

THE DEVELOPMENT OF OFF SHORE OIL RISKS INSURANCE IN AFRICA

By

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From the moment Elf discovered the first oil wells in Gabon in the 1950s to this era of mega installations in Angola, Nigeria and Congo, the sums insured for offshore oil risks in Africa have continued on an upward trend. Today, with the continued reduction of oil resources, a new development boom is unfolding in Africa: new players, new investors are venturing into new oil wells even in very deep seas.



In what ways, then, have African insurance markets, lawmakers, insurers and reinsurers been involved in the insurance of off shore oil risks?

COMPULSORY INSURANCE

Off shore oil business was subject to the compulsory insurance Act in practically every African country. Although lawmakers did not particularly have oil risks in mind, that class of business was naturally included as one of those to be compulsorily insured.

What was the financial reality?

On the one hand, the African insurers had:

- Inadequate shareholders' funds (often less than US\$1 million)
- Reinsurance treaties that excluded off shore oil risks
- Annual premium income that could not measure up to the oil risks
- Underwriting limits that could not cover beyond the national territory
- Little or no training in the insurance of off shore oil insurance risks
- Little or no contact with international facultative reinsurance markets, which had little confidence in the security of African insurers.

On the other hand, the insured oil companies had:

- Shareholders' funds that were far higher (100- 1000 times higher) than those of African insurers

- Cumulative risks that were hardly lower than US\$50 million (physical damage, cost of control of wells, liability and cumulative transports)

International reinsurance programmes that covered their risks all over the world

Captive insurance companies that are also members of Oil Mutuals (OIL)

- Constant relationship with large international brokers and facultative reinsurance markets
- A good knowledge of their own risks.

Oil companies have always been aware of the conflict between their legal obligations and financial reality. Initially, they either ignored the law or obtained waivers from African political authorities.

Does that situation still obtain today?

The answer is affirmative in Equatorial Guinea, where no off shore oil company insures with a local insurer despite the substantial amount of oil produced and the fact that CIMA code applies. To the best of our knowledge, no other African country still remains in that situation.

THE PERIOD OF FRONTING

A balance had to be found between the legal obligation and financial security: fronting was adopted and still remains the most appropriate solution. Depending on the level of confidence reposed on the local insurer and the financial dimension, fronting is characterised by several features:

-The level of confidence:

- High level of confidence: the insurance premium is paid by the locally insured oil company to the local insurer who in turn pays, within a reasonable

period, the international reinsurer or captive imposed or proposed by the insured oil company. The international reinsurer or captive pays the reinsurance claim to the insurer who then settles the claims within a reasonable period.

- Minimal confidence: the locally insured oil company pays the insurance premium to the international reinsurer or captive and separately pays the reinsurance commission and local taxes to the local insurer either directly or through the broker. Reinsurance claims are paid directly by the international reinsurer to the locally insured oil company. A full cut-through clause on the payment schedule for premium and claims is included to mutually discharge the insurer and reinsurer of reciprocal responsibilities and liabilities towards the insured.
- Between these two extreme scenarios, several options are applicable. It should be recognised that the clauses governing these options are normally formulated by international brokers who are more concerned with protecting the interest of their oil clients than those of local African insurers. There have, indeed, been cases of clear aberrations: there was a case where losses exceeded USD 10 million and the local African insurer was bound to notify the lawyers representing the American bank - lenders of the oil company - but the addresses of the lawyers were never communicated to the African insurer who also never asked for them.

- The financial dimension

The commissions for fronting negotiated between the local insurer and the oil company would depend on the political situation and the number of local insurers that are likely to take part in the fronting: if the insurer has a monopoly of the market or if political Authorities impose a single oil insurer in a market of several local insurers, the single insurer would find itself in a position of strength and could negotiate a double digit figure as commission for premiums that exceed a million dollars.

