TRUST RE

PERSPECTIVES

MASSIVE INFRASTRUCTURE PROJECTS AND REGULATORY CHANGES BODE WELL FOR SURETY INSURANCE

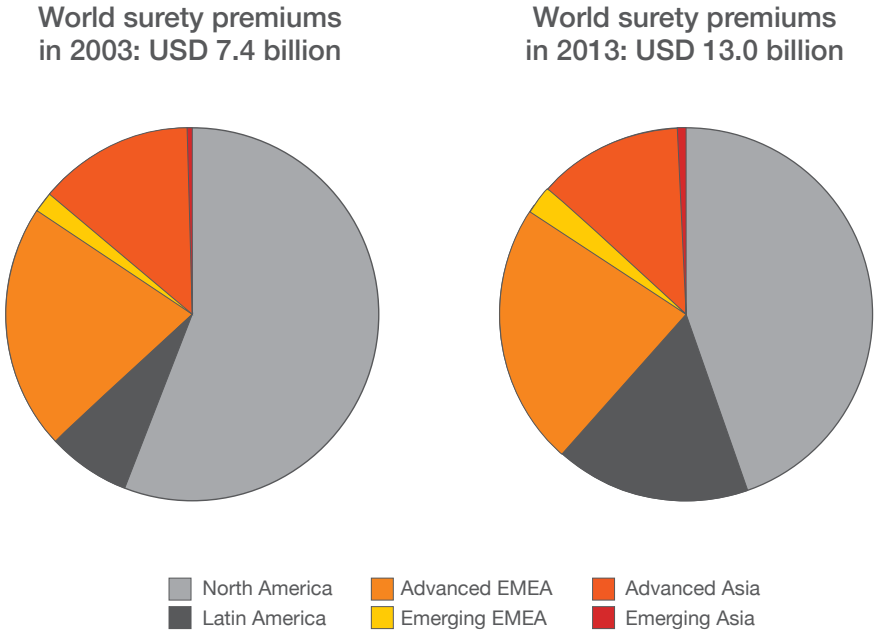
SURETY UNDERWRITING DEPARTMENT, FEBRUARY 2018

Strong growth dynamics, with setbacks due to the global financial crisis and commodity price fluctuations

The global surety insurance industry has steadily grown in relevance (see figure 1). Given its high dependence on public spending and investments in construction and infrastructure projects, the industry suffered a setback and contracted following the global financial crisis in 2008, but continued to benefit from a powerful structural trend - the growing need for infrastructure investments in both emerging and mature markets. Surety insurers enjoyed further tailwinds from tightening capital and other regulatory requirements which were imposed on the banking industry after 2008: traditionally the dominant providers of guarantees, many banks refocused on their core business and reduced their involvement in the guarantees sector. Surety insurers happily closed the resultant gap in supply. They also profited from amended regulations, which recognized surety insurance cover as an alternative to bank guarantees.

In emerging markets, including the Middle East, surety insurers were adversely affected when in 2013 commodity prices started their descent and, as a consequence, mounting fiscal pressure led to a reduction in public-sector infrastructure investments. Offsetting these headwinds, in the meantime, mature economies had recovered from the aftermath of the financial crisis, offering renewed fiscal leeway to modernize their ageing public infrastructure.

Figure 1: Geographic distribution of surety premiums, 2003 and 2013



Source: Swiss Re Institute

Surety premium volumes are difficult to establish because reliable figures are available only for a few markets. According to Swiss Re, in 2013 the global surety insurance market amounted to roughly USD 13 billion, with the US accounting for about 40% of the total. Compared with 2003, surety premiums expanded by about 75%. However, surety insurance remains a niche business, with a share of less than 1% in global non-life premiums and about 0.02% in global GDP.

An estimated USD 14.5 billion global market, with the US accounting for 40%

According to Willis Towers Watson, the US surety market has grown to USD 5.8 billion by 2017, which, assuming an unchanged market share, would translate into global premiums of about USD 14.5 billion. Other significant surety markets include Italy and Germany, Latin America (where surety cover is partially compulsory for the construction sector) and South Korea, with a dominant role of the state-owned Seoul Guarantee Insurance Company (SGIC).

