

SPECIAL REPORT

The case for captives

The rise of risk management up the corporate agenda of organisations in the Middle East is leading some to reassess their insurance buying strategies and consider the potential afforded by the captive insurance company, says Stephen May

Companies operating within the GCC (the Cooperation Council for the Arab States of the Gulf) are adopting an increasingly proactive approach to their risk management. The extraordinary economic growth witnessed in the region over the past decade, enhanced corporate governance requirements, greater international interaction, a more rigorous regulatory environment and increasing frustration at the impact of an ever-more volatile global insurance market on premium rate levels in what is a relatively stable region, are all factors serving to generate a greater risk awareness among organisations in the Middle East and an increasing desire to retain exposures on their balance sheets.

Insurance on the rise

Insurance penetration in the GCC remains low, with insurance spend representing just over 1.3 per cent of GDP, compared with more than seven per cent in the USA and about eight per cent in Europe. However, market forecasts predict that, given the rapid increase in insurance demand in the region, this figure will triple in the next few years. While only accounting for about one per cent of global premiums, the size of the insurance market in the Middle East has experienced a significant upturn since 2000, recording an annual premium growth rate of 17.5 per cent between 2001 and 2005. In 2006, insurance premiums in the region topped US\$6 billion. According to Standard & Poor's, if the region was to achieve the world average per capita insurance premium level of US\$550 (a feat that, given current market conditions, the region is well on track to achieve) this would create an insurance market of approximately US\$20bn.

A key driver behind the surge in insurance demand has been the huge increase in insurable corporate assets and liabilities resulting

“ The property portfolios of many companies in the region are bulging and provide an ideal captive proposition as the risks associated are relatively straightforward ”



Further factors fuelling insurance growth in the region include: the expansion of compulsory lines of insurance in the region, such as health insurance; new insurance requirements emerging as a result of the privatisation of some state assets; and an increased corporate accountability from investors and regulators. However, perhaps one of the most influential long-term drivers for insurance expansion in the region is a growing awareness among organisations of their risk appetite and the limitations imposed on them by the traditional insurance market in the region.

International influence

While there exists a burgeoning regional insurance market, the Middle East is dominated by international insurers, a fact which is unlikely to change in the foreseeable future. According to Standard & Poor's, while the rating agency believes there is a growing appetite among the leading regional insurers to retain greater amounts of risk and reduce the volume ceded

from the rapid economic growth experienced in the region. According to MEED, over the next 10 years an additional US\$2 trillion worth of investment in infrastructure has been earmarked for the region. As this wealth permeates into the economy, individuals are now seeking personal insurance, particularly in relation to housing, life insurance and retirement planning.

FIG 1

What captive techniques can achieve

Financial	Risk management and claims	Coverage	Others
Access reinsurance markets	Value creation	Planning	Adhere to specific requirements, eg Takaful/Shari'a compliance
Access financial markets	Convenient structure for assessing/modelling, eg insured/insurable risk	Design tailored coverage	Risk mitigation within the captive can be for any period
Self-investment policy	Implement risk-management policy/reporting	Include/exclude at will	Retention strategy can be used to optimise risk/reward and as negotiating tool with insurers/ reinsurers
Turn cost centre into profit centre	Claims control/handling	Set retentions	

Insurance on the rise



Property, aviation and energy are prime candidates to explore the captive insurance option



to the international markets, the scale of development in the region means that the majority of the projects involved are simply beyond the ability of a regional insurer to manage effectively without international support.

At the mercy of the vagaries of a volatile international insurance market, and restricted by the limited range of insurance products available to them, many well-run operations in the region are being forced to subsidise poorly managed organisations in other territories through the payment of above-average premium contributions relative to their risk exposures. An increasing awareness of this situation – and with it an increasing frustration at having to bear the financial fall-out of events that are completely beyond their control, such as earthquakes or market downturns – is seeing some organisations, both corporations and regional insurers, reassessing their insurance-buying strategies in an effort to create a risk transfer scenario that is more commensurate with their levels of assessed exposure.

The captive option

As the gap grows between what the international market demands and the regional players are willing to pay, the option to retain more risk is going to become an increasingly attractive option for insurance buyers.

Low insurance penetration levels in the Middle East already show that many organisations are retaining sizeable amounts of uninsured risk on their balance sheets. An extremely financially robust economy has seen many organisations achieve sufficient balance sheet integrity to enable them to do this. However, it should be noted that in most cases this dynamic has occurred, not as a result of a conscious risk-management decision, but rather a simple lack of awareness of the value of insurance and the range of insurance mechanisms available.

The priority for the majority of companies in the region over the past decade has been expansion and resourcing that expansion. Insurance has been low on their list of priorities, with self-retention and captive strategies barely warranting a foot note for most organisations. However, as mentioned earlier, there are a number of factors serving to push these issues rapidly up the corporate agenda.

The region has taken a major step in raising awareness of the self-insurance option with the establishment of captive legislation. While some



companies already operate captives domiciled in other territories, the implementation of state-of-the-art captive legislation by Bahrain, Dubai and Qatar, has laid firm foundations for the development of captive insurance in the Middle East. While the various legislative structures are relatively untested, having only been ratified in the past few years, the jurisdictions have each sought to base these frameworks on the robust models that have formed the basis of the captive market in the western world for

the past 50 years.

