

Ing. Kurt Staub
Swiss Reinsurance Company



Insurance and Reinsurance in Project Financing

I know how this field is, in fact, very much behind the know-how of the banks, we have no specialized department, specialized service in this field, but I think there are good chances that we might catch up in the very next future. My presentation will first include a summary of the present situation and our position in respect of the insurance covers available in this field and I'm obviously open in this respect to any new ideas that have already been expressed by Mr. Franco Curioni and then Mr. Spasiano. Many issues I'm dealing with overlap with other presentations and contributions which have been made yesterday and this morning and therefore I will go quickly on my slides and maybe emphasize those few aspects where I see specific problems related to P.F.

In the second part I will deal with one of the interesting issues in this field. There are two interesting fields, one is advancement of profit, but you already heard Giorgio Tiozzo talking about it and later Mr. Haeger will speak about this subject, but I will make a short presentation of the problems we are facing now with the so called "non vitiation" clause in C.A.R. or E.A.R..

The problem basically is that there are very high risks in the field of P.F. due to the high leverage, as it was already said before, and the lenders obviously try to transfer most of this risk to the insurers and reinsurers.

We are obviously prepared to look at these issues, but there are few fundamental scenes we have to take into account: we always need sufficient information and one interesting aspect I saw from the presentation of the Credit Suisse.

Well, in the bank they are investing a lot of time, a lot of expertise in this field. They are doing a very thorough assessment of the situation and I would wonder whether this information could be made available to the insurers too.

The second condition is that obviously all possibilities of avoiding/mitigating risks have to be exhausted, so we don't want to step finally into the field of the banks, or the field of the owners as such and the third condition is that the criteria of insurability have to be satisfied. They can be satisfied in the field of the very traditional insurance, but we are also thinking more and more about the so-called alternative risk transfer models which are being developed at present. First, I would like to show the different classes of risk we see in the P.F., maybe it will be different than the classification made during other presentations.

We see first of all fundamentally the entrepreneurial project risks. They are not separated here into the very stages of the project.

The second are those related to the performance of the contract, mainly technological and contract performance risks.

The third are the political risks, then accidental loss, damage or injury and the last one the third-party liability aspect, damage to third parties. Let's start with the first class. We've already seen some examples of this risk, the very classical one of underestimation of costs: let's say that the Channel Tunnel is a very good example.

The overestimation of productivity, think about a mine, for instance; the market risks when I produce something I can't sell later and last the so-called currency risks: in many countries I will have different currencies in dollars, but then I would sell a product in the local currency and these are the very, the main, I would say, as there are others we have seen yesterday, but these are the main risks we have seen in this field.

These risks are fundamentally the risks of the sponsors, the owners and the lenders. We know that the main consequence can be no or insufficient return.

I would say fundamentally for this kind of risk the insurance is not available. Why is it not available?

Because we feel that it really corresponds to the core activity of an owner and it is really the field we do not want to step into, because we feel that as insurers and reinsurers we don't have the necessary expertise and anybody in our field feels that's his job and to do his job very well. I think that Mr. Spasiano already had some very similar results.

The second class would be those risks related to the execution of the contract where we are faced with such poor design, not well defined specifications. We are facing probably this prototype, insulations, new design, new technology, we have to deal with problems relating to the performance of the contractor. He is not doing well his planning, he does not supply the products according to the specifications, the manufacture is not being well done and we may have to face some cost estimation borne by the contractor, I'd say. Therefore the people responsible in this field finally: there's risk of the designer, risk of the contractor and risk of the suppliers. But one thing we have to bear in mind in this field, that these entities have all been chosen by the owner and with the support and the assessment made by the lender; therefore I think there's really a kind of shared responsibility.

The consequences we all know: we can have no completion or late completion, cost overrun, we can have low plant performance. Again we will have no or insufficient return, but those things may also lead to so called accidental loss or damage.

In the insurance field there are some possibilities here to partially cover these risks: the professional indemnity to cover the interest of the designer, which I didn't mention and obviously the performance bunch the contractor can take, protecting not his own interest, but the interest of the owner.

In this field some cases of liquidated damages have been discussed. Mr. Christen did a good contribution to this field saying again that in fact they don't think it's our core role as an insurer/reinsurer to

cover the low performance of the contractor. Again, in another field, I mentioned before the field of the owner.

The owner has to know what he's doing, what he wants to do and he has to bear some of these risks.

And again there are the contractor and the designer. They are the professionals to carry out properly the work to do, a good manufacturing and a good design and therefore we are not very in favour of covers in this field of tenant's liquidated damages.

We know that certain covers might be available, maybe in the London market, but I would say anyway if such covers are being given by the insurers and reinsurers that will be in a selective way. We will certainly not give covers for insurers who do not perform according to international standards.