In countries where several insurers compete within the market, the law of competition takes effect and unless the insurers reach an agreement, the commission rates

or fixed amount for fronting could, after the tender for local services, be ridiculously low. If the local insurer does not take the precaution of striking a balance between its commission for fronting and the various taxes and liabilities on the written premium as well as the costs necessitated by the legal balance sheet reserves obligations, it could end up with a financially negative fronting. Meanwhile, 100% of the local insurance premium would have been reflected in its turnover, placing it above other competitors in the ranking of insurance companies within the country.

A quick word on the obligation for statutory reserves: there have been cases where companies were compelled to constitute reserves for oil business in which there were very precise cut through clauses discharging the African insurer of any liability towards the insured should the reinsurer that was imposed by the insured not pay losses. Such a clause is perfectly normal. However, why do some lawmakers, as is the case with CIMA, compel the African insurer to constitute a reserve in such a case? It should be noted that the French law imposes similar obligations and the African lawmakers should, in their interest, detach themselves from the French example.

THE PERIOD OF RETENTION

Several countries have refused to be satisfied with the fronting solution. Angola is certainly the most radical of these countries as it has imposed, by law, its own local insurer, its local broker, its reinsurance broker in London, its London reinsurer and its own adjusters allowing the local oil company the liberty of choosing its deductibles.

The security of the London reinsurers was presented to the oil clients who found the names of their reinsurers on the list and therefore could not oppose it.

These same oil companies who are interested in producing in one of the most promising countries in Africa accepted the insurance terms imposed by the Angolan Authorities. Angola, the fourth African producer, was able to obtain a favourable outcome that a country with a lesser level of petroleum resources would probably not have been able to achieve. Indeed, it would be difficult for another country to give such conditions, if it desires to attract new oil operators.

There are also doubts as to the medium term reliability of the system in Angola as the only insurance company that is allowed to write oil risks now has private shareholding, yet a monopoly is still granted by the State of Angola. Other local insurance companies and international multilateral institutions in Angola would wish for the restoration of open competition sooner or later.

On its part, Nigeria has introduced a local content development policy, i.e. local retention in which local insurers and reinsurers are expected to write a minimum of 45% of oil risks in 2007, to be increased to 70% at the end of 2010.

Each insured oil company should submit to the Nigerian supervisory Authority the proof that it has exhausted the financially available local capacity before receiving approval to patronise international reinsurers. It is also envisaged that the Nigerian local insurer and no longer the insured oil company would select appropriate international reinsurance broker to cover the relevant risks. At the same time, Nigeria has carried out the sanitisation of licensed insurance companies, which with effect from 28 February 2007 are required to have a minimum capital of 3 billion Naira (about US\$22 m) to continue to carry out business in the Non-Life class, which covers off shore oil risks.

The policy reasoning behind this reform is as follows: an oil producing country should take advantage of its oil wealth to develop other non-oil sectors of its economy. It is abnormal for the bulk of the oil insurance premium to be exported abroad for the economic development of foreign countries.

Again, while the Nigerian insurers will invoke the legal obligation, the international insured oil companies will harp on financial security. The Nigerian insurers will also refer to their increased capital (the authorised minimum has been increased by 20 times), their improved experience in writing oil risks after over ten years, their numerous contacts with the London reinsurance market, while the insured oil company would counter with the argument that the cumulative limit of the existing or prospective deep sea Contractors' All Risks Policies exceed one or more billion dollars. Therefore, 45% of that amount would be completely beyond the financial capacity of local insurers. They would also

argue that their bankers, lenders and shareholders require their insurers to have a minimum of A- rating by Standard & Poor's. It would be noted that Africa Re is the only Nigerian based reinsurer with a BBB+ rating by Standard & Poor's, which is lower than A-.

WHAT ABOUT INDIGENOUS AFRICAN OIL COMPANIES

It is not only international oil companies that operate in Africa. There are also an increasing number of African companies, both state owned and private.

