

Enterprise risk management in the GCC – how Qatar is capturing the momentum

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The risk landscape of the six GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates) is evolving rapidly. Fuelled by surging oil prices since 2003 some countries in the region have displayed some of the world's highest GDP growth rates. Investments in public and private infrastructure have reached unprecedented levels. At the same time, the social and political environment is subject to increasing volatility.



In such an environment, corporate risk management has risen onto the strategic agenda of companies operating in the GCC. The challenge of identifying, prioritising and mitigating risk is viewed in a more holistic manner, paving the way for what has become known as Enterprise Risk Management (ERM). In the GCC as well, more and more companies are waking up to the need to manage compliance, financial, hazard, operational, as well as strategic risks in a comprehensive way and more closely align these activities with the enterprise's objectives and risk appetite.



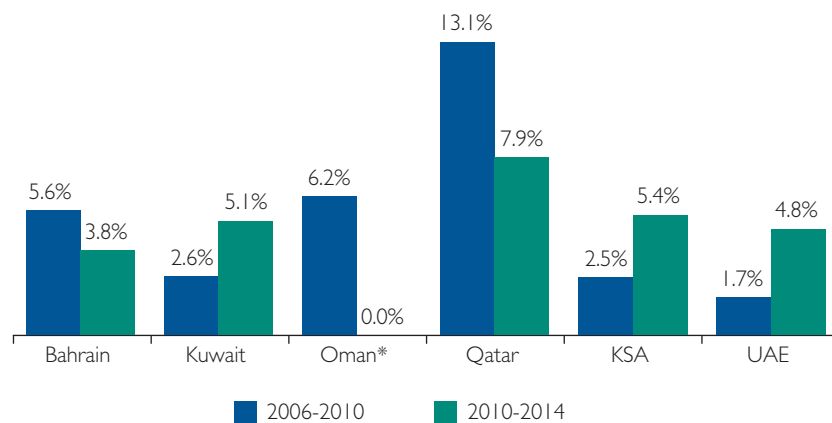
Against this backdrop, the following article examines the macroeconomic dynamics of the GCC as well as the breathtaking development of the region's insurance industry, the traditional absorber of corporate (hazard risk). This is followed by an examination of the main drivers and prospects of ERM in the region. Finally, we discuss Qatar's efforts to play a leading role in shaping the regulatory and operational environment for the future rise of ERM in the GCC region, and captive insurance in particular.

The vibrant economies and insurance markets of the GCC countries

In 2010, the six GCC countries generated a combined estimated Gross Domestic Product (GDP) of US\$805bn (at constant 2005 prices). This level of output ranks the GCC amongst the 20 largest economies in the world. At an inflation-adjusted 3.4% p.a., the region's economies grew twice as fast as the rest of the world. At a 13.1% real annual rate of GDP growth Qatar stands out, primarily driven by a significant expansion of LNG production capacity. Qatar is expected to remain the region's most vibrant and, as a matter of fact, one of the world's most rapidly growing economies. Growth will continue to be underpinned by huge hydrocarbon reserves at an estimated worth of between US\$40 trillion (at a US\$55 barrel of oil equivalent) and US\$70 trillion (at a US\$95 barrel of oil equivalent), according to BP and QFCA analyses.

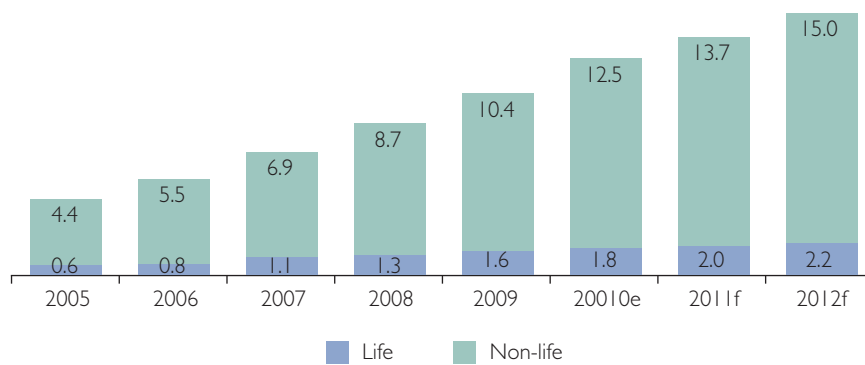
Insurance markets in the GCC mirror the macroeconomic dynamics of the region. For 2010, total non-life and life premium volume in the GCC is estimated at more than US\$14.3bn and projected to

