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Political Risk Insurance: Insuring Against Man-Made Risk

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◆ Introduction

Political risk insurance (PRI) is one of the many tools that companies can use to mitigate the risk factors that can be inherent to operating in the developing world. By allowing policyholders to protect themselves from specific risks deemed to be most threatening to their venture (i.e., expropriation of control for an electrical company investing in a foreign domestic firm), PRI can pave the way for much needed development and help to make otherwise dubious projects into competitive ones. Put simply: PRI protects companies from risks arising from actions either directly or indirectly resulting from their host country's governance. Policies can be written to protect the holder from a number of eventualities, including currency inconvertibility and transfer restriction, expropriation and war, terrorism and civil disturbances. It can also be a tool used by investors to mitigate country risks associated with emerging market debt and equity investments, as well as the area of lending.[1]

Fundamentally, insurance is the business of pooling policyholder dollars to protect against a future undesirable event. The motivations underlying PRI are not dramatically different from those of other forms of insurance, but the scale is much different. This article introduces readers to PRI and provides an overview of the types of PRI offered by insurers and the state of the contemporary PRI industry. This article also provides valuable insights offered by Country Risk Solutions CEO Daniel Wagner.

◆ Demand for PRI on the Rise

Since the end of the World War II, the world has been dealing with globalization at an increasingly quickened pace. Multinational corporations (MNCs) from dozens of nations currently pursue opportunities in their established markets and in places only recently realized as opportunities for trade and development. To better envision this global marketplace, consider the business done by U.S. MNCs and investors. In 2010, U.S. MNC expenditures totaled approximately $621 billion and U.S. MNCs made use of the services of some 34 million employees (just less than half of those being employed abroad).[2]

The 21st century, while still young, has seen its share of the uncertainty and risk. Wagner notes that there is a general failure to acknowledge that "…the globalization process, while further enriching the world's most prosperous nations, appears to have contributed to the further marginalization of at least one-third of the world's people…"[3] The Correlates of War project reports that no fewer than 25 wars have occurred between 2000 and 2007.[4] The financial crisis of 2007–2008 kicked off a wave of financial reforms and social movement, and the effects can still be felt across the developing and developed world alike to this day. Unrest as a result of ethnic and social factions ousted long-standing governments in Tunisia and Yemen, spawned protests throughout the Middle East and precipitated civil war in Libya and (more recently) Syria, in what has become known as the Arab Spring.

Qualitative judgments regarding the legitimacy and morality of these events aside, it is risky for executives to seek expansion in the affected territories. Why open a mine when it could be lost to fighting? Why accept a contract to build a highway when the government enlisting that service might very well be gone tomorrow as a result of revolution or peaceful election? Why invest directly in a domestic company if new regulations might be passed to render that investment worthless?

That being said, there are absolutely reasons to engage with these nations. Africa, while still plagued in some areas by the deprivations of war and poverty, is setting the stage to be an enormous potential growth region. *Foreign Policy* magazine reports that the region will exhibit a workforce to rival any individual country, including the powerhouse markets of China and India.[5] The report goes on to detail that the African workforce is better educated than ever before and eager for jobs that will provide a good wage. The potential for mutually beneficial economic relationships between MNCs and the growth areas of Africa is high, if the associated risks can be effectively addressed. Tools for risk management are critical to businesses seeking to invest and operate in regions where stability is less than certain.

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[1] Hamdani, K., Liebers, E., and Zanjani, G., Federal Reserve Bank of New York (2005). *An Overview of Political Risk Insurance*. Retrieved from www.bis.org/publ/cgfs22fedny3.pdf.

[2] Department of Commerce, Bureau of Economic Analysis. (2012). *Summary Estimates for Multinational Companies: Employment, Sales and Capital Expenditures for 2010*. Retrieved from www.bea.gov/newsreleases/international/mnc/2012/mnc2010.htm.

