Playing politics

Executive summary

- The political risk market has developed significantly since its early days in the 1960s. Unlike less specialist forms of insurance, political risk products vary from insurer to insurer, but there are two basic categories: asset-based risk and contract-based risk. The former protects a company's investments and the latter relates primarily to its exports. Many financial institutions fuel the demand for the second type of cover.

In an often unpredictable and violent world, should companies with worldwide operations insure themselves against losses from unpredictable or violent political acts?

Many have decided that they need such protection, which has seen the insurance market develop a range of political risk products. The market's development dates back to the 1960s, when there was a growing requirement from companies for financial guarantee cover. The Lloyd's of London insurance market responded to this demand by developing a product initially known as contract frustration.

Paradoxically, says Keith Thomas, head of the political risk practice at HSBC Insurance Brokers, the product was aimed at companies but not at banks. In today's market, by contrast, the majority of cover written by political risk insurers is for companies in the financial sector.

PLAYERS WHO PROVIDE POLITICAL RISK POLICIES The political risk market has developed significantly since those early days. It has become more sophisticated over the years and given a boost by the entrance of industry giant AIG in the early 1980s. By then, Lloyd's had coined the term "contract completion insurance" for the product, rather than contract frustration.

Today's political risk market consists of around 10 main players: Lloyd's, Ascot (now owned by AIG), Ace, Axis, Chubb, Zurich, Atradius (formerly NCM) and Sovereign; Houston Casualty is a major US provider of the cover.

So what has spurred the development of political risk insurance and why do companies buy the cover?

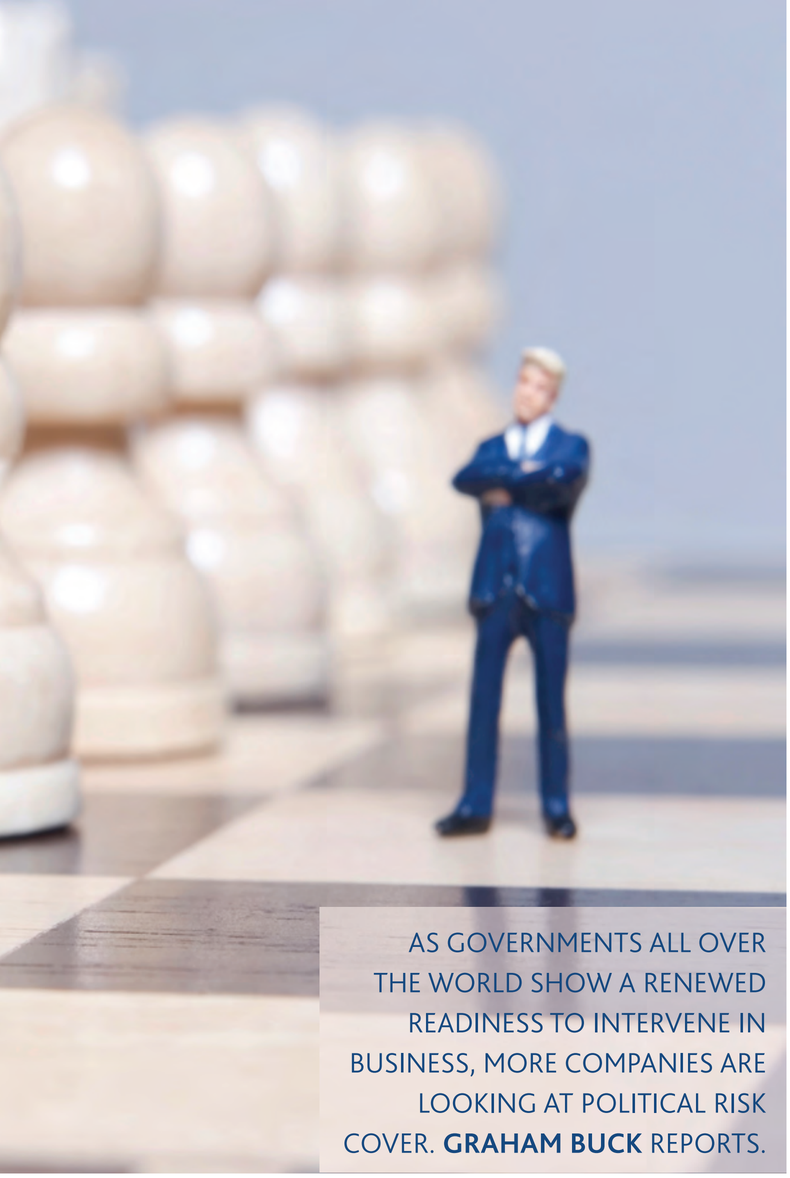
According to Charles Berry, chairman of BPL Global, a broker that specialises in emerging markets risk, companies buy it principally because their general property insurances cover risks such as riot, civil commotion and terrorism only when the likelihood of such an event is seen as fairly remote.

