In this issue, we examine China’s astonishing plan to recreate its glory days – and Asia-Pacific risk managers reveal why large-scale infrastructure projects don’t always run as smoothly as planned.

By Jessica Reid, StrategicRISK editor (Asia-Pacific)
Following the risk managers’ roadmap

Planned infrastructure projects are said to be worth $9trn, with Asia accounting for a third of this. But a StrategicRISK survey of Asia-Pacific risk managers suggests there’s room for improvement.

1 Getting in on the ground floor (if that’s possible)

Large infrastructure projects suffer from significant under-management of risk in practically all stages of the value chain and throughout the life-cycle of a project, according to McKinsey & Company.

In particular, the consultancy says poor risk assessment and risk allocation early on in the concept and design phase lead to higher materialised risks and private-financing shortages later on.

The results of the StrategicRISK survey echo this sentiment. Risk managers said they were least involved during the planning/design phase of infrastructure projects.

Gammon Construction risk and opportunities manager Eamonn Patrick Marley says that optimistic planning and assumptions need to be challenged. Risk managers have a role here, but the opportunity is limited. “There is more involvement at the tender stage, but I think again it is limited,” he adds.

“Risk managers/management should be involved from the earliest stage as possible and have a continuous integrated role. This would be consistent with, say the risk CDM (Construction Design and Management) processes in the UK.”

Lendlease group head of risk and insurance Kevin Bates says “risk management is whole of project in my mind.”

He explains: “The risk professionals need to be involved before the project even becomes a project, and maintain involvement right through to carrying out a lessons learnt at the close of a project.”

2 Deciding how much time and money a project needs

Infrastructure projects are high on the agendas of governments, and the infrastructure development and investment pipeline is huge.

The global project pipeline is estimated at present to be $9trn, with Asia accounting for one-third of this.

Many major projects suffer from cost overruns and delays, but proper risk management can help, according to 65% of Asia-Pacific risk managers involved in infrastructure projects (see graph below).

Lendlease group head of risk and insurance Kevin Bates says this figure should be higher. “Most overruns come as a direct
The infrastructure sector significantly undermanages risks and lacks professional risk management, according to a recent McKinsey & Company report.

One issue, it says, is gaps in risk training and a lack of commitment in embedding a risk culture from senior management. The survey respondents appear to agree. Some 80% said there were gaps in risk training in their infrastructure project, and 63% agreed that each division on the project has different practices on risk management, some formal, others less so (see above).

Singapore-based risk manager Eric Lee agrees that much more can be done. “Managing of risks should be a company-wide responsibility. It starts from management and cascades all the way down to the person making risk decisions on the project (e.g. project managers and engineers) on a daily basis,” he says.

With so many parties involved, maintaining consistency in risk culture and training can be a problem. Lee recommends educating staff and contractors through constant dialogues and reinforcing the message of decentralised self-management for the project: “These actions taken on the sub-project level will enhance the capabilities when aggregated at the project level, bringing down the overall project risk.”

result of the competitive tension in a bid situation.

“Clients want speed and cost efficiency and, as a result, programme and budget need to be engineered to be as economical as they can be,” he adds.

“This of course means that float and contingency are eliminated. The downside, in addition to this, is that the client contractually passed both time and cost risk on to the contractor, while retaining the upside risk in that the contingency and float have evaporated in the bid stage.

“If the client accepts that, contractually, the risk of time and money rests with the contractor, then they need to allow for appropriate float and contingency. If they want to retain the contractual risk themselves, then they need to allow for mechanisms to adjust for overruns.”

Gammon Construction risk and opportunities manager Eamonn Patrick Marley agrees that overrun issues can occur in bid situations.

“As approval processes lengthen and infrastructure projects become increasingly complex and unique, this increases the programme duration, which is not always reflected at the initial planning/design,” he says.

According to Peter Jackson, director, Asia region for Lockton brokers, the survey results illustrate that effective risk management can anticipate where issues are most likely to arise.

“Important parallel skills are effective project management to co-ordinate work streams and also effective contractor management. This includes aligning major contractor risk management with the overall project management approach.”

He adds: “Too often major projects can descend into acrimonious legal disputes because client and contractor interests aren’t aligned, resulting in finger-pointing rather than collaboration to get issues fixed.”