By implementing captive legislation, the three regions have provided enterprises in the Middle East with the ability to overcome the limitations of the traditional insurance market and empowered them to take control of their risk strategies.

With some 5,000 captives established worldwide, the captive insurance company has become an integral part of today's insurance landscape. A key component of the risk strategies of virtually all Fortune 500 companies, the appeal of the captive has spread to every corner of the industrial and commercial industries, and beyond.

The captive provides an excellent value-generating mechanism, enabling organisations to turn what was previously a cost centre into a profit centre. Key benefits include:

- Greater control of insurance-related costs
- Wider coverage options
- Improved access to reinsurance markets and more favourable terms
- More control over the selection of partners/supplier
- Enhanced claims monitoring capabilities
- Flexibility over claims settlements
- Control of investment policy for unclaimed funds
- Tax efficiencies for any surpluses

Captives can be applied to most areas of insurance if the risk is clearly defined. Such areas may include: product and operating

Which GCC companies/enterprises will benefit most from the captive?

Maintainable and diversifying industries in the GCC including:

- Energy industry
- Tourism and travel (airlines, service providers, air traffic control)
- Property/construction (including infrastructure, such as ports, airports and public transport)
- Financial services (including banking)
- Law firms
- Hi-tech and value manufacturing industries
- Service/technological industries
- Healthcare/medical
- Utilities (including telecoms)

liability; terrorism and natural hazards; professional indemnity; employee liability; constructors all risks; property liability; and business interruption liability.

However, the captive option is not suitable for all companies. The mechanism is ideally suited to those organisations which operate a robust balance sheet, are profitable, operate from a stable base and have a high level of understanding of their risk exposures, resulting in an above-average risk profile. Running risk through a captive requires both capital and appetite. However, if an organisation employs sophisticated risk-modelling techniques, has conducted detailed analysis of its overall exposures, and is capable of pricing those exposures accurately, then the decision to establish a captive can be a relatively straightforward one.

The Middle East appeal

On a sector-by-sector basis, the appeal of the captive insurance company for the Middle East is far-reaching. Energy, property and construction are prime candidates to exploit the captive option, while other sectors, such as aviation (and in particular non-airline-related exposures, such as service providers and airports), tourism, transport and public utilities can also benefit from the structure.

The oil and gas industry has had a long-standing relationship with the captive market, with many market leaders in the petrochemical sector operating sophisticated risk-retention structures. In fact, one of the largest insurance companies in the world is the super-captive operated by BP. By implementing captive legislation, however, oil and gas companies in the Middle East will now be able to domicile these structures in their own backyard, rather than locating them on the other side of the world.

The property sector is also primed for captive insurance. The property portfolios of many companies in the region are bulging and, therefore, provide an ideal captive proposition as the risks associated are relatively straightforward and can be priced easily.

The aviation sector also affords a number of captive opportunities. The airlines in the Middle East utilise the latest in aviation technology, both on the ground and in the air. As a result, they have achieved an enviable risk profile. However, there are question marks over the extent to

which their efforts are being reflected in the premium rate levels they are being charged on the international market. While it may still be the best option to purchase insurance for the specific airline risks through a specialist aviation underwriter, in terms of the non-airline risks associated with the airports, such risks can prove ideally suited for a captive.

A prime location

While development in the Middle East has been little short of meteoric over the past few decades, the corporate environment that it is based on has succeeded in achieving this growth in a controlled, structured and sustained

manner. This has enabled them to create enviable economic growth, which is founded on a relatively benign risk environment, when compared to other regions. When one adds to this equation a growing awareness of the need for more proactive risk management, and a greater acknowledgement of the restrictions imposed by the international insurance market, then it would appear that the captive insurance company could well become an integral part of the risk-management strategies of many forward-thinking organisations in the region. ■

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Room for growth in the insurance markets

Fareed Lutfi, secretary general, Emirates Insurance Association, considers the growth potential which exists in the Mena insurance market.

There is ample room for growth in the Mena insurance and reinsurance markets. However, development in the sector has been hindered, in my opinion, by the fact that low capital levels are limiting the amount of risk that can be retained in the region and insurers, therefore, have to cede much of the risk into the reinsurance market.

In the wake of joining the World Trade Organisation, and the signing of individual free trade agreements, many Middle Eastern countries sought to develop their legal and regulatory frameworks – a move which has proved extremely beneficial. Measures such as compulsory insurance requirements have served to shift the burden of insuring the public onto the private sector. This will obviously drive

demand on the retail side and advance the growth of the insurance market.

The region has also experienced macroeconomic growth, particularly in energy-rich countries in the GCC, where we are witnessing large investments in infrastructure and growing international trade. The establishment of international financial centres in some countries has attracted large financial conglomerates, created a professional legal environment and generated capital market interest.

The changing regulatory environment, coupled with

the impact of major foreign investment and a greater focus on corporate governance and enterprise risk management, has resulted in increased interest in insurance outside of the traditional classes, particularly in relation to professional indemnity.

The region has also witnessed increased interest from captive management companies, and in particular the GCC. With the establishment of large corporations in the region and a regulatory environment encouraging large family businesses to partially go public, captives could prove attractive. Captives offer advantages, including the ability to meet bespoke needs, reduced operating costs, increased coverage and capacity of risks, plus investments to fund any losses, direct access to wholesale reinsurance markets, and claims control. While there are disadvantages, I believe the advantages outweigh them.



Fareed Lutfi