

Insurance Industry And Country Risk Assessment:

Israel: Property/Casualty

June 11, 2021

Overview

Strengths

Solid technical profitability in motor casualty and collision (casco) and property lines.

Product diversification mitigates and limits potential volatility from specific product risk features.

Fast economic recovery should aid property/casualty (P/C) insurance activity.

Risks and weaknesses

Volatile profitability of the other liabilities line.

Fierce competition especially in the motor segment.

Regulatory oversight on motor third party vehicle liability (MTPL) tariffs.

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Rationale

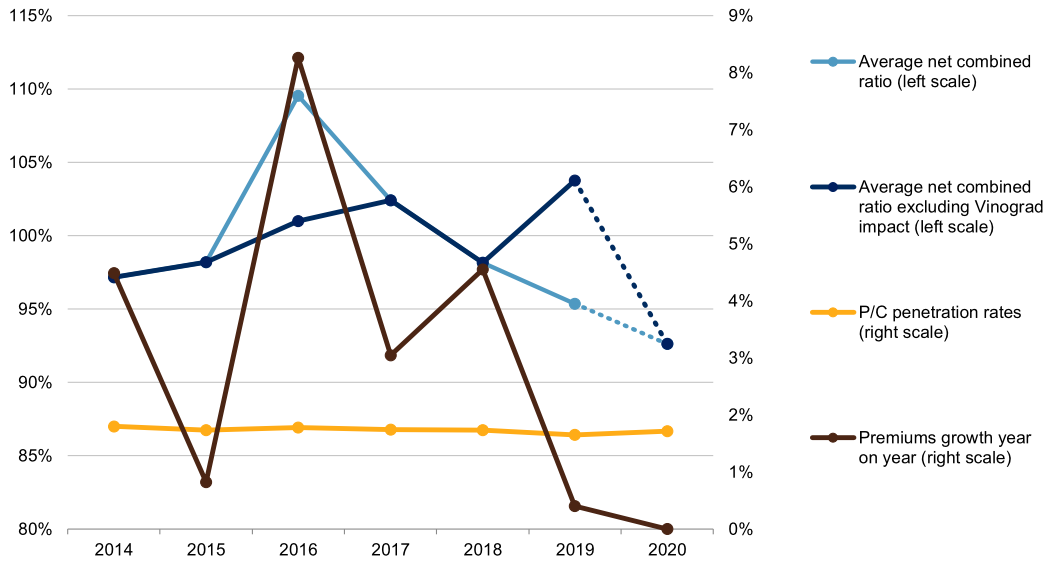
S&P Global Ratings assesses the industry and country risk in the property/casualty (P/C) insurance sector of Israel as intermediate. The sector benefits from a diversified and resilient economy, strong demand from the motor segment, and good profitability. The overall assessment reflects the risks typically faced by P/C insurers in Israel and is comparable with other markets such as Czech Republic, Italy, the Netherlands, and the U.K.

Country Risk: Intermediate

Our view of Israel's intermediate country risk continues to be supported by the country's 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, yet strong macroeconomic fundamentals and high monetary flexibility should allow the country 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 P/C insurance sector in Israel.

Chart 1

Competition And The Pandemic Drove Premiums Decline While Average Net Combined Ratio Benefited From Reduced Claims On Mobility Restrictions



Source: S&P Global Ratings.

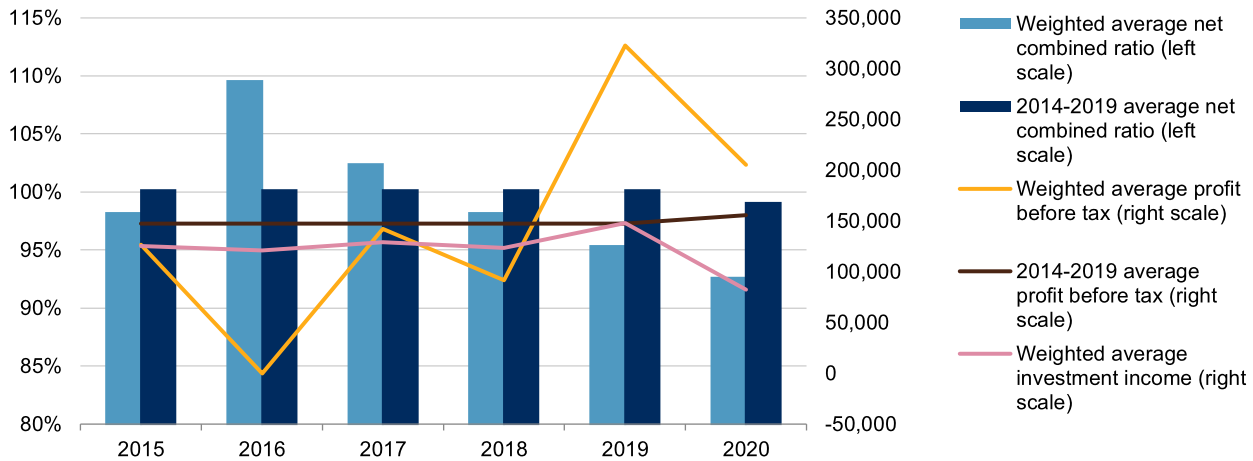
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Industry Risk: Moderately Low