WHAT IS THE SINGLE BIGGEST RISK FACING YOUR INFRASTRUCTURE PROJECT?

- Labour shortage
- Cost
- Completion on schedule and as per initial plan
- Macroeconomic conditions
- Financial risk
- Country security and instability
- Lack of suitable labour due to government competition
- Getting entitlement
- After safety of personnel, failure to deliver on time to budget
- Project management competency
- Overruns in cost and time
- Delay in delivery of project
- Lack of skilled labour
- Lack of civil projects to win – this affects foundation, E&M and other supplementary divisions
- Inadequate innovation to deal with changing technology
- Scope creep, resulting in potential costs, time and operational delays

3 Risk culture and training

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THE KNOWLEDGE

INTERNATIONAL TRADE

How the president plans to make China great again

Xi Jinping’s hugely ambitious One Belt One Road initiative aims to emulate the economic glory days of the ancient Silk Road. Many observers are convinced it will fail. Has he bitten off more than he can chew?

In 2013, Chinese president Xi Jinping launched an epic plan to revive domestic growth and ramp up the country’s position in the world.

One Belt One Road (OBOR) covers about 65% of the global population, more than a third of the world’s GDP and about a quarter of all the goods and services the world moves.

As the name implies, the initiative comes in two parts: the belt and the road.

The ‘belt’ is the physical road from China through Europe to northern Scandinavia. The ‘road’, on the other hand, is actually the maritime Silk Road – essentially, shipping lanes from China to Venice (see map, pages 6-7).

“The belt, the physical road, and the maritime Silk Road would recreate the shipping routes that made China one of the world’s foremost powers many, many years ago,” says McKinsey & Company Asia chairman Kevin Sneader.

The idea, in short, is to redirect China’s excess capacity and capital and export it to Eurasia via these two ‘new’ trading routes.

This will require major infrastructure, trade and investment. Many doubt that the initiative will come to fruition.

But then again, the Chinese and their backers have deep pockets.

BACK TO THE DRAWING BOARD?

China itself has set up a New Silk Road Fund of $40bn to promote private investment along OBOR. In addition, the Asia Infrastructure Investment Bank (AIIB) has supported the initiative with some $100bn in lending. While the China Development Bank will invest a similar amount into more backer projects across 60 countries to bolster the scheme.

McKinsey & Company managing partner Joe Ngai remains sceptical. “While we have the AIIB and the Silk Road Fund and the New Development Bank, if you add it all together, it’s still a very, very small amount relative to what needs to be funded, which is roughly between $2trn and $3trn per year,” he says. “There’s a lot that’s got to happen before this moves off the very grand and appropriate drawing board and into practical reality in some countries where it’s proved quite difficult to deploy funds.”

Big questions also remain on transparency and the deployment of funds. But for every skeptic there are two optimists and, to date, the funding and political backing for the projects has certainly been impressive.

When it comes to likely beneficiaries, Deloitte Global Chinese Services Group Southeast Asia head Dr Ernest Kan - and Xi Jinping - have money on Indonesia.

In April last year, the Chinese government loaned the Indonesian government $50bn to help develop its electrical, mining, energy and railways projects.

“The Indonesian economic growth is very promising,” says Kan. He points out that Joko Widodo, the president since 2014, “has committed to building close to 40 infrastructure projects, including seven railways, six water supply and power, six toll roads, seven sea transportations including sea ports and 12 air transportations, including airports”.

He adds: “By lending money, it could also help the Chinese to win some of these foreign construction contracts.”

Observers expect Hong Kong to be a key player too. McKinsey’s Sneader says: “Hong Kong’s role has been the gateway on many levels for China to the rest of the world. “While that role has been shifting, Hong Kong remains a vitally important financial centre, an RMB trading centre and a source of advice, perspective, and assistance for Chinese companies and Western companies trying to work with each other. So it would be disappointing if Hong Kong somehow didn’t have a very important role to play.”

Western companies looking to capitalise on infrastructure opportunities are likely to encounter hurdles. Dr Kan says that because its purpose is to push out excess Chinese capacity, major projects will largely be undertaken by domestic players.