How do they manage the placement of their off shore oil risks? It is difficult to have an exhaustive understanding of their insurance placement policy as we do not have specific knowledge of each of them. In the course of our professional life, we have only been able to gain insight into their insurance policy, which is characterised by wide diversity:

- Some African oil companies are not key players but only act as partners in fields operated by international players. In that case, the percentage of their interest in the partnership is normally reflected in the insurance policy of the operator. Thus, the international operator decides on the insurance policy. By contrast, in Cameroon, the national oil company is not an operator but controls the insurance policy. It places the risks in the local market, which reinsures them with international and African reinsurers. In that case, the African insured takes charge of its insurance policy and decides on the risks, the sums insured, the values and deductibles. In the previous case, it supports the policy of the operator, which does not often suit that of the local African oil company. The financial resources of a local African company are totally different from those of the international operator. Therefore, insuring the two companies with the same deductibles makes no sense. This case is only one example but there are other inconsistencies, whenever an international oil company includes an African oil company in its international insurance programme. Insuring two such different entities in exactly the same way makes no sense.
- Large national African operators in Algeria, Libya, Nigeria and Angola have their own insurance

policies and cede various shares to the African insurance market (local insurance and reinsurance companies) and it would be interesting to quantify these shares precisely.

- New African private operators generally approach international insurance brokers, which assist them to design insurance policies that respond to their needs and, subsequently, place their risks in international markets with very low local retention. Thus, African insureds demand the same level of financial security from their insurers (a minimum of A- from Standard & Poor's). At first, it could appear surprising that these African insureds behave in the same way as international insureds and do not seek to favour African insurers. Two reasons can be adduced for this behaviour:

1. They are equally concerned with their financial security.
2. Most often, they also borrow from the international money market to finance their activities and the lenders demand the same security covers for their insurance. The same security rules apply, as required by globalisation.

WHAT ABOUT LOSSES?

In the policy reflection that led to the development of local insurance retention, the issue of losses in off shore oil insurance is rarely mentioned. One only has to read the press in markets where local content is canvassed to have the impression that losses do not exist. Premiums develop the local economy but losses do not impoverish the local economy because no body talks about losses. One cannot treat the issue of insurance risks in off shore oil activities in Africa without mentioning the risks of losses and their consequences on the local insurer and the local economy.

Let us take a specific case: a storage vessel in an off shore field in Cameroon is worth about US\$60-80 million. In the event of explosion and total loss, the cost of pollution, the cost of cargo and loss of business for several months have to be added to the amount. In all, such a loss would exceed US\$100 million.

Let us imagine that the Cameroonian insurance market is bearing these risks solely without reinsurance sup-

port: payment of such a loss would throw Cameroonian insurers into insolvency as they, consequently, would no longer be able to pay losses in the Motor, householders' comprehensive, SME fire, etc...and the failure of insurers would lead to a series of other failures. How would the economic interest of the country be served? It would be recalled that, in the early 1980s the storage tank « Fako » exploded off the coasts of Cameroon.

THE WORLD MARKET

An analysis of global financial results in this class of business in the past decades would reveal that there are cyclical variations of four to five years. While some cycles are profitable, others are to a large extent negative. By and large, insurers do not or hardly balance their technical result and the cost of operation (international brokerage, underwriters, Claims Managers, specialised and highly paid adjusters) is very high compared to other classes of business.

In Europe, these results have led to the following phenomenon: in the early 1980s several insurers took part in the risks with the majority and the most prominent based in London, but today, how many of them are still writing off shore oil risks?

- No insurer or reinsurer from Spain, Portugal, Italy, Holland and Denmark (the list is not exhaustive);
- Two companies from France, two from Switzerland through their London office and one from Norway;
- Insurers from England, although the number of underwriters has dropped drastically.
- A few American insurers, mainly through their subsidiaries in Bermuda or London
- Some new companies from the Middle East, Africa and lately China, which restrict their activities to their natural geographical space.

The rate of failure has therefore been very high and African insurers should reflect on this as well as the reasons for the survival of English insurers. In our opinion, the reasons are as follows:

- Financial consolidation (the coming together of syndicates, mergers of companies) and the regular inflow of fresh capital.