Figure 1: Real annual GDP growth, 2006-2014 (%)



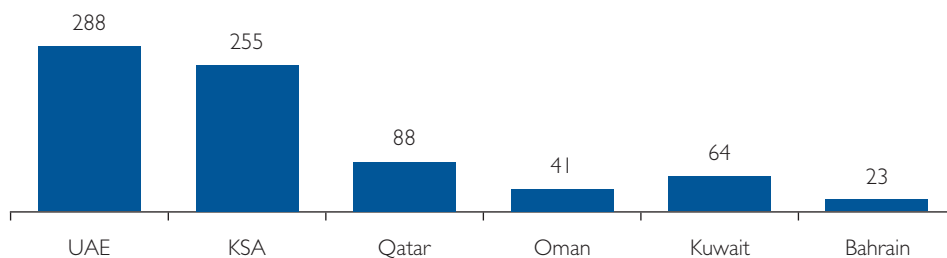
Source: EIU

Figure 2: GCC insurance premiums by type, 2005-2012 (US\$bn)



Source: Compiled by QFCA Analysis based on Swiss Re, Central Bank of Bahrain, Business Monitor International

Figure 3: Project currently being executed by country, January 2011 (US\$bn)



Source: MEED Projects - January 2011

exceed US\$17bn by 2012. Life business grows faster than the non-life segment but continues to be of marginal importance.

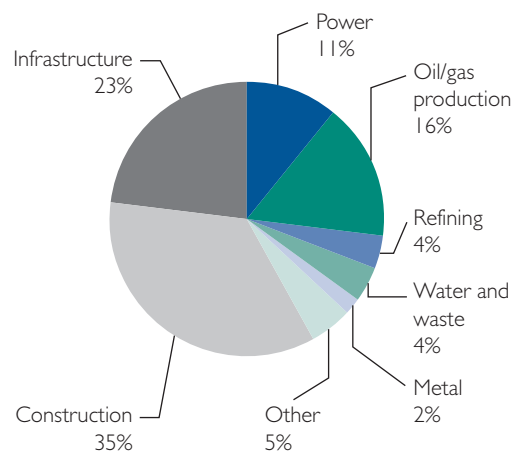
Between 2005 and 2009, GCC insurance premiums almost expanded five times as fast as the global average, with Qatar registering an impressive 25% nominal growth p.a.

Infrastructure and construction spending on a massive scale continues to be the single biggest specific driver of insurance demand in the region. In Qatar alone more than US\$75bn were awarded to infrastructure projects between 2004 and 2010. As of January 2011, US\$88bn worth of projects were underway in the country, with a further US\$130bn in the pipeline for the next three years.

Infrastructure and construction projects dominate the projects pipeline, with a combined share of 58%. Hydrocarbon and power projects contribute another 31%.

In the GCC, 43% of non-life premiums are ceded to reinsurance companies, reflecting the preponderance of a direct insurance business model based on commission and investment income. The total reinsurance market volume for 2010, accordingly, amounts to close to US\$5.5bn. Even though cession

Figure 4: GCC projects currently executed by sector, 2011 (%)



Source: MEED Project – January 2011

rates have been declining recently they remain high compared with other countries of similar wealth.

At 57% Qatar displays the highest cession rate in the GCC given the high share of large risks in energy, engineering and other commercial lines. In these volatile areas domestic companies retain hardly any

risk on their own balance sheet. At 40%, Saudi Arabia has the lowest cession rate, reflecting compulsory local reinsurance requirements as well as the significant growth of compulsory medical business which is largely retained by domestic insurers.

Takaful insurance is a particularly dynamic facet of the GCC insurance market place. With estimated contributions of US\$6.4bn in 2010, the GCC markets account for approximately 70% of the global market for Shariah-compliant insurance solutions. Within just seven years this business has grown tenfold and now makes up almost 45% of the region's total insurance premium volume.