[3] Wagner, D. (2002, March). *The Battle Against Terrorism: A Battle Against Stomachs, Hearts and Minds*. Retrieved from www.irmi.com/expert/articles/2002/wagner03.aspx.

[4] *Chronological List of All Wars* (n.d.). Retrieved from www.correlatesofwar.org/COW2Data/WarData_NEW/WarList_NEW.pdf.

[5] Lund, Susan and Van Wamelen, Arend. *Lions on the Move: 10 things you don't know about Africa's booming economy.* Foreign Policy Magazine. August 31, 2012.

◆ WHAT IS POLITICAL RISK INSURANCE?

Political risk insurance is defined as:

> "…a tool for businesses to mitigate and manage risks arising from the adverse actions—or inactions—of governments. As a risk mitigation tool, PRI helps provide a more stable environment for investments into developing countries, and to unlock better access to finance…"[6]

One of the primary factors in this definition is that the action triggering payment is prompted by a political action (though the specifics of what triggers a policy are determined by the policy's language). Even in the field of political science, scholars sometimes cannot say affirmatively whether government action brought about a series of circumstances, and studies have noted that the level of ambiguity inherent in political events can lead to disputes between insurers and policyholders over whether an insured action has taken place. Take, for example, the scenario outlined in one report. In the case of currency inconvertibility or transfer restriction policy, it would *not* trigger a policy if a local business simply stopped making a payment on its obligation, as this could be due to a number of factors pertaining to their own credit supply or business choices.[7] In order to trigger the terms of some currency inconvertibility or transfer restriction policies, payment must continue into the account over a period of months.[8]

At a basic level, PRI works in a fashion similar to many other forms of insurance. A policy is written to cover losses in the event of a finite event. Several features distinguish PRI from other insured risks.[9] For one, PRI addresses strictly noncommercial risks. Wagner states that "usually, answering the simple question of whether an action was in an insured's control or a government's control will determine whether a risk can be covered by PRI."[10] There is also a lack of hard data from which to draw conclusions, in addition to the fact that events leading to the payment of a policy are harder to define in actuarial terms.

PRI is characterized by this uncertainty to the extent that distinguishing between actual and perceived risk is difficult. It has been noted that "effective political risk management requires distinguishing developments that pose true risks—a well-defined threat to corporate performance—from political events that are merely dramatic."[11] In other instances, the perception that an area is risky creates a problem whether or not that perception is based on accurate information.[12]

These peculiarities led to some cost issues in the PRI market. The Federal Reserve Bank of New York conducted interviews with PRI providers in 2005 and found that issues surrounding the quantification of risk results in gaps in coverage and high prices that discourage participation in the market by some businesses. The Federal Reserve reported than only 10% of those requesting PRI accept the quote they are given for a policy, with 50% not receiving quotes for a project at all and 40% not accepting the quote they are given.[13] The high expense of underwriting political risk for the insurer is also a defining characteristic of these policies.

Despite some of the drawbacks that plague PRI, there is certainly a need for a risk-mitigation tool for corporations or investors seeking to enter developing markets. Many of the world's most lucrative business opportunities, be they taking advantage of new and growing labor pools or bountiful natural resources, are located in regions that are likely to be subject to the types of events PRI can help address. Terrorism is a threat to ventures across a number of continents. Wagner points out that terrorism has historically had consequences for businesses and will continue to do so, as businesses represent excellent "soft targets." Businesses may be the target of terrorism, or simply collateral damage. The terrorists who orchestrated the Sept. 11, 2001, attacks on the United States invested less than half-a-million dollars in their attacks, but were able to cause more than $50 billion in property damage. [14]

Where political circumstances allow for, or necessitate, strict measures of state control, various forms of expropriation are possible. The effects of the global financial crisis have exacerbated the likelihood that governments may take

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[6] PRI Center, PRI Essentials, "What is Political Risk Insurance?" Retrieved from www.pri-center.com/directories/priessentials.cfm.