- Consolidation of knowledge: with the drop in the number of insurers, there has been a marked improvement in the quality of underwriters and claims managers.
- Geographical scope: all the oil business from all over the world find their way to London, thereby ensuring:
 1. Geographical diversification of risks,
 2. Constant improvement in the quality of underwriters who are able to assess and accept or reject the risks. A London underwriter handles about 20 risks per week; how many does an insurer from Africa handle in a year?
 3. The high number of risks (and therefore premium) written for the same underwriting capacity. Providing a capacity of US\$25 million 150 times in a year for 150 different risks from 50 different countries enables you to protect yourself with an oil treaty that is hundred times better than if you were only able to provide the same capacity of US\$ 25 million only twenty times in the same country.
- Proximity of the reinsurance market: apart from these advantages that are related to the diversification of the portfolio offered to treaty reinsurers, U.K. insurers have always been very close to the U.K. or European reinsurers. The reinsurers trust them because they have confidence in their professionalism and therefore can create solid protection by way of good oil treaties whereas local African insurers can hardly obtain an oil treaty from the same reinsurers.

THE WAY FORWARD

Having undertaken this overview, it would be difficult to complete this article without proposing improvements that would enable African insurance markets to make progress in the area of off shore oil risks. Let us go back to the reasons for the success of the U.K. insurers and consider whether African insurers can draw inspiration from them and adapt appropriately:

- Financial Consolidation: this is an imperative that has not escaped the initiators of the reforms in Nigeria. The minimum capital of USD 22 million that has been fixed is not adequate compared to

the existing deep sea off shore risks in Nigeria, but that is a tremendous step forward. The shareholders who invested their capital would now start clamouring for return on their investments and if 20 companies are left in the market in 2007, it will not be easy for each of them to make profit on the sum invested. That would have been easier if only 10 companies were left.

It is now left to monitor or see if other countries would decide to follow the example of Nigeria. In our opinion, that would be a necessity. Indeed, should this financial consolidation be limited to only the existing national boundaries or extended to cover the entire African geographic zone?

- Improvement in know-how: this improvement can only come by way of consolidation of companies. First, the initial training cost and effort could be easily borne by companies that have already been consolidated. Secondly, know-how can only develop and be sustained if those that have acquired it are able to apply it on about fifty different risks in a year rather than one or two. That being the case, the field of operation of the oil insurer should not be limited to its national territory, but should at least become pan-African.
- Geographical scope: London insurers accept business from all over the world. No African insurer can balance its results by remaining in its national territory. It should at least be able to write within the frontiers of the African continent. There is also the need to consider how this necessity can be allowed to flourish side by side with the practice of local fronting which is already in existence and assures local insurers of some income.
- Proximity to the reinsurance market: in this regard, the London advantage can only be recognised and not adapted. It is only when African entities have been adequately consolidated, present an improved quality and write sufficient number of business that they can create their own treaties or at least line slips, that would enable them develop their underwriting capacities.

Apart from the English example, it would be necessary to consider the success of the Energy business in

Africa Re: With a paid-up capital of US\$100 million, the Corporation offers an underwriting capacity of US\$ 27.5 million, including the oil pool, which is an average capacity of a Lloyd's of London syndicate. Africa Re writes off shore oil business from the entire African continent and has started accepting risks from the Middle East and South East Asia. The Corporation, which obtains two reinsurance treaties to protect its capacity and is rated by Standard & Poor's (BBB+) and AM Best (A-), has trained competent personnel and does not hesitate to engage the services of foreign specialists.

It has earned the trust of Chevron, Total and ENI, oil companies that require a minimum of A- rating

(Standard & Poor's) from international insurers and reinsurers. Indeed, Africa Re involves interested African insurers through the Energy pool, which it manages.

In my opinion, it would be interesting for the Management of that Corporation to present a brief background of that success in a future article and emphasise the difficulties the company had to overcome to arrive at the current stage of development.

That example could inspire some groups of African insurers in various countries, as I consider it important that companies should be able to write off shore oil risks from as wide a territory as possible to have a chance of maximising their investment.