“In basic infrastructure [the Chinese] deem themselves capable, so there’s probably less opportunities in those areas than the Western companies are looking for,” he says.

They will also need to compete with Japanese and Korean firms that are “very active players in Asia when it comes to infrastructure”. However, Western firms that operate in niche technology fields such as defence and aerospace will be well placed to capitalise. “That’s where [Chinese]
technology has been left behind the Western technologies,” he says.

Otherwise, says Kan, Western companies should look for smaller subcontracting opportunities on the larger projects.

But all of these OBOR initiatives depend heavily on political support. “It has to be under a very stable political environment for these projects to continue,” he notes.

And in some countries where leadership changes and political coups are not uncommon, investors and developers alike have voiced concerns.

“If you have a change of government, there may be challenges,” Kan says.

“Just like the nuclear plant project in the UK that was signed between Xi Jinping and David Cameron, the immediate past prime minister of the UK. Theresa May (the new prime minister) seems to take a different view on the nuclear plant project and they want to put it on hold, even though it was approved under the Cameron government.”

SOCIAL CAPITAL
Kan also predicts challenges for local Chinese players, particularly those building projects in countries with differing languages, cultures and risk tolerances.

“The Chinese will have to learn how to build social capital to make sure that they also take care of the local social environment,” he says.

Zurich China’s chief executive, Michael Yu, agrees that differences in risk management approaches could prove a hindrance, especially when it comes to projects developed by China’s state-owned enterprises (SOEs).

“Most [SOEs] are far away from [having] a global risk management culture and risk management systems and they are also very much challenged by the lack of talent and leadership teams who fully and truly understand their global exposures,” says Yu.

Many of these multi-billion-dollar, SOE-led projects don’t even have a risk or insurance manager. This raises difficulties for insurance partners trying to ensure their exposures are covered, not to mention concerns for international investors.

Insurers like Zurich, who are looking to capitalise on the initiative, see an opportunity to offer risk services and risk transfer products, with an understanding of the risk, compliance and regulatory requirements of the countries that SOEs are looking to develop in.
GLOBAL CONNECTIONS

The ultimate in joined-up thinking

The implications of One Belt One Road are staggering. Our illustration shows exactly how it will criss-cross much of the world – while opposite, we look at the projects that stand to benefit.
China
China invested ¥820bn in railway infrastructure in 2015, with total investment expected to surpass ¥4trn in the next five years. The Export-Import Bank of China is one of the banks funding rail construction projects. It recently signed a lending agreement with China Railway Corporation granting a loan of ¥500bn for major infrastructure projects.

A high-speed rail route connecting China’s northwest region to West Asia via Central Asia has been proposed. China and Laos have also announced a 430km railway connecting Boten on the Laos-China border with the Lactian capital, Vientiane. The $6bn project will create a new freight and passenger route into emerging markets in Southeast Asia. Eventually this could extend to Singapore.

Russia
China has invested $5.2bn in a high-speed railway project that will connect Moscow to Kazan in Russia’s Tatarstan region. This will extend more than 770km and reduce a 12-hour journey to three-and-a-half hours. The longer-term plan is that the railway will be extended into China. China Railway Group will design and build the rail connection, while Chinese company CRRC will supply the rolling stock.

Aeroplane routes
China intends to add another 200 international air routes in 2016, focusing on flights to nations involved in the OBOR initiative. This should boost its growing aviation industry, which recorded its highest ever profits (¥54.8bn) in 2015. Aviation is key for strengthening connectivity between China and OBOR nations. A shortage of relevant infrastructure is being addressed, with Beijing committed to investing ¥77bn this year on the construction of civil aviation infrastructure.

The Middle East
Chinese president Xi Jinping pledged in January that China would provide financial support to Iran, which recently saw longstanding international sanctions lifted, to construct a domestic high-speed train connection between Tehran and Mashad as part of OBOR.

During a stop in Cairo earlier on the same trip, the president reportedly signed a number of agreements with Egypt under which China will provide financial support for Egyptian infrastructure projects. The total investment in these projects will amount to $15bn.

Kazakhstan
In early 2015, the Chinese government announced that it would invest more than $20bn in Kazakh infrastructure projects. China is Kazakhstan’s second-largest trading partner and largest export market, especially for oil, gas and uranium, the major Kazakh exports.