[7] Hamdani, K., Liebers, E., and Zanjani, G., Federal Reserve Bank of New York (2005). *An Overview of Political Risk Insurance*. Retrieved from www.bis.org/publ/cgfs22fedny3.pdf.

[8] Ibid.

[9] Wagner, D. (2000, April). *The Impact of Political Change and How to Protect Your Business Against It*. Retrieved from www.irmi.com/expert/articles/2000/wagner04.aspx.

[10] Ibid.

[11] Wagner, D. (2000, October). *Defining 'Political Risk.'* Retrieved from http://www.irmi.com/expert/articles/2000/wagner10.aspx.

[12] Wagner, D. (2001, May). *Political Risk in Asia: The Need for Structural Reform and the Impact on Political Risk Insurance*. Retrieved from www.irmi.com/expert/articles/2001/wagner05.aspx.

[13] Hamdani, K., Liebers, E., and Zanjani, G., Federal Reserve Bank of New York (2005). *An Overview of Political Risk Insurance*. Retrieved from www.bis.org/publ/cgfs22fedny3.pdf.

[14] Wagner, D. (2004, May). *The Implication of Recurring Terrorism for Business*. Retrieved from www.irmi.com/expert/articles/2004/wagner05.aspx.

action to restrict the free flow of cash or the foreign ownership of domestic resources. Not only can PRI provide a structured bulwark against financial losses, but many (especially public) PRI providers have developed working relationships with foreign governments to help ensure their clients are exempted from potentially damaging laws.[15]

PRI can also help to serve a public need. Investors and insurers are fundamentally businesses and often find it difficult to balance the need to make an investment successful and profitable with local concerns, such as socioeconomic factors, rights of indigenous peoples and ecological concerns, but the project finance industry (of which PRI is one component) creates an environment where those pursuing ventures have good reason to look at their project margins *and* social factors.[16]

PRI is provided by three major types of entities: public insurers, private insurers and multilateral entities. Following describes more about their individual character:

> Public insurers have a mandate from their government to dispense PRI. They are more likely to write coverage with a policy goal in mind, set by their parent government.[17] As they are funded out of the public treasury, these insurers are also more likely to have restrictions on who they can insure and whether or not they are required to be an "insurer of last resort" for companies that cannot acquire policies on the private market.[18]
>
> Private insurers serve a niche market. They supply insurance in a similar manner to other product lines, but are more often than not associated with big multi-national or multi-line insurers.[19]
>
> Multi-lateral insurers are non-governmental entities (NGOs) that often seek to foster development in troubled or impoverished regions of the world that private insurers may not have an interest in covering.

It is worthwhile to address the fundamental question of what types of firms or investors most need PRI. Wagner said companies generally fall into three categories: those that insure everything; those that that insure nothing; and those that insure against the things that keep them up at night, which is a function of their own perceived risk. He said that the most important factors are an individual investor or firm's beliefs, experiences and risk-management philosophy, and whether those factors lead them to believe that their cost-benefit analysis values PRI. Ventures in a new place, with a new partner or in a new area of the world that traders of investors might not be comfortable with could be triggers for a company to seek PRI.

It is also important that some local companies acquire PRI when investing in projects in their home country. At the time of the Argentine economic crisis a decade ago, local companies could not obtain PRI due to prohibitive costs and a lack of interest in covering those companies on the part of insurers.[20] Information provided by the Multilateral Investment Guarantee Agency (MIGA)—which is a member of the World Bank Group that both provides and studies PRI with the aim of fostering investment in developing economies avoided by the private sector—shows that, while it is not strictly impossible for domestic investors to acquire PRI, it is still difficult.

MIGA can provide coverage to local investors who are repatriating capital to their home country, and many other multilaterals can provide policies under similarly restricted circumstances. They stated that private PRI has a wider variety of coverage circumstances and said that most Lloyd's syndicates would be willing to offer it, but questions would be raised about the level of risk in the country if its own nationals were seeking protection, and that these questions might affect that investor's ability to get a policy.

