(Re)insuring large risks in the Middle East

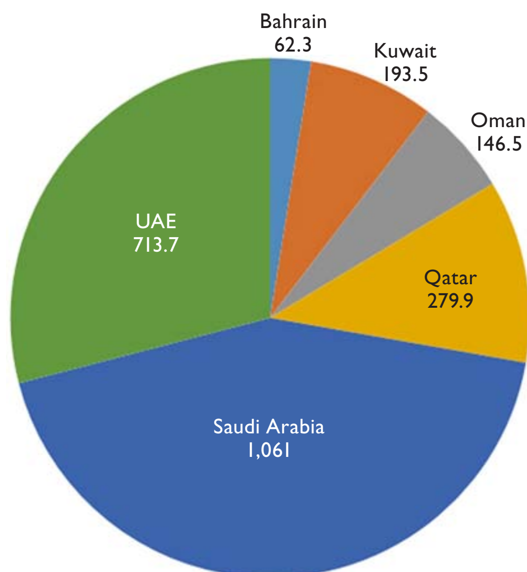
Mr Rainer Lehner of **Asia Capital Re** traces developments in the way large commercial risks are placed in the Middle East and looks at why there is a need for more innovative approaches.

More so than in many other parts of the world, large commercial risks are part of the DNA of Middle Eastern insurance markets; this will be especially evident in the upcoming decade. Massive infrastructure and construction spending continue to be a major driver of insurance and reinsurance demand in the region. Most of these projects are funded by governments as part of their long-term economic diversification strategies aimed at securing their nations' prosperity for the post-hydrocarbon age.

After some setbacks related to the global financial crisis in 2008, construction activities have rebounded strongly and are being boosted further by major upcoming events such as the 2020 World Expo in Dubai and the 2022 FIFA World Cup in Qatar. According to MEED, in Saudi Arabia, the biggest economy in the Gulf, projects worth more than US$1 trillion are in progress or being planned. In November 2013, the total value of projects in the GCC countries that were being planned, or already underway, neared $2.5 trillion, more than 150% of the combined GDP of the six countries and up 26% y-o-y (see Chart 1).

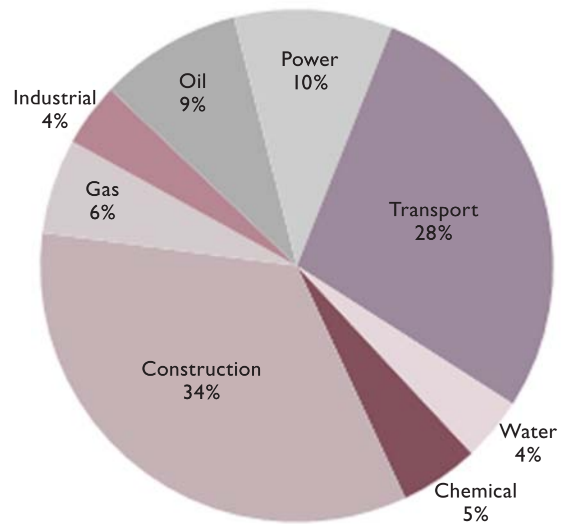
Construction and transport projects dominate the portfolio of activities with a share of 34% and 28%, respectively. Hydrocarbon and power projects contribute another 25% (see Chart 2).

Chart 1: GCC projects planned or underway
(November 2013, in US$ billion)



Source: MEED Projects

Chart 2: GCC projects underway by sector
(August 2013)



Sources: MEED Projects, QFC Authority

Against this backdrop, commercial risks insurance is set to remain a key pillar of the region's insurance markets, despite the fact that personal lines, and medical insurance in particular, have recently grown even faster on the back of compulsory insurance requirements.

Major changes in placement modalities

The way large complex risks are placed in the Middle East has changed significantly over the past 10 years. One particularly noteworthy development is the almost universal requirement to tender insurance. This way of purchasing is driven by both compliance and commercial considerations and certainly confers short-term benefits to the corporate risk owner. However, these gains can be offset by a neglect of a longer-term strategic perspective on corporate risk management, less smooth and durable relationships, delayed placements and cover uncertainty.

In addition, brokers now play an increasingly important role. According to various sources, their regional market share in commercial lines has more than doubled over the past 10 years. This development was favoured by the growing complexity of cover which has fuelled demand for expert advice beyond brokers' historical, mainly transactional, role. In response to this global trend, brokers have stepped up their game. Leading players now offer a wide spectrum of value-added services such as risk engineering and catastrophe management based on a comprehensive and

quantitative approach to risk assessment, risk transfer and risk mitigation. In addition, drawing on their actuarial resources, brokers can also help analyse economic costs and benefits of any risk transfer solution the client considers. Of course, the rise of brokers, in combination with expanding tendering requirements, has made the marketplace significantly more competitive and put pressure on rates and terms and conditions.