Pakistan
The Asian Infrastructure Investment bank (AIIB) is to make its first ever loan on a Pakistan-based project, financing the construction of a 64km, four-lane segment of a highway in the Punjab region. The AIIB will be a co-financier of the project along with the Asian Development Bank (ADB). AIIB and the ADB are providing $100m each in financing.

Europe
China’s premier Li Keqiang has said that his country is looking to co-operate with the upgrading and improvement of port facilities/areas in countries such as Croatia, Slovenia, Poland, Latvia and Bulgaria.

With billions up for grabs, where is the money going?
The past two years were a slog. Now it’s getting exciting

The Chinese have bought Australian construction and engineering firm John Holland. Risk manager Bronwyn Friday suspects they’ll be more adventurous than their predecessors.

“In a construction and engineering company, you’re up against optimism bias. Even when they’re seeing projects go wrong, they always believe they’ll get the next project right.”

According to Bronwyn Friday – group general manager, risk management, at John Holland – this is one of the key risk management challenges in the construction and engineering industry. And she should know. A construction manager by trade, Friday has worked in risk management at John Holland for the past eight years.

But her role, and the company, have evolved significantly over that time, she tells StrategicRISK.

One driving force has been the company’s ownership. In April last year, the Australian-headquartered business was sold by Leighton Holdings to China Communications Construction Company, the largest listed company in the international infrastructure and engineering sector.

New owners mean a new risk appetite and risk tolerance.

“We’re still in the process of getting to know our new owners and getting to understand what they need, and what’s just a legacy from our old owner versus what’s going to actually generate benefits for us,” says Friday.

Indeed, when she spoke to StrategicRISK, she was putting the finishing touches on her enterprise risk management board report.

OPEN TO PERSUASION

“In two months’ time I’ll have a much better sense of where they sit [on ERM],” she says. But her feeling is that they will be more willing to take on risk than their predecessor.

“I wouldn’t say they’re risk-aggressive, but they’re more open for us to have a conversation that we’re confident taking a risk on to win a job. The board and the management team are in a sweet dance at the moment of trying to understand what is the actual risk profile.”

This is evolving as new business opportunities arise, and the company seeks to expand into new markets and change its strategy.

“They want us to be a development and investment company. They want us to develop our own [projects] and they also want us to go overseas,” she says.

The global expansion play shouldn’t be a surprise, given the state of the construction and engineering market in Australia.

Like most of its peers, John Holland has shrunk significantly over the past few years as the country’s pipeline of work has dried up.

“At the moment, we’re focused on Singapore and as our owners get more confident, they will express where we can start looking outside that, but they do have a desire to take our skillset and the brand further than Australia. And they also want to own more of these operational businesses,” says Friday.

“It’s been a big slog to get through the last two years, through the sales process and the new owners getting to know us, but now it’s getting exciting,” she adds.

She thinks the acquisition allowed her team to look at the business through fresh eyes.

“There were times in the sales process where we looked like we...
I wouldn't say they're risk-aggressive, but they're more open for us to have a conversation that we're confident taking a risk on to win a job. The board and the management team are in a sweet dance at the moment of trying to understand what is the actual risk profile.
could be split apart, and so we wanted to make sure that all parts of the business would be successful as it went forward and so we also developed an org structure for a split business. In the end it didn't happen, but that was quite a valuable process to go through," she says.

From setting up frameworks around strategy and business planning to pricing risk in pre-contracts, Friday's role now covers both corporate risk management and project risk management. "It's this division of work that keeps her engaged."

"I love working with engineers [and] being in a company that builds things and makes things. There aren't many [risk] jobs out there that you can be so embedded in how the company is actually doing the work and I really love it," she says.

She also thrives on the ups and downs of the sector. "The construction industry's a rollercoaster – you have incredible booms and incredible busts. Where in Western Australia and Queensland we're in utter bust – there's just hardly anything there – in Sydney and Melbourne there are more major projects than we've seen for decades."

Friday graduated from her construction management degree during one of those busts. Work opportunities were scarce in the mid-90s and she bounced between companies, changing firms depending on the project, before landing a project management role at GE.