About 40% of GCC-generated Takaful contributions are ceded to Shariah-compliant reinsurers (Retakaful companies). This cession rate is slightly lower than for the insurance market as a whole reflecting the fact that the share of largely retained personal lines business in the Takaful segment is above-average.

The mounting relevance of enterprise risk management in the GCC

The historical and international dimension

A textbook definition of risk management would perhaps encapsulate the following: "The identification, evaluation and economic control of events that threaten the assets, human resources and earning capacity of, or pose a liability or reputation threat to, an enterprise."

Risk management is, arguably, as old as risk. For example, the precursors of bills of exchange and promissory notes date back to the *feitsyan* of 8th century China, the *suftadja* and *hawala* of the 10th – 13th century Arab merchants and the Italian merchants' *respondentia* bonds of a similar period. These combined between them protection, risk transfer and collateral properties associated with risk management. The industrial revolution gave impetus to the practice of risk management as a pre-requisite to insurance in certain classes.

However, it is only a few decades ago that professionals started linking the practice of risk management to corporate governance, creating a more holistic enterprise risk management (ERM) or integrated governance, risk management and compliance (GRC) culture, tied to internal audit processes. On that basis, a comprehensive approach to managing compliance, financial, hazard, operational, as well as strategic risks, while ensuring a maximum alignment with the enterprise's objectives and risk appetite, evolved.

The initial impetus in the UK was certainly the Cadbury Commission Report and regulations that

ensued spanning two decades since the early nineties. Similarly, in the USA, Sarbanes Oxley (SOX) legislation impacted not only the corporate conduct of US joint stock companies but also that of international organisations directly or indirectly active in the US. According to the Business Finance Journal "About 35% of Sarbanes-Oxley compliance is ERM companies need to be able to measure risks that are material to the business" (April 2004). Similarly, the Cadbury Report and subsequent regulations pushed corporate risk management from a traditionally fragmented ('silo') process to a more holistic process with board oversight.

In addition to legislation and regulations, strategic thought on the topic has also been greatly influenced by losses and failures which grew in scale as economies became more globalised in nature. In fact, integrated corporate governance, risk management and compliance together with internal audit gained new precedence as a result of the recent financial crisis. A typical example of this is the changes international rating agencies, such as Standard & Poor's, made to their credit rating methodologies putting significantly more emphasis on ERM as a measure of credit worthiness and financial strength.

Environmental catalysts to ERM development in the GCC

A more structural catalyst to ERM is the socio-political and economic environment, in particular in the GCC region. This is perhaps the main differentiator between the development of ERM on either side of the Atlantic when compared, for example, to the Middle East. The reasons why ERM/GRC is less prominent in the Middle East stem from:

- a more fragmented socio-political environment: for example, the US or the EU drive governance legislation over 50 or 27 states, respectively. In contrast, the Middle East region is not a unified socio-political force and therefore lacks that collective impetus to implement change as effectively as other unified geographical blocs;
- the Middle East region also exhibits a significantly higher number of family-owned businesses. This poses a greater challenge when trying to instill ERM since the corporate governance dynamics of these business models as compared to limited liability and/or public shareholding companies vary significantly. The owner/director/manager functions are less delineated in family businesses, even in the larger ones. This makes board oversight and the role of certain board committees less relevant;
- the cross shareholdings of the large business families within the region from import, export, construction and other sectors into banking and insurance

entities also challenge in the minds of many the applicability of ERM tools such as captive insurance companies. If, for example, a large family business empire owns a significant stake in a conventional insurance company, their perception is that the group already has a captive insurance company, albeit an 'open market' captive. With this state of affairs several benefits derived from captive insurance are actually being forfeited;

- post-Sept 11, 2001, the petro-dollar boom and the relatively benign impact of the global crisis on most regional economies, also meant that traditionally little, if any, attention has been diverted from core business activities to focus on cost containment (including risk control/transfer and alternative risk financing).

