related Criteria

- Insurers Rating Methodology, July 1, 2019
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

This report does not constitute a rating action.