Her introduction to risk management didn't come until a few years later, however, when she took a role at Marsh Risk Consulting. Corporate risk management roles at PowerCor and Fosters followed, meaning Friday could cement her skills in using risk management to empower strategic and business decisions.

"If we are not enhancing how [executives] can make a business decision then I don't see any value for doing risk management," she says.

CLIMBING A MOUNTAIN
So, how does she challenge the common perception of risk management as being a 'handbrake' to progress?

"Sometimes I don't. Sometimes I sit there and think I have no idea how to go forward. Then I go back to what a really good mentor told me – the only way to eat the elephant is to keep eating," she says.

"I have already climbed half the mountain and I just look at all the more I'd like to see happen, which I don't think is all that different from any risk manager I've ever met.

"We can always see how we can help make better decisions for the business; it's just how much time and effort the business wants to put into it being focused on risk management versus they believe they already do it well enough."

At the moment, innovation and corporate governance are two of the key areas that Friday is helping the business to navigate. "If we can't keep with or ahead of innovation that's happening across the industry, then you can get yourself lost behind," she says.

From 6D modelling to robotics, drones, the Internet of Things and 3D printing, massive change is happening right across the industry. "It's that sort of innovation that we need to be right there or ahead of it to be offering clients and to stay relevant to the industry. But all of these innovations also bring new risks," she says.

They are also, typically, being introduced by smaller, more agile companies, which presents another challenge. "The business is literally in this decision process at the moment in how do we allow ourselves to be agile and resilient as a company by having the right governance structure and the right operating model. I don't think we're there yet," Friday says.

Another big risk is resources. "At the moment there are resources out there – you've got them all flowing off the oil and gas and mining jobs. But there's a point on the mega-jobs where we're going to hit not being able to have the resources in the industry to support all of them," she says.

Despite facing the trifecta of smaller turnover, fewer resources and new owners, Friday remains upbeat. "Risk management gave me the skillset to understand that you can focus on what's going wrong but the aim is to work out how to make it go right," she says.
The construction industry’s a rollercoaster – you have incredible booms and incredible busts. Whereas in Western Australia and Queensland we’re in utter bust – there’s hardly anything there – in Sydney and Melbourne there are more major projects than we’ve seen for decades.”
TROUBLESHOOTING

Nip that crisis in the bud

The operational risks associated with infrastructure projects are many and varied. In this illustration we’ve highlighted a few of the common risks facing major projects, citing examples of how risk management and risk transfer can help to mitigate the exposure.

**Nat cats**
Natural catastrophes and other poor weather events can cause significant delays and damage to construction projects that are difficult to predict and budget for. Inadequate infrastructure and weak logistic chains also substantially increase the risk that an extreme natural event will become a disaster, according to the UN’s World Risk Report 2016. Its author, Dr Matthias Garschagen, notes: “Sufficient, high-quality infrastructure, which is well managed institutionally, can not only prevent the often catastrophic consequences of natural hazards such as flooding or storms, but it can also play a crucial role in the distribution of humanitarian aid supplies in the event of a disaster.”

**Bribery and corruption**
The most corrupt Asia-Pacific countries, according to Transparency International’s Corruption Perception Index, are North Korea (167th out of 168 countries), Cambodia (150), Myanmar (147), Laos (139), Vietnam (112), the Philippines (95), Indonesia (88) and China (83). The region-wide infrastructure and development boom means that the risk of bribery is high.

**Red tape and regulation**
Peter Jackson, director, Asia region for Lockton brokers in Thailand, said insurers and brokers can help construction companies manage their regulatory risk in three ways: by ensuring that all insurance policies are locally compliant; by checking a company’s risk management practices meet local, if not global, safety standards; and by making sure that a client’s insurance cover is consistent across multiple jurisdictions.

**Strikes and protests**
Gammon Construction risk and opportunities manager Eamonn Patrick Marley says identifying and assessing the risk of unrest is vital. Financially unstable subcontractors should be filtered out, he adds, citing “failure to pay labour” as a cause of strikes. He suggests sharing previous experience and lessons learnt, and carrying out stress-testing on projects for a strike/protest scenario in the business continuity plans.
Supply chain disruption

Lockton’s Asia region director, Peter Jackson, says it is crucial to map supply chains to identify potential bottlenecks: “The key issues are single supply arrangements, ability to deliver on time and product quality. Getting assurance around these three issues is essential in mitigating supply chain risk. Procurement processes need to include these in supplier assessments and in mapping the entire supply chain.”