There is also a flip side to the above. There have been forces pushing for greater corporate governance, accountability and cost consciousness particularly in markets within the region, such as Dubai, that have been hit harder by the global financial crisis than other places in the GCC. Other than the crisis, catalysts for this include:

- the transfer of assets and projects from government hands to corporate institutions, resulting in more stringent reporting and control requirements;
- the listing of corporations on regional securities markets and increasing stakeholder scrutiny associated with it;
- international agreements (such as on anti-money laundering and counter terrorist financing), economic sanctions (such as in the case of Iran) etc. to which the countries in the region are signatories;
- legislative developments in certain spheres effecting ERM as well as GRC: one such development is that of captive insurance legislation that has attracted some of the larger international captive insurance managers (e.g., Kane which is licensed by the QFC Authority) to set up a presence in the region. In addition, the increasing number of insurance companies operating in the GCC, in conjunction with the expanding presence of international reinsurers within the region, provide potential captives with greater proximity to well-rated international reinsurance capacity and expertise.

Qatar as an aspiring regional hub for captive insurance

Qatar is determined to capture the momentum created by the region's economic dynamics, the rapid growth in insurable corporate assets and the increasing awareness of the benefits arising from a holistic approach to corporate risk management.

Therefore, besides reinsurance and asset management, captive insurance is one of the Qatar

Financial Centre's three financial hub strategies, aimed at diversifying the national economy away from hydrocarbon revenues. The main reason for choosing the captive sector was the opportunity to develop an industry with significant potential and little competition in the region. Captives are beginning to be considered by GCC-based corporations as viable solutions for their insurance requirements and an integral part of their overall risk strategy.

The first step of Qatar's captive hub strategy was to ensure a reliable and effective regulatory and supervisory environment. The Qatar Financial Centre Regulatory Authority (QFCRA) released in June 2010 a Consultation Paper that proposed several amendments to the QFC's captive regime, which would facilitate the establishment, licensing and supervision of captives. The recently published draft rules, among other things, propose to:

- clarify captive classes, to allow greater flexibility between the captive owner and the captive's policy holders;
- extend the definition of captive to recognise rent-a-captive and producer owned reinsurance captives, or any other potential type of captive structure (based on a case-by-case assessment of their commercial and risk profiles);
- review minimum capital requirements to ensure these are appropriate to the nature of the underlying risk profile of the business as well as ensure these requirements are comparable to other captive jurisdictions;
- possibly introduce a single rulebook for 'insurance intermediaries' which would include captive managers;
- introduce a capital requirement for insurance intermediaries that will be based on Singapore's approach, which requires minimum levels of paid-up share capital and a net asset value test;
- allow letters of credit to be used as eligible capital (entertained under certain conditions);
- base capital requirement on the higher of a percentage of premium or a percentage of technical provisions, similar to other captive jurisdictions;
- establish a zero tax environment.

Overall, the objective of the captive rule book is to ensure the legislative framework requirements are in line with other successful captive domiciles. These efforts have culminated in Kane being the first captive manager to be awarded a licence by the Qatar Financial Centre Regulatory Authority (QFCRA) and now being authorised as an insurance manager in the Qatar Financial Centre (QFC).

Overall, Qatar's aspirations in the area of captive insurance and corporate risk management will benefit from the country's unique advantages that will

underpin its development into a vibrant, modern and well-diversified knowledge economy:

- strong and sustainable economic growth perspectives based on huge natural gas reserves which are the world's third largest and have made Qatar's economy exceptionally resilient to the global economic downturn in the wake of the financial crisis;
- full access to the domestic market for foreign insurers, reinsurers and captives, rather than just an off-shore location - a key differentiating factor from other jurisdictions in the region;
- a superior legal framework which is based on English common law. Civil and commercial disputes may be brought before the QFC Civil and Commercial Court (in English), with laws independent from the state and adapted from major financial jurisdictions across the world;
- strong and credible governmental support, which includes the establishment of Qatarlyst, an electronic (re)insurance platform to conduct risk trading activities and the Qatar Finance and Business Academy;
- a rapidly developing domestic (re)insurance cluster;
- strong political, economic and historical ties, not confined to the Middle East but also extending to North Africa, Central and South Asia, making the country a formidable gateway to a wider region;

- a highly competitive operating cost environment (taxation, commercial real estate and the quality and quantity of air links);
- a firm commitment to establishing world-class regulatory standards modelled along the lines of the UK Prudential Regulation Authority;
- an attractive quality of living based on an effective balance between Western lifestyle and Arab heritage.

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