But once the level of political violence in a country seriously deteriorates, those risks are effectively returned to the policyholder. This is done through the application of the standard war risks exclusion found in policies; this kind of exclusion was first adopted by the property insurance market as a result of the War Risks Agreement of 1936 amid growing fears of aerial bombardment caused by the Spanish Civil War.

Many companies assume that a war exclusion on their policy means that the cover excludes losses from a conventional war between two sovereign states. But the exclusion is considerably broader than the name implies, and also applies to armed conflicts such as those in Iraq, Afghanistan and Sudan as well as the type of political violence regularly occurring in countries such as Nigeria, Thailand and other emerging markets.

The violent unrest that hit Kenya last December offers an example of risk beyond the province of property insurance, and that requires specific political risk insurance. The disturbances were regarded as falling within the term "riots and civil commotion" and therefore covered – or at least not specifically excluded – under a conventional property policy. However, had the unrest escalated to the point where it became an uprising, the war exclusion clause would have come into play.

Banks have become significant buyers of political risk policies as they cover the non-payment risk on a broad array of debt financing transactions and can also be extended to include emerging market credit risks as well as the country political risk particular for the more complex structured credit deals.



AS GOVERNMENTS ALL OVER THE WORLD SHOW A RENEWED READINESS TO INTERVENE IN BUSINESS, MORE COMPANIES ARE LOOKING AT POLITICAL RISK COVER. **GRAHAM BUCK** REPORTS.

POLICIES WILL VARY Unlike less specialist forms of insurance, political risk products can vary from insurer to insurer. But Paul Davidson, managing director for financial solutions at broker Willis and deputy chairman of its FINEX division, says policies divide into two basic categories: asset-based risk and contract-based risk.

The former primarily protects a company's investments against occurrences that range from physical damage to nationalisation or expropriation by the government. Contract-based risk relates principally to a company's exports; it is largely the financial institutions that fuel demand for this cover.

Asset-based cover responds to events such as:

- confiscation by a foreign government of the company's assets in that country, which could be through deprivation, nationalisation, expropriation or selective discrimination, forced abandonment or forced divestiture;
- political violence through war on land or terrorism;
- the company's inability to convert or transfer currency; and
- repossession of aircraft.

Contract-based cover would extend to:

- events occurring pre-shipment, such as an import or export embargo, licence cancellation, war or breach of contract caused by government intervention;
- events occurring post-shipment, such as non-payment, non-delivery of prepaid goods or the inability to convert or transfer currency; and
- unfair calling of on-demand contract bonds.

Ascot Underwriting gives the collective title of "political violence" to cover that includes physical loss or damage from terrorism, social perils including strikes, riots and other civil unrest, war on land and political perils that include confiscations and contract frustration.

THE CREDIT CRUNCH HAS FOCUSED MINDS ON THE POTENTIAL APPLICATIONS OF THESE POLICIES, AND THE BANKING COMMUNITY'S INTEREST IS DRIVEN BY THE NEED TO MANAGE THEIR PORTFOLIO OF BUSINESS AND TO DISTRIBUTE THE RISK.

But in many cases, policy wordings are the outcome of lengthy negotiations so that the political risk insurance provided is tailored to meet the specific needs of a company.

"The business has to reflect what's going on in the real world, which means policies continually evolving to meet the new forms of transaction and trading," says Davidson.

"As it is quite a sophisticated class of business, it's not unusual for it to take four weeks or even six weeks to put together a policy," adds HSBC's Thomas. In one particular case, he adds, where cover was for a company active in an emerging market unfamiliar with the international debt market, finalising the detail took an entire year.

WHO BUYS POLITICAL RISK COVER? Although UK banks and multinationals are buyers of political risk cover, Thomas says that rather greater demand comes from Germany, where the economy is more geared to manufacturing than services and there is a higher level of exports. French banks and commodity traders are among other major buyers.

"The banks are strictly regulated on the amount of business they can accept for specific countries," Thomas adds. "Certain limits are imposed and once these are reached they need to seek some collateral such as political risk cover.

"Basel II requires them to make provision for up to three times the loan amount if there is no risk mitigation in place."