Quickly the political risks. Well, we all know war, civil war, S.R. C.C., expropriation, we can have problems with the governments, the government may stop a work, they may also face the situation where the security in a country is not sufficient anymore to have the people stable there: that's also a risk. This risk, I mean, the risk born again by the owner and by the lender, but obviously the contractor. They are also faced with this risk and other parts involved, as the suppliers. We must say this is one of the very very delicate fields where I can understand that they are looking for insurance, but I can feel that the insurance, the classical insurance has tremendous difficulty in properly assessing the risks.

We know the consequences of this: we can have no or late completion, cost overrun due to the delays, abandonment of the works, we can have also again physical loss or damage.

As I said before, fundamentally no cover is available the traditional no cover is available in the traditional market. You will find it more by the so-called export credit agencies.

I will not go in depth into this problem here. They rely on mainly government protection and they are obviously in a much better position as we as reinsurers and insurers.

Let's go to a chapter which is obviously much more familiar to myself and mainly to most of you, when we talk about so-called accidental loss, damage or injury.

I think the risks in this field and the causes are known to you: major perils, fire, technological design, material workmanship, negligence, malicious acts and, at a certain extent, also the political risks.

The interesting fact is that these risks finally are a bit borne by all the parties involved in a project, starting from the lender and finishing with the supplier and the sub-contractors; they all bear a part in this risk.

Generally the direct consequences are the accidental/physical loss or damage every kind of injury too and, as a consequence of them the so-called delayed start-up.

Insurance is available. Obviously you all know C.A.R., E.A.R., where we put in some limitations i.r.o. political risks: we're not going to cover the consequences of a war, for instance. We also might find it necessary in some fields to put in limitations i.r.o. the purely entrepreneurial risk; we are talking not about the entrepreneurial

risk of the owner, but the entrepreneurial risk of the contractor and the supplier.

I'll take a very classical example nowadays: the gas turbines.

We know the gas turbines, their constant evolution, every year the manufacturer finds a new solution to improve the performance.

This a clear risk, where we have to put in some limits, we are not prepared to overtake them in full.

We protect here the interest of all the parts and what a very peculiar example Mr. Spasiano said. He gave us a good example of where an insurer or reinsurer look at a very, nearly at a package of problems. He does not only look at one specific aspect, like doing liability, for instance.

It's a very, very broad cover, covering a lot of interests against a lot of different causes. Later we have the delayed start-up, called also advanced loss of profit cover, but as I said already, some colleagues will go more in depth into this problem. Here clearly, as I said, we protect only the interest of the owner, not the interest of the contractors.

This one is a very wide cover and I would go in a problem which was raised in the past days or yesterday, I think.

For it's an extremely wide cover, comprising material damage and the consequences, the delay in fact.

I find that the price being asked for by the insurers and the reinsurers will sometimes have a certain influence on the price, not always, I must say.

These prices remain finally very reasonable. If you look at what was raised yesterday by some of you, of how much are the costs, the additional costs for the project, for the financing, you know, we remain at a very reasonable level: we still use to calculate our prices in permille, not in percent.

And finally, if you look at an average international product, I would say that if you look at the material damage cost, we would have a range of, say, 4 to 10 permille, depending on the type of project and if you add, let's say, 50% approximately for a reasonable delayed start-up cover, we are in a range of 16 to 15 permille.

This price is applied not on the overall cost of the finance project, but just in fact on the contract value, on the value of the works and therefore in the overall it remains a very reasonable price for an extremely wide, extremely complete cover we are granting.

But that is also one of the reasons why in fact I must say we have not, as reinsurers at least, we have not been very successful in the past years, I must say, to all of you here.

The C.A.R., E.A.R. business: we have lost quite a lot of money, mainly in the last five years, and therefore I hope you will understand some time when we say we have to get a the reasonable price for a highly exposed project with a rather wide cover.

We go a bit into the operational phase. Obviously, we have the very classical fire cover and the business interruption. All are loss of profit, how it's called here; the machinery breakdown is a loss of profit, but there is also one cover which is not very well known in several countries. Well, we call it completed construction, it's also called

C.C.E.R., which means completed civil engineering risk cover. This cover is a kind of fire cover being available not for buildings of plants, but available for civil engineering risks which could be roads, which could be dams or some other items.

It can be in a war risk form, all these forms are available, all these forms can be dangerous, but sometimes we are able to answer correctly the covered risks.

Obviously with this cover we can easily add also a business interruption. We have been building certain portfolios and certain for a project which have been realized within the P.F. concept, which are now in operation.

Maybe motorways and this is a very interesting field, which we will be able to develop in the future.

I think that all the covers I mentioned here are very familiar to you, so I would not say anything about it.