Cultural issues

Instilling a consistent risk culture across regions is one of the key challenges facing global infrastructure firms, particularly in developing countries where standards tend to be less rigorous than those associated with Westernised companies.

One risk manager who works for a global construction firm says tone from the top is essential in helping to set risk culture: “Without demonstrating that management and the board takes risk management seriously, staff might not get the essential motivation to focus on risks as part of their daily activity. Leading through example and constant query on risk matters will enhance the overall buy-in within the rank and file.”

Lendlease group head of risk and insurance Kevin Bates says: “You can tell people what to do and attempt to make them compliant, but until you have them thinking and believing and feeling it for themselves, you’ll never quite get there.”
Risk professionals on major projects are meant to deliver value. So why aren’t they?

As an extraordinary number of complex projects fail to come in on time and budget, it seems that owners are losing faith in risk management. The following five phenomena help to explain what’s going wrong.

1 The governance gap
The importance of effective decision-making and oversight in attempting to control material project risks is well documented. Despite this, good governance appears to be a forgotten premise in many environments.

If establishing a sound governance framework is so critical to project control and risk management, then where is the globally endorsed PMI, OGC or ISO project governance standard/guide and why do so few projects proactively test, validate and report on their governance effectiveness? Surely meeting attendance rates, captured minutes, decision approvals and completeness of assigned actions should be regularly audited?

Until project risk management standards, guides and practitioners start placing credible emphasis on closing the governance gap, conventional risk management approaches will potentially remain ineffective in major project environments.

2 Hidden hands and under-costing
A phenomenon exists in major project environments whereby those tasked with costing a project will often plan for the most optimistic cost or schedule estimate to get an investment decision across the line. This is often referred to as the hidden hand or optimism bias.

Such under-costing has proved problematic as the advanced strategies and resources required to effectively mitigate complex risks are often compromised from the very start due to the lack of an assigned budget.

Projects with ineffectively simplistic delivery frameworks will almost certainly overrun the owners’ agreed budget. The owners will almost certainly task the project executives to bring costs under control, and when these executives fail, the owners will be forced to raise more capital and dismiss them.

It appears a correlation exists between under-costing and executive longevity. If risk management is to add value to major projects, robust strategies, systems and resources will need to be costed in and planned for from the beginning.

3 Wicked risks and complex uncertainties
In complex projects, a class of risk that cannot be proactively predicted, identified or forecast in sufficient time and context to be controlled is known as a ‘wicked risk’. Risk forecasting processes are limited as they are systematic, linear and rational, while complex risk environments are more likely to be dynamic, deviant and irrational.

Risk practitioners need to move beyond standard process-based methodologies and design dynamic, multi-dimensional and collaborative risk strategies, systems and behaviours.

4 Lord of the Flies
William Golding’s 1954 novel describes how children trapped on an island resort to tribal savagery to survive. It was inspired, in part, by studies that observed how mild-mannered people will exhibit extreme or uncharacteristic behaviours if they believe their self-preservation is at risk, particularly in isolated or pressured environments.

Major projects often operate in an isolated manner removed from the line of sight of the corporate owner, and employees are expected to deliver without question or be replaced. The potential for uncharacteristic behaviour is rife.

5 Those who don’t learn from history are doomed to repeat it
There are now a few hundred years of major project learnings to use as a reference for best practice in infrastructure. Despite this, project owners often opt for strategies that are questionable, primarily due to their need to make budget, resource and schedule decisions. This may help explain those major project environments that:
- place limited emphasis on establishing a robust governance framework;
- intentionally under-cost projects just to get them across the line;
- adopt systematically linear risk management processes to mitigate complex and wicked risk environments; and
- appoint risk officers to report to the very same project executives who are incentivised to hide risks.