Davidson adds that the discussions surrounding Basel II sparked much activity in the insurance market for providing political risk cover that offered both capital relief and risk mitigation.

"The credit crunch has focused minds on the potential applications of these policies, and the banking community's interest is driven by the need to manage their portfolio of business and to distribute the risk," he says.

But he stresses that events in Latin America and Russia in recent years have done rather more than the credit crunch to stimulate interest in political risk insurance.

It should be added that Western companies are generally the buyers; underwriters would be uncomfortable with providing political risk cover for, say, China or Nigeria and then also insuring Chinese and Nigerian companies.

A high level of enquiries comes from companies involved in gas/oil exploration and production, although major groups such as Shell tend to use their own internal captives when insuring. But for the smaller operators, political risk is a key balance sheet exposure, and they tend to insure to protect shareholders.

EVEN WHERE THE COUNTRY IS REGARDED AS A POOR RISK, UNDERWRITERS OFTEN PROVE WILLING TO PARTICIPATE IF ONLY FOR A LIMITED PERIOD OR A RELATIVELY MODEST TRANSACTION.

While Brazil has done much in recent years to improve its international standing, other parts of Latin America are regarded as high risk, thanks to the actions of the governments of Bolivia, Ecuador, Peru and Venezuela in taking back property from companies in the energy sector.

Most recently, Venezuela announced plans to nationalise the country's wholesale fuel distribution networks and pass them to state-owned Petroleos de Venezuela. Distributors, including subsidiaries of BP, Exxon Mobil and Chevron were given 60 days to negotiate the sales of their businesses and surrender their brand names to the government or face expropriation. While compensation will be offered, few expect the amount to be generous.

Many of these countries' sources of oil and gas are in deep water or dense jungle and they needed the expertise of foreign companies in order for projects to be developed. Expropriation became a real concern only once the development work was completed and the projects were up and running, says Thomas.

There is also considerable concern over recent developments in Russia, despite its status as an investment-grade country. The market can only offer limited capacity for Russia-based political risk and the threat to the Baku-Tbilisi-Ceyhan oil pipeline, which was temporarily closed due to the fighting in Georgia, added to the apprehension.

These worries have resulted in many investors pulling their money out of Russia. Their concerns extend to the other member countries of the Commonwealth of Independent States, a fact noted by Zurich whose emerging markets solutions unit was recently selected as political risk insurer for Ukraine's first public asset-backed securitisation.

Dan Riordan, president of Zurich's surety, credit and political risk group, says that as capital market transactions became more common in the emerging markets, investors were checking whether bond issues coming out of the emerging markets were supported by political risk insurance – particularly currency inconvertibility and expropriation coverage – when deciding whether to commit money.

In addition to the power and energy industries, many companies in other high-profile sectors such as metals and mining, infrastructure and telecoms require political risk cover, says Davidson. Here again, though, some of the larger operators assume the risk themselves through captive insurance businesses while some exposures are simply so immense that the market is unable to offer sufficient capacity.

RISKS ON A GLOBAL SCALE While Russia, Zimbabwe, Bolivia and Venezuela all provide political risk underwriters with cause for concern, it's not always possible to generalise as to which regions of the world are the worst risks. Africa is generally regarded as a more attractive risk than it was five or 10 years ago but Zimbabwe, which recently legislated to transfer foreign-owned assets to indigenous businesses, has gone against this trend.

In some countries, insurers may regard the government unlikely to confiscate, expropriate or nationalise foreign corporate assets, but the economic situation may be dire or it might represent a bad risk as regards payments.

Broking and risk management group Aon provides a yearly assessment of the risk level around the world through its annual Political Risk Map, which this year has been extended to include a Global Credit Crunch Index. This new feature measures how emerging markets are responding to the resulting international financial turmoil. It deemed that political and economic risk was low in 25 of the world's top 50 economies, but gave readings ranging from medium-to-low to high for the other 25.

There are relatively few areas of the world that insurers regard as no-go. Even where a country is regarded as a poor risk, underwriters often prove willing to participate if only for a limited period or a relatively modest transaction.

While the market's capacity is restricted for hazardous countries, there is also a shortage for some countries where a lot of business is undertaken, says Davidson. One example is the so-called trunk countries (Turkey, Russia, Ukraine, Nigeria and Kazakhstan).

The shortage has been intensified by the fact that policies are commonly for longer periods than before, with five to seven-year coverages common and even some for 10-year periods.

Graham Buck is a reporter on The Treasurer.
editor@treasurer.org