The problems now, but I will not go into depth, are some insurability criteria in the delayed start-up, advanced loss of profit covers.

It is a very delicate field and I assume that Mr. Haeger will say something about it.

And I will therefore go over quickly to the second part of my presentation: non invalidation. In fact we said something about the third-party liability aspect. It's all known to you.

Liability is available in different countries: third-party liability, the motor insurance, professional indemnity, all kinds of liability cover. We are also granting liability within the C.A.R., E.A.R. and somebody mentioned yesterday that in fact we are very rather restrictive in granting high sums for liability in C.A.R., E.A.R. and we all know that and we have to go to this.

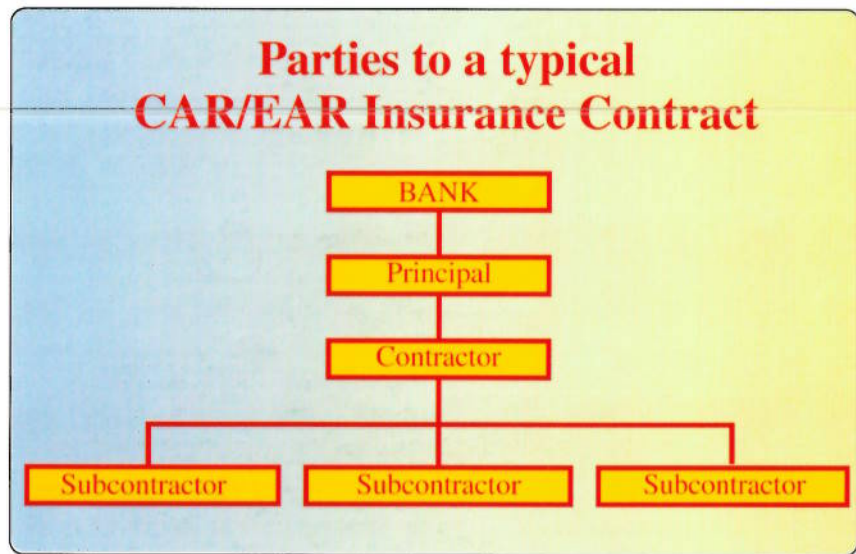
We have to take this step, because the liability problem has become an increasing difficult field in the last years and we say, OK, we do liability as an ancillary cover to C.A.R. and E.A.R., but it should be the main cover and let do the liability to the liability people and we still can put together, as we have done in several cases, a package of policies with the same insurers, the same reinsurers - why not - including the material damage section and then the liability section. I think the possibilities there are very, very wide, but we would not want this, we don't want to have these liability covers reinsured in the engineering market.

That's just the message but there's also a delicate problem in the liability, but that would take us half a day to talk about, that's the cross liability. So I just mentioned it here and maybe next time we can look into this. If I'm not too late, I would show you a few slides on the non-vitiation clause.

Non vitiation clause: we talk about the implications and recommendations to C.A.R., E.A.R. insurers. In fact this non-vitiation is appearing in other policies, but where we really have faced the problem recently is in C.A.R., E.A.R. We all know who are the parties in a typical C.A.R., E.A.R. contract, I don't have to go into this again.

But what does it mean to vitiate? Vitiate means to make nil and void or to invalidate. The non-vitiation clause in fact obliges the insurer

not to invalidate the policy under any circumstances whatsoever, that's what the clause says (Picture 1).



Picture 1.

In the general conditions of the C.A.R. or E.A.R. policy, we will find some cases, some situations where a policy cover can be validated. For instance, it's very classical the non-disclosure of material change of risk, the cessation of works, misrepresentation, fraudulent claim, false declaration, those are very classical articles we'd find in a policy. Also we can have wilful act, intentional lack of safety measures, non-compliance with statutory requirements, non-compliance with technical clauses like, say, the open-trench clause, for instance. Where's the origin of the non-variation?

The origin are the banks. They probably talk to the brokers and they have a good idea: let's transfer this risk to the insurers and reinsurers.

So this is a requirement of the banks in the debt-financed ventures. It should be in fact that the initial intention was that it should be for the benefit of the banks. In fact it has become, as shown in the latest formulae, not only for the benefit of the banks, but also for the benefit of the principal and the benefit of the contractors and the sub-contractors and that in a very wide cover. Again I draw your attention to this fact: an extremely wide cover, with all parties insured, has considerably increased, is going to increase, the cover being granted by a C.A.R., E.A.R. policy. In fact in the C.A.R., E.A.R. policy we would have two different possibilities (Picture 2).

The normal possibility would be consider the joint insured status where all the parties insured are in fact regarded as a single entity that's how we understand in fact the C.A.R., E.A.R. policy.