Over the past two decades, the global project industry has experienced noticeable improvements in defining and standardising both project control and risk management better practice. Despite this, complex projects are failing to come in on time and under-budget at an abnormally high rate. A number of phenomena impair risk management from delivering value in major project environments. These include:

- appoint risk officers to report on their governance effectiveness;
- intentionally under-cost projects;
- place limited emphasis on closing the governance gap;
- proactively test, validate and report on their governance effectiveness;
- until project risk management standards, guides and practitioners start placing credible emphasis on closing the governance gap, conventional risk management approaches will potentially remain ineffective.
IF AN OVERSEAS JOB GOES AWRY, HERE’S ONE WAY INSURERS CAN HELP

From regulatory restrictions to new tax requirements, contractors going abroad will face a host of new challenges that they might not have experienced in their home country.

But whichever country the new project is in, both project owners and contractors need to have some form of guarantee that the project will be completed and paid for as agreed. This is where surety bonds come in. And one of the key decisions with this is determining whether to source a surety bond from a bank or an insurer.

The purpose of the surety bond (or bank guarantee) is to guarantee the faithful performance on the part of the contractor of the contract being awarded in accordance with all contract conditions. In circumstances where there is one or more defaults on the part of the contractor, thereby resulting in a financial loss to the project owner, the issuer of the bond will have to pay the project owner up to the amount of the bond.

In some countries in Asia, project owners prefer a bank guarantee to a surety bond. But in markets such as Hong Kong and Singapore, both bank guarantees and surety bonds are acceptable.

Issuers of surety bonds/bank guarantees will usually assume to recover a meaningful portion of the loss if the bonds are called upon. Banks will rely on collateral deposited by the contracting entity when a credit facility is granted, while insurers will seek recourse against the defaulted contractor under an indemnity agreement.

There are a number of pros and cons to consider when choosing between surety bond issuers. Insurance companies typically charge competitive rates in most markets and in some cases are even more competitive than those offered by banks.

Nevertheless, insurers are also more stringent in their approach to underwriting because surety bonds are usually not fully “backed” by collateral as banks would require for issuance of bank guarantees.

Some contractors have the perception that applying for bonds from banks is easier than from insurance companies – this is partly true. Banks, especially the principal bankers of these contractors, should have already analysed the credit profile of these contracting entities when extending a credit facility to them. The downside of a bank guarantee is that the amount of such a guarantee will deplete the credit facility limit available from the issuer; or be considered as a drawdown from such credit facility. As a result, the more bank guarantees that are issued to a contractor, the less liquidity that contractor can have from their banker.

On the other hand, insurance companies will require more information from the contractor, especially when they do not have any previous relationship with them. As a minimum, an insurer will need audited financial statements of the contracting group for at least the past three years. This is because the insurer will underwrite the counter party credit risk to make sure that if they have to seek recourse against this contractor and/or its parent, the group will have sufficient funds to pay back the insurer.

Insurers also require contract backlogs and new contracts awarded to ensure the contractor has sufficient funds from its operating activities to satisfy their short-term debt obligations.

In case the bond is required to be issued by a locally licensed insurer domiciled in the country where the project is undertaken, the insurer will make use of its international network for issuance, or select a ‘fronting partner’ in markets where it has no local presence. The upside to an insurer issuing bonds is that insurance companies typically do not charge interest on the amount, nor deplete any credit facility available to the contractor from their bankers.

The wording is also important to consider. A bank guarantee is usually written on ‘unconditional demand’ format, where the issuer will pay the claim upon receipt of a written demand from the project owner, regardless of whether or not the claim is a legitimate one. The bond wording issued by an insurer, however, can differ from one project to another and can be conditional, conditional demand or unconditional demand.

If a claim is made under a bond which is issued on conditional wording or conditional demand wording, the insurer will usually engage internal and external counsels to review the details and negotiate with the project owner for a reasonable settlement. The contractor is also engaged, as this is an important part of the claims process conducted by an insurance company.

As a rule of thumb, an insurer will never deliberately settle a claim without consulting with the contractor, especially when they have the right of recourse over the indemnity agreement executed by such contractor and their parent company. By doing that, the contractor can mitigate some of their exposures associated with ‘unfair calling of bond’ on the part of the project owner.

In short, insurers can help contractors to overcome some of the hurdles of entering a new market, such as bond issuance, in a more cost-effective manner and without adversely impacting on their overall liquidity and cashflow.
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