Israel's P/C industry risk assessment reflects the current and prospective sufficient level of profitability, as the six-year weighted-average return on revenues is approximately 9.3% for 2015-2020 and the calculated net combined ratio (CR) is 99%. This is supported by the sufficient institutional framework, limited potential volatility arising from product risk features, improving underwriting profitability, and sound investment income, which compensate for the more volatile performance of the long-tail products. At the same time, recent easing of the regulatory barriers to entry, allowing new digital players, is further intensifying the competitive landscape and leading insurers to adapt their products and pricing.

Chart 2

Investment Income Compensates For Long-Tail Liabilities Products' Negative Impact On Net Combined Ratio



Source: S&P Global Ratings.

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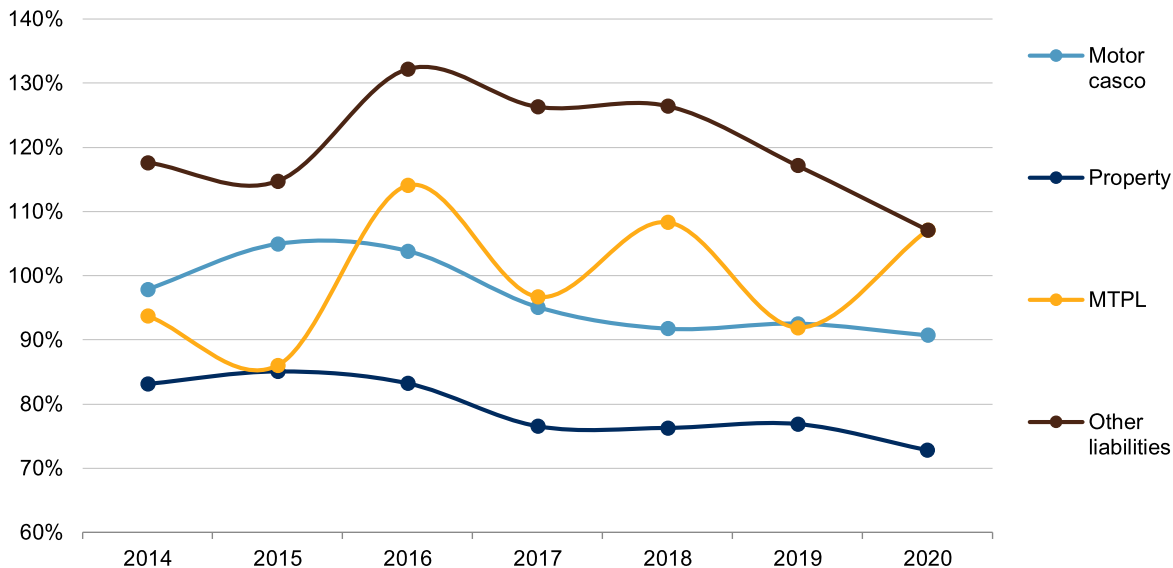
Net CR improved in 2019 to 95.4%, benefiting from reserves release following the cancellation of a Vinograd committee decision (excluding this, the net CR is 103%). Due to the mobility restrictions posed by the pandemic and lower claims frequency in the motor segment, net CR in 2020 was 92.6%. The net expense ratio also contributed to the improved technical profitability in 2020, deriving from 15%-20% of employees being on unpaid leave over the first lockdown, and from the insurers' efforts to optimize their cost structure, mainly by streamlining their internal processes. While 2020 will reflect the one-off impact of the pandemic, for 2021 we expect to see CRs returning to a more reflective level of 99%-100%. This is because we expect the competitive pressures to intensify, limiting the ability for improvement below these levels in the next two-to-three years. (The lower the CR, the more profitable, and a ratio of more than 100% signifies an underwriting loss.) Potential improvement in profitability level could stem from lower expenses, should the efficiency measures taken in 2020 prove sustainable.