◆ HISTORY OF POLITICAL RISK INSURANCE

PRI first came into being following World War II, when a degree of uncertainty regarding global and regional stability discouraged investors from putting funds into areas that could be threatened by the spread of communism. The 1960s saw the U.S. Agency for International Development (USAID) begin providing investment guarantee programs,

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[15] Hamdani, K., Liebers, E., and Zanjani, G., Federal Reserve Bank of New York (2005). *An Overview of Political Risk Insurance*. Retrieved from www.bis.org/publ/cgfs22fedny3.pdf.
[16] Wagner, D. (2004, January). *Project Financiers' and Insurers' Roles in Promoting Social Responsibility in the Developing World*. Retrieved from www.irmi.com/expert/articles.
[17] Hamdani, K., Liebers, E., and Zanjani, G., Federal Reserve Bank of New York (2005). *An Overview of Political Risk Insurance*. Retrieved from www.bis.org/publ/cgfs22fedny3.pdf.
[18] Ibid.
[19] Ibid.
[20] Wagner, D. (2004, January). *Creating a Level Playing Field for Local Investors in the Developing World*. Retrieved from www.irmi.com/expert/articles/2005/wagner05.aspx.

with those functions being handed off to the Overseas Private Investment Corporation (OPIC) in 1969. It was not until the next decade that private players began to get involved in the PRI market, beginning with underwriting syndicates at Lloyd's of London and American International Group (AIG).[21] Demand for PRI was expected to wane without the looming threat of expropriation by communist regimes after the fall of the Soviet Union, but the attacks on Sept. 11, 2001, highlighted the vulnerability of many enterprises to risks still posed by terrorist organizations.[22]

◆ TYPES OF POLITICAL RISK INSURANCE

As with other types of insurance, specific PRI policies must be tailored to protect against specific types of political risk and is determined by a variety of interdependent factors. Not all nations will be subject to the same types of risk. Below are brief explanations for the common types of PRI.[23]

1. ***Currency Inconvertibility and Transfer Restriction*** – Protects against losses incurred from being incapable of converting local currency and/or the inability to transfer local currency or foreign exchange outside the country. This is specific to situations arising as a result of government action.

2. ***Expropriation*** – Protects against government action that would result in the loss of the rights to or control over insured property as a result of government action. This could take the form of outright expropriation (e.g., a mine is seized by a foreign government's troops overnight) or might include what is termed "creeping expropriation." Indirect or creeping expropriation would involve actions that, when taken cumulatively over a number of years, have the aggregate effect of a loss of control or rights to an investment or, alternatively, when a host government's actions interfere so much as to render the rights to property useless. This can take a number of forms, from the replacement by company-appointed management with state-appointed management, government takeover of a key supplier, restrictions on occupation of acquired land (or activities on that land) and confiscatory taxation.

3. ***Political Violence, War, Terrorism and Civil Disturbance*** – Protects against the loss, damage to or disappearance of tangible benefits as a result of the outbreak of hostilities or unrest in a host country. These policies can be written to include hostilities as a result of host country actions or the actions of a third party. Those policies can also cover losses resulting from the interruption of business due to hostilities. For example, an oil rig crew might have to be evacuated because a local conflict increases the likelihood that rig will become a target. Despite the fact that the oil rig is not physically destroyed, it cannot be operated without a crew and, therefore, the revenue for the period of the evacuation would be lost.

4. ***Breach of Contract*** – Protects against a failure of a government to pay or perform under a contract. This coverage is often used for infrastructure and mining projects.

As more and more nations become home to large investment ventures, some of these types of insurance have had to evolve to accommodate new leadership styles in developing and developed economies. One article observes that "… governments that may have once upon a time been in the habit of throwing out the rules at the whim of the latest autocrat are these days more likely to simply change the rules."[24]

Regulatory takings are also becoming more common at the expense of outright expropriation, according to a report by MIGA.[25] They note that those regulatory actions can be purely in the name of achieving a measure of expropriation more to the liking of new administrations but can also be a legal and legitimate exercise of regulatory power. To distinguish between legitimate and illegitimate regulatory action resulting in losses for investors, one must consider:[26]

a) Whether it interfered with an investor's property rights.
b) Whether the regulation was enacted for a public purpose, was non-discriminatory to a particular entity and followed due process.
c) Whether the economic impact was substantial enough to warrant compensation.