Positive global sector outlook reflective of accelerating economic and construction growth

The overall outlook for the surety sector is positive. Global construction activities as its main driver steadied in 2016, growing at 2.4%. The global construction industry's growth is expected to accelerate in the next five years, at a projected annual average rate of 2.8%. This pick-up is reflective of a much brighter global economic outlook: over the next few years, the International Monetary Fund (IMF) expects real average annual growth rates of close to 4%.

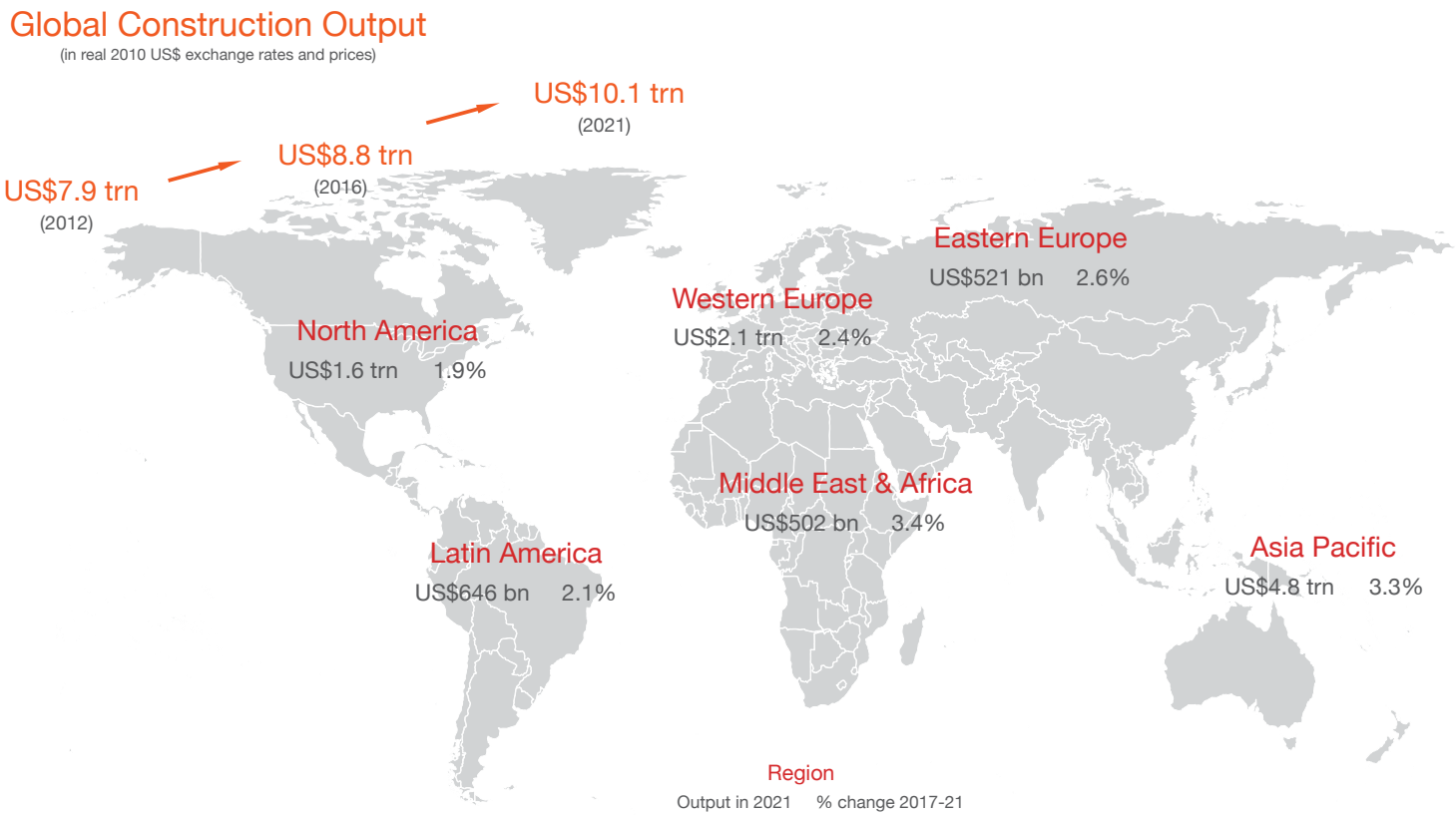


Figure 2: Global Construction Outlook 2021
(Source: Construction Intelligence Centre)