Investment income remains an essential component of the Israeli P/C sector's profitability, and it often compensates for the technical loss from long-tail liabilities lines (see charts 2 and 3).

Chart 3

Increasing Focus On Underwriting And Pricing Drive Improved Net Combined Ratio In The Short Tail Segments

Short tail segment net combined ratio improved



Casco--Casualty and collision. MTPL--Motor third party liability. Source: S&P Global Ratings.

Factors supporting profitability

- Improved underwriting profitability in motor casco and property lines. The insurers increased use of data and advanced technology, while focusing on customer specifics to develop more tailor-made products, drive better underwriting profitability (see chart 3).
- Limited potential volatility is arising from product risk features. Overall, the P/C products' features expose the insurers in Israel to limited risk. Short-tail products comprise about 60% of gross premiums written where asset liability management (ALM) is limited and claims settlements are relatively predictable. The residual 40% of gross premiums written expose the Israeli insurers to long-tail liabilities-product risks, such as unpredictable settlement and interest rates movements.
- Insurance businesses where the claims are relatively predictable were affected by the Vinograd committee's decision in 2016 to lower the interest rate used in reserve calculations, leading to reserve strengthening across the industry. However, the impact of this was significantly minimized by the Supreme Court's decision in 2019 not to adapt the use of a lower interest rate, which drove a significant reserve release back to P&L.
- Investment income constitutes a significant part of the sector's profitability, on top of the technical profitability. For example, in the compulsory motor liability insurance segment, the

companies were able to offset the weaker technical profitability with strong investment income, resulting in the segment's overall positive return on revenue of 9.3% in 2015-2020, on average.

- Barriers to entry are lowered because regulatory requirements have eased for new P/C players in Israel to start operating in the market; for example, by reduction of the minimal required equity size for P/C insurers to Israeli new shekel (ILS) 10 million (about \$2.8 million) from ILS59 million. Two new fully digital players started operating in the market, offering mainly motor policies, after more than a decade of no new entrants to the market. The supportive regulatory environment and the actual entrants of new digital players reflects the lower operational barriers to entry in our view, especially when compared with the life industry. Nevertheless, we do not see this as a major threat to the P/C sector's stability for two reasons. First, the role of traditional distribution via insurance agents was already weak to some extent, due to the simple and more commoditized nature of products such as motor casco and apartment. Second, traditional insurance companies were already adapting their direct distribution capabilities and offering new products with a clear branding. Therefore, the entrance of new players has somewhat forced insurers to accelerate the change and adapt, while the threat to profitability levels has so far proved manageable. To date, the new entrants have gained very modest market share with a limited impact on the overall sector's profitability.
- The Israeli institutional framework is robust, in our view, and we consider it as 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, which will allow the sector to become more aligned with the European regime. 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. While the multiline insurers chose to adopt the proposed amendment, pure P/C players preferred to stick with the previous Solvency II adoption path, which will be implemented in full in 2024. The P/C segment is less affected by the transition to the Solvency II regime, since the majority of the risks are short tail (60%), and the cost of capital is not expected to materially change for P/C products through the implementation process, meaning it has less impact on profitability compared with the life insurance segment.

We view the regulator as prudent and proactive in terms of products and pricing. The regulator often acts by capping the prices on certain products or preapproves the tariffs. The regulator is also promoting the level of transparency and comparability of insurance products, which may affect the sector's profitability but at the same time supports its customers.

We recently observed higher involvement from the regulator with regard to protection of corporate governance in disputes between the management and the board 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

- Growth prospects have moderated. The P/C insurance sector premiums grew by an average of 2.6% over 2014-2020, supported by GDP and population growth. However, we believe the fierce competition, which was further fueled by the entrance of new digital players to the market, is expected to continue affecting pricing and hence limiting premium growth prospects, as demonstrated by 2019's 0.4% moderate growth rate, because of the impact on prices. In

addition, the premiums stagnation in full-year 2020, stems from the growth in unemployment and decline in private consumption resulting from the challenging pandemic-induced economic conditions, as well as tight competition's effect on prices. We expect moderate prospective growth rates of 0.5%-1.5% in the next two years. Excluding the pandemic's impact on the labor market and consumption in 2020, our growth expectations are driven by the fierce competition and greater awareness of end customers, who increasingly compare prices. We view the motor property segment as the main factor in price decline, evidenced by the growth of insured cars in Israel alongside the average premium decline over the past two years.

Related Criteria And Research

Related Criteria

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

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