Key stakeholder relationships

Given the increasing size and complexity of risks, a close cooperation between key stakeholders is more vital than ever. Despite the growing role of brokers, reinsurers and corporate risk owners remain the key parties involved. Interaction and information sharing between them is absolutely essential to the cost-effectiveness of cover purchased.

In this context, reinsurers should seek to build a network with corporate risk owners, going beyond corporate risk managers. It should also encompass senior operations managers, who are closest to the risks transferred. Their insights and input could add significant value to the quality, adequacy and effectiveness of cover. These managers would also greatly benefit from insurance solutions, which are specifically tailored to their location's or business unit's needs. Such quality relationships are difficult to conceive in a purchasing environment dominated by short-term optimisation and rigid tendering requirements. All parties involved should think of the longer-term benefits of a strategic collaboration, which is not just about doing things right (from a cost efficiency point of view) but also doing the right things.

Need for innovation

Most large risk insurance programmes in the Middle East are standardised solutions. This state of affairs is surprising given the scale and complexity of the risks involved. It may have to do with buyers' strong focus on cost, at the risk of neglecting the effectiveness and overall adequacy of cover. But the status quo does not only reflect demand-side factors. Some reinsurers prefer to offer plain-vanilla solutions to their clients in the Middle East. This attitude may partially be attributable to margins which are low by international standards.

Having said this, we believe that an increasing number of buyers would seriously consider innovative approaches to their risk management needs. Multi-line solutions, which are based on a more holistic and aggregate view, are an example. These products already exist in the Middle East but their potential is far from exhausted. They promise a more cost-effective approach harnessing the diversification features inherent to the client's overall large risks portfolio. Clients could also "afford" higher deductibles and reduce the massive administration expenses associated with frequently claiming very small amounts.

Another example of innovation is modular types of cover. These would offer a more differentiated approach to sub-limits and help design covers, which more precisely address the client's specific needs. Of course, such solutions may come at a higher price than "discount cover" with very low limits and no real value for larger corporations from an earnings or balance sheet protection point of view.

A more demanding area for innovation is cover for business interruption (BI) or even contingent business interruption (CBI). Following the Great East Japan earthquake and the Thai floods in 2011, CBI was generally excluded or sub-limited – globally. From a Middle Eastern perspective, progress in this area would address the growing vulnerability and internationalisation of value and supply chains in the region and, as such, help mitigate one of the most serious entrepreneurial and commercial risks. As in other parts of the world, such covers would require much improved exposure transparency, on accumulation risk in particular.

It is precisely here where a more comprehensive and long-term oriented relationship between reinsurers and risk owners could pay off handsomely for all parties. On the basis of such partnerships, BI/ CBI might even be offered as a stand-alone cover. For very high layers, and assuming an appropriate degree of transparency, there might even be some potential for alternative risk transfer (ART) through collateralised cover.

On the other hand, the scope for captive insurance, one of the oldest forms of ART, continues to be limited in the Middle East. Some oil and gas firms have been using captive insurance for more than 20 years as a strategic risk management tool. However, they chose Bermuda as the place of incorporation. It was not until 2006 that the first captive insurer was established in the Gulf region as a result of regulatory improvements. A lack of awareness of ART mechanisms in general and the captive concept in particular remain major impediments to captive insurance growth in the Middle East. In addition, very soft traditional insurance markets weaken the case for captive insurance, in particular as the non-pecuniary benefits, for example, the optimisation of total cost of risk as well the promotion of risk control and loss prevention, remain largely ignored.

Need for new approach

We believe that commercial insurance rates in the region are close to bottoming out. A further erosion of rates appears unlikely as the threshold of pain has been reached for most market participants and prices are generally considered to have fallen to below technical levels. In addition, treaty reinsurers have become less accommodating whilst primary insurers' claims and operating expenses continue to rise. From a line of business perspective, engineering and liability are expected to keep their status as the most profitable segments. However, downward pressure on rates may pose some concerns in the years to come.

Overall, the growth prospects for large risk (re)insurance in the Middle East remain attractive even though rates and profitability are widely viewed as marginal. Against this backdrop, market participants need to rethink their approach to the business. Corporate risk owners should consider the benefits of insurance beyond the fulfilment of contractual requirements, in particular if based on stable, tailored and comprehensive risk cover. At the same time, insurers and reinsurers need to develop more innovative product and service offerings which would prompt more corporate insurance buyers to question the wisdom of a short-term, cost-driven approach to insurance purchasing. M

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