The second possibility is that we have a composite insured status, where each of the parties, the principal contractors, the sub-contractors are considered as separate entities and when we say "the insured" everyone is considered as an individual insured (Picture 3). You might find this concept also appears for instance in the cross liability: they bind up some common problems here together with the cross liability.

Clauses			Who can recover from Insurers?			
Joint Insured	Innocent Non-Disc	Non-Vitiation	Named Insured			
			Subcontractor	Contractor	Principal	Bank
NONE			NO	NO	NO	NO
√			NO	NO	?	?
	√		NO	?	?	YES
		√	NO	YES	YES	YES

Assuming the **Subcontractor** is responsible for the misrepresentation - answers differ acc. to local jurisdiction

Picture 2.

Clauses			Who can recover from Insurers?			
Joint Insured	Innocent Non-Disc	Non-Vitiation	Named Insured			
			Subcontractor	Contractor	Principal	Bank
NONE			NO	NO	NO	NO
√			NO	NO	?	?
	√		NO	NO	?	YES
		√	NO	NO	YES	YES

Assuming the **Contractor** is responsible for the misrepresentation - answers differ acc. to local jurisdiction

Picture 3.

How does a non-vitiation or so-called non-invalidation clause look like? The summaries, the papers you'll find on your desk may be a bit more extensive. I don't want to be too long and too boring on this subject.

Fundamentally it says that, I will just read it: it is agreed that failure by one insured to observe and fulfil the conditions of this insurance shall not prejudice the rights of other parties under this insurance. That's what such a clause says.

What does it mean? In fact it means that the insurance is not invalidated by any action; the ones we have seen before, the exclusions we have seen before.

It could be wilful or not, it could be fraud, misrepresentation, non-disclosure of material change and the insurance has to pay in such cases anyway and there's no right of recourse (Picture 4).

In fact there's no right of recourse in our policy being considered. One of the consequences is if such clauses are included in a policy, but I would say that in fact the problem is not very well under control, because even in policies where we have no clear definition, we don't know finally whether we have joint insured status or composite

Clauses			Who can recover from Insurers?			
Joint Insured	Innocent Non-Disc	Non-Vitiati	Named Insured			
			Subcon-tractor	Contra-ctor	Principal	Bank
NONE			NO	NO	NO	NO
√			NO	NO	NO	?
	√		NO	NO	NO	YES
		√	NO	NO	NO	YES
Assuming the Principal is responsible for the misrepresentation - answers differ acc. to local jurisdiction						

Picture 4.

insured status. I must say that we could face some problems in the future, but in fact if it is expressed clearly, I think that the risk is much more increased that the judge will be against the insurance. It increases generally the moral hazards, covers the fidelity and integrity of all the insured parties and in fact we are leaving with such clauses the basis of an insurance party: the material damage insurance policy.

So we are stepping in a very delicate field.

There's an example here of what could happen for instance if one of the sub-contractors tells the main contractor that, instead of doing a costly pile foundation, he will do a cheap slab foundation. There's a consequence that has happened already: several times, we have had a few cases in Zurich development, the building subsides and suffers a serious damage which can lead obviously to a total collapse.

So we would obviously normally deny such a claim, saying that this has been a material change of risk and the insurer has not been informed about that.

With the non-vitiati/invalidation clause, there is no change to reject such a claim.

Therefore we would recommend that we should refrain from accepting such clauses in C.A.R., E.A.R. policies and we should insist in fact on having, if possible, a so-called joint insured clause in the policy. I said it before, even in policy with no stipulation in this respect is not very clear how the situation is, so you'll find here one of these examples.

I think it will not be very useful that I read it to you here in detail. Be careful, because these clauses can be included under many titles; we've also seen non-vitiati, non-invalidation.

The joint insured clause can be very dangerous, it can express not what we think is a joint insured, it can be something really different, we also call it sometimes bankers clause.

I just say be careful. If you're doing business in the international market these things do not seem to do in C.A.R., E.A.R., but obviously we have to find a solution for this field and also we are strongly against, we refuse to see these covers in the C.A.R., E.A.R. We know

that the London market - maybe Richard can say something about it later - and we Swiss in Zurich, we are also looking at this field and we would be glad to be able to prepare a solution in the next future. It will be probably by a separate policy made available mainly to protect certain interests; I could think of the interests of the banks maybe, maybe the owner, but obviously we would need for such a project all the collaboration. As I was saying at the beginning: take the information on the risk, for instance.

The information we get is generally by far not of the level of the information that the bankers get and, since they work in percent and we work in permille, we don't have even the money to make any extremely thorough assessment in this field.

We also feel the pressure of the brokers, of the reinsurance brokers, they usually prefer a quotation yesterday than tomorrow.

Anyway these problems are not new, so I hope we will be able in the future to talk again about this extremely interesting subject and I thank you very much for your attention.