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[21] (2012, March 25). Retrieved from www.credit-to-cash-advisor.com/Articles/CreditManagement/PoliticalRiskInsurance
[22] (2002, Jan. 22). *Investment Guarantee Guide.* Retrieved from www3.cfo.com/article.cfm/3003066
[23] World Bank Group, Multilateral Investment Guarantee Agency (2012).
[24] Tuohy, C. (2011, May 1). "Twisted Turns in Political Risk Coverage." *Risk & Insurance*. Retrieved from www.riskandinsurance.com/story.jsp?storyId=533336574.
[25] World Bank Group, Multilateral Investment Guarantee Agency (2011). *World investment and political risk*.
[26] Ibid.

It is also worthwhile to recognize that buying PRI is not just useful for financial compensation in the event of a failed investment. Indeed, having PRI measures can serve to prevent harmful measures from ever targeting a company. In "Political Risk Investment Insurance: Renaissance Revisited," West and Martin point out that disputes have negative effects on existing ties (i.e., informal ties, trade agreements, security agreements, etc.) between an investor's home nation and host nation. Some countries and multilaterals have "nearly automatic sanctions against countries that have not effectively compensated their national insurers who have assumed…the rights to an insured investor's assets or shares…or to the local currency…."[27]

Certainly, a number of current events highlight the importance PRI policies can provide in mitigating risk for policyholders. The democratizing wave of protests and rebellions that has come to be known as the Arab Spring is likely to result in the renegotiation, and perhaps even total breach, of some contracts between affected nations and investors. A MIGA study reported that the events making up the Arab Spring have thus far resulted in a small number of claims, although sources also report a number of large trade credit claims in Libya.[28] The report estimates that Libya alone could see between $300 million and $500 million in losses, although, to date, little of what has happened has resulted in losses by insurers. In nations like Egypt, where foreign engagement was permitted, new governments might not look favorably on companies that chose to do business with their oppressors.

◆ CONTEMPORARY PERSPECTIVES ON POLITICAL RISK INSURANCE

In 2008, MIGA surveyed major PRI providers on their perceptions and experiences participating in the market. The data shows that, while PRI is increasingly popular, the market for such insurance is still relatively small.[29] Approximately 71% of respondents estimated that the contract written for PRI totaled to less than half of their total business written. That being said, the vast majority of providers believed that their PRI business would increase.[30]

In a 2011 report, only one-in-five firms reported using investment insurance akin to PRI.[31] MIGA reported that most mitigated their risk in foreign investments by implementing their ventures through a domestic partner, moving the project along slowly or undertaking detailed risk analysis as a precursor to putting a project into action. Further, firms viewed informal engagement with local leaders as the best approach, and many respondent firms expressed the belief that no tool could effectively alleviate certain manifestations of political risk.

Even taking all these concerns and alternative methods into account, the 2011 report stated that the market for PRI had increased by approximately one-third over the previous year.[32] In fact, for five years prior to the 2011 report, the PRI market grew more than the levels of foreign direct investment it was meant to protect. The bulk of contracts were written to protect against expropriation with coverage against war, civil disturbances and terrorism, forming the second-highest event insured against.[33] Clients seeking PRI coverage were primarily engaged in the financial market and infrastructure sectors and were seeking to cover ventures located in East Asia/Pacific, Latin America and South Asia regions, respectively.

