TACKLING POLITICAL RISKS


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All international trade carries inherent risk arising from the economic and political condition of the partner with whom you are trading, whether they are a private company or a foreign government department. Governments change, spending priorities are amended and the consequences for an exporter can be severe. It is also an unfortunate reality of life in the early 21st Century that any trade contract can be exposed to the risk of political violence, be it war or terrorist activity.

These, and other risks, all fall under the banner of political risks, and it is important that exporters make a full assessment of such risks, and obtain an understanding of the tools available to protect themselves, so that the cashflow of the business can be managed appropriately. Political risks not only impact export sales, but can also impact the investments made by UK-based companies overseas, where assets based in emerging markets are exposed to such risks as confiscation, expropriation, nationalisation and deprivation. But for the purpose of this article, we have chosen to focus on the risk associated with export contracts.

DEFINING POLITICAL RISK. Essentially, a political risk event is one that frustrates the performance of an export contract, where that event is an action of a foreign government, or a foreign state-owned company, or even the action of the exporter's own government. We must also include in this definition frustration of contracts arising out of terrorist activity, war or other acts of political violence. Some examples are as follows:

- non-payment by a foreign government department in respect of their obligations under an import contract;
- the inability of a customer to meet their payment obligations due to restrictions placed on the transfer of foreign exchange (FX) by the customer's government;
- the calling of a performance bond by an importer following the revocation of the exporter's license by their own government, and the subsequent cancellation of the contract; and
- the frustration of an export contract through political violence, war, civil war or a terrorist act.

These events are all outside the control of the exporter and could result in their financial loss and the loss of their market share. Recent events that illustrate some of these political risks include the civil unrest in Haiti, the currency crisis in Argentina during 2002 and the war and continuing turmoil in Iraq.

HOW WOULD POLITICAL RISK IMPACT TREASURY? Any treasurer will be concerned to maximise cash and ensure optimum usage of banking facilities. To achieve this, it is obviously crucial to ensure prompt payment from customers, and many of the risks outlined above have the potential to disrupt cashflow and increase the risk of a bad debt. Exports to customers in developing markets often have increased margins. It is, however, a classic 'increased risk for increased return' position – that is, the margins are so attractive because the business is exposed to additional risk. This is especially true when dealing with foreign government departments, often over an extended payment period.

In addition, export contracts often require the issuance of on-demand bonds to foreign customers, which can restrict banking facilities, because of banks' requirement for counter indemnities to protect against their exposure to the exporters contractual performance risk (see *Box 1*).

WHAT TOOLS ARE AVAILABLE TO MITIGATE AGAINST POLITICAL RISK? The banking and insurance markets both offer solutions to the exporter when seeking protection against political risk. Which tools you, as an exporter, choose to use will depend on the structure of your contract, the need for external financing from your banking partners and your relationship with your customer.

First, it is important to understand the political and economic context in which your customer operates. Correct assessment of their circumstances will allow you, in conjunction with your professional advisers, to identify the risk mitigation tools appropriate to your situation. At each stage of the contract, the exporter is exposed to different risks and as a result will need to utilise different risk management tools.

'FOR EXPORTERS, IT IS IMPORTANT TO UNDERSTAND THE POLITICAL AND ECONOMIC CONTEXT IN WHICH YOUR CUSTOMER OPERATES'

BOX 1
An example of a typical contract

At the tender stage of the project, the exporter is required to issue a bond with its tender and therefore its banks are likely to require a counter-indemnity, which will be counted against the exporter's available lines of credit.

Once the tender is won, the importer is likely to provide an advance payment, but is also likely to require a bond to be provided for the same value. Over the life of a capital project, stage payments will be made, but at each point the exporter may be required to provide a further bond. Again, the exporter's bank will require counter-indemnities from the exporter to protect its exposures. These advance payment and performance bonds are almost always on-demand instruments, which can be called without reason by the customer in a developing country. They may also be called fairly if an exporter is unable to perform its contractual obligations as a result of some intervening political risk event, such as the cancellation of an export license or the occurrence of war in the importer's country. In either scenario, the exporter's bank would be required to pay under the bond, and would then claim against the exporter through its counter-indemnity.

A further exposure during the project could occur if the contract were cancelled by the importing government. Here, the exporter would be left with not only the expenses incurred under the contract to date, but also half-completed goods that are probably not saleable elsewhere. In addition, if the contract requires payment in US dollars, the exporter is exposed to the risk that the customer does not have access to sufficient dollars to pay them; either through lack of funds or through government action to restrict access to hard currency.

Often, political risk Insurance can provide a viable alternative to the more traditional banking approaches to risk, as the following examples illustrate:

- During the pre-shipment phase of a contract there is a risk that a political risk event will prevent delivery, leaving the exporter out of pocket and holding onto goods they cannot sell. This risk can be dealt with by asking your customer for an advance payment, or various stage payments during construction so that you remain cash-positive. Alternatively, a political risk insurance policy can be purchased to protect the exporter in the event the contract is cancelled. Such a policy will compensate the exporter for the cost they have incurred up to the date of contract cancellation. By using insurance, the exporter is able to help their customer's cashflow, giving the exporter an advantage in the tender process.

- During the post-shipment phase, the exporter is exposed to payment risk, as there is a potential that it will be unable to collect the money it is owed. This risk can be eliminated if no credit is extended to the buyer, or if a letter of credit is requested and confirmed by a bank in the exporter's country. The exporter could also consider using bills of exchange or promissory notes, which could be discounted without recourse to obtain cash. Alternatively, the exporter could purchase political risk insurance that will protect it in the event the buyer defaults on payment. In this way, the exporter can, again, help their customer by allowing them to enjoy a period of credit, and not requiring them to issue a letter of credit, which would tie up some of their banking lines. The existence of insurance may also make it easier for an exporter to discount bills of exchange or promissory notes.

Whether insurance or banking solutions are the correct risk mitigation tool will depend upon the circumstances of each contract. What is clear is that a treasurer should explore all the options when looking at an export contract to ensure that they take advantage of the most appropriate solution.

To help in this decision-making process, the services of a good insurance broker would be recommended so that a full understanding of the available options can be obtained. Brokers can provide independent advice on how to structure an insurance programme and can access all insurance markets to obtain the best terms and conditions for their clients.

HOW DOES THE POLITICAL RISK INSURANCE MARKET OPERATE? Within the political risk insurance market there are a number of different providers that can be approached, and they can be categorised as follows:

- Export Credit Guarantee Department (ECGD): the government-funded ECGD, which is part of the Department of Trade and Industry. ECGD supports UK exports with coverage for medium and long-term overseas projects.
- The Companies Market: various international insurance companies offer political risk insurance.
- The Lloyd's market: a number of different syndicates within Lloyd's.

Coverage is available for periods of up to five years, and to protect export contracts in almost all countries worldwide, subject to the provisions of the individual contract or investment. For example, underwriters have been quick to offer coverage in respect of mobile assets in Iraq. It is also anticipated that, as sanctions ease against Libya, there will be greater capacity to support UK export deals.

ECGD will deal directly with the exporter, whereas access to the companies market and to Lloyd's is usually through a specialist political risk insurance broker.

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