Increasing relevance of surety insurance in the Middle East

In the Middle East, surety insurers benefit from the region's large-scale infrastructure projects. Following the decline in oil prices in 2014 and 2015, some of these initiatives had been suspended. With recovering hydrocarbon markets and easing pressure on public budgets, construction activities picked up again rapidly. Dubai, for example, is currently preparing for the Expo 2020, which is expected to boost its economy by an estimated USD 23 billion, close to 25% of the emirate's overall GDP. Further big-ticket infrastructure and construction projects include Qatar's investments of about USD 140 billion in preparation for the FIFA World Cup 2022 and Saudi Arabia's USD 500 billion earmarked for the "futuristic" city NEOM. Initiatives of this scale offer huge opportunities for local insurance markets, but require capacity support from regional and international reinsurers.

As a result of falling oil prices, economic growth across the GCC region slowed down significantly in 2014 and the subsequent years. In response, regional banks tightened their lending practices and scaled back their exposure to guarantees. This retrenchment enabled surety insurers to assume a larger role in the contract guarantees business, providing more cover for so-called unfunded exposures, such as bonds and letters of guarantees, while the banks reserved their capacity for funded lines, facilitating the injection of liquidity in the market. We at Trust Re consider this mutually beneficial split of responsibilities between banks and insurance companies as one of the ways forward to develop the surety market in the Middle East, but we also believe in bank-surety syndication schemes as an innovative solution, leading to cooperation rather than competition among these players.

Surety opportunities in Asia

Driven by strong fundamentals, the surety sector is set to expand in Asia-Pacific, too. By 2021, the region is projected to account for close to 50% of the world's construction volume. China, which is expected to overtake the US as the world's largest economy by 2030, is becoming an increasingly attractive surety market. Previously, construction companies had to turn to banks for guarantee products but, as in the Middle East, China's Insurance Regulatory Commission (CIRC) now recognizes the benefits of surety guarantees, not least in order to secure sufficient surety capacity for the country's massive construction and infrastructure projects. In Southeast Asia, too, significant infrastructure projects are in the pipeline, auguring well for surety demand. This potential is partially related to China's 'One Belt, One Road' initiative (B&R) of developing trade links from China across Asia, Europe, Africa and the Middle East. B&R is projected to require overall investments of up to USD 7.5 trillion by 2030, generating significant amounts of additional insurance premiums across a wide spectrum of lines of business. See Trust Re's 2017 report on construction insurance in high-growth markets here.

Figure 3: 'One belt, one Road' investment opportunities
(Source: JLT Group and BMI Research)

Country	Total project value (millions of USD)	China-backed project value (millions of USD)	Precentage of projects backed by China
Bangladesh	82,349	13,381	16%
Indonesia	210,510	37,334	18%
Sri Lanka	13,493	2,744	20%
Kenya	43,387	13,005	30%
Kazakhstan	36,379	5,393	15%
Laos	22,298	9,141	41%
Pakistan	105,059	71,725	68%
Vietnam	300,927	26,146	9%

Conclusion

As explored in our study, the sheer size, scale and complexity of the envisioned investment activities, compounded by the heterogeneous nature of the territories involved, will give rise to significant risk management challenges in a wide spectrum of areas, among them classical credit, surety and political risks, such as defaults, non-payments of services or failure of the contractors to perform their contractual obligations.

Surety insurers and reinsurers are able to support the construction industry in managing these risks with sizeable capacity and know-how. We can contribute to bridge the gap between contractors and banks and inject liquidity into the system, making contractors less vulnerable to external shocks.

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