Investment insurance claims specifically have risen in recent years, totaling nearly $221 million in 2010.[34] MIGA cautioned that single-year figures were prone to the effects of "single data point" events, but the claims statistic still illustrates an important point in the overall market picture. It is becoming evident that stability in the short-term is not a climate that can be taken for granted. In the Middle East/ North African region, a number of regimes that have stood for decades are falling victim to unrest as a result of shifting socio-economic factors. Reliance on local leaders alone does a firm no good if that leader falls victim to a coup or popular movement for regime change. If the leader is particularly unpopular, such past ties could serve to hurt a company's prospects for doing business with that leader's successor(s).

◆ CONCLUSIONS

Industry experts anticipate that the demand for PRI will rise in the coming years. With escalating tensions across the world, it is likely that analysts of foreign policy would agree with that assessment. A new, Western-educated leader has come to power in isolated North Korea, prompting discus-

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[27] West, G. T., and Martin, K. (2001). "Political Risk Investment Insurance: Renaissance Revisited." *International Political Risk Management: Exploring New Frontiers*.
[28] World Bank Group, Multilateral Investment Guarantee Agency (2011). *World Investment and Political Risk*.
[29] World Bank Group, Multilateral Investment Guarantee Agency (2008). *Survey of Political Risk Insurance Providers*.
[30] Ibid.
[31] World Bank Group, Multilateral Investment Guarantee Agency (2011). *World Investment and Political Risk*.
[32] Ibid.
[33] Ibid.
[34] World Bank Group, Multilateral Investment Guarantee Agency (2008). *Survey of Political Risk Insurance Providers*.

sions that he may be more developmentally oriented.[35] Vast deposits of energy resources have been discovered in the vicinity of Vietnam and the Philippines, sparking a standoff with the People's Republic of China, which disputes the other Pacific nations' territorial claims. A similar, if much less developed, tension has risen up around energy reserves in the Black Sea.[36] All of these scenarios provide opportunities for potentially profitable and potential risky ventures that might require companies to seek security through political risk insurance policies.

Wagner believes the market is likely to continue to expand. He pointed out that the PRI market has been expanding dramatically for more than a decade: "If underwriters and brokers didn't think they could make money, then they wouldn't get in it or stay in it." He believes that education about the product will help feed that growth, but that ultimately the market will be subject to the risk appetites of those participating in it.

"You can't invent perceived need and you can't create believers. Either companies perceive value in PRI or they don't," Wagner said. "There are many ways to manage cross-border risk, but over more than 40 years, PRI has proven to be effective, particularly to an educated consumer."

In an uncertain world, neither traditionally insured risks such as fire and flood nor commercial risks alone represent the entirety of risk facing investors and companies. Actions taken by governments, or as a result of governments, can be covered under PRI. The ill effects of currency inconvertibility, expropriation (either in its outright form or a more gradual "creeping" expropriation) and even civil disturbance, terrorism and war can be mitigated by seeking coverage from one of the many providers of PRI.

Despite the high cost of coverage and difficulty in obtaining PRI, it is one of many tools that can be used by risk managers to help reduce the risk facing their ventures in a foreign market. It is also a tool that can provide an incentive for companies to think about the social consequences of its actions. From a regulatory standpoint, however, Wagner sees no reason that it should be considered differently from any other line of business. "It's important that the industry be well regulated," he said, "but, at the same time, the industry also regulates itself." He pointed out that insurance wordings are frequently modified when claims are filed, as insurers learn from each claim experience, and that clients themselves tend to revise policy wordings according to their own risk perceptions. Compared to more mainstream lines of insurance, PRI is small, but its impact is much larger than its size would suggest, given its ability to prompt lenders to lend and investors to invest.

Small or large, it is undeniable that PRI plays a vital role in allowing companies to trade and invest in developing regions across the globe.

[35] Evans, J. R. (2012). "North Korea: Moving Toward Chaos or Reform?" The Brookings Institution. Retrieved from www.brookings.edu/research/opinions/2012/07/23-north-korea-revere.

[36] Kucera, J. (2012, June 22). "The Great Caspian Arms Race." *Foreign Policy*, Retrieved from www.foreignpolicy.com/articles/2012/06/22/the_great_caspian_arms_race.

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