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CIP Society Trends Paper

Understanding Political Risk Insurance

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When it comes to decisions about whether to do business in a foreign country, particularly an "emerging market," which many insurers define as any country that's not a member of the European Union or the OECD (Organization for Economic Co-Operation and Development), there are many factors to weigh and a wide variety of risks to consider. While traditional business due diligence may uncover some risks the business is used to handling, risks related to a foreign country's political and economic situation can be hard to predict, foresee, and quantify. Recent events in the Ukraine are a good reminder that political turmoil and unrest can crop up in places that a year or two ago might not have been on many peoples' radar.

Fortunately, for those interested in doing business in parts of the world that are less stable, political risk insurance (PRI) can help manage non-commercial risks. For PRI insurance purposes, political risks are basically risks associated with government actions (or the failure of a government to act) that deny or restrict the right of investors/owners to use or benefit from their assets or that reduce the value of their assets.

PRI has been around for nearly 100 years. Initially it was offered mainly by government-supported export credit agencies (ECAs) – so called public providers. ECAs, which are encouraged (if not mandated) by their government to foster foreign trade and direct investment by nationals of their home country in business activities in foreign countries, are still key players in the PRI field. Canada has had an ECA since 1944 – Export Development Canada (EDC). In fact, EDC is the biggest player in the Canadian PRI market, even with the requirement that to qualify for insurance from EDC the operations must generate economic benefits to Canada (for example, job creation or a contribution to Canada's GDP).

Over time the market for PRI expanded beyond insurance for export cover to project finance coverage and infrastructure development. As the market evolved, private insurance companies entered the market, as well as multilaterals, which are basically international organizations established to foster trade and development in specific geographic regions, such as the African Trade Insurance Agency and the Inter-American Bank. In Canada, in addition to EDC there are a number of private PRI insurers, including AIG, Zurich, Atradius, Coface, Euler Hermes, and various Lloyds syndicates.

The Multilateral Investment Guarantee Agency (MIGA) reported in 2013 that there's been a dramatic increase in PRI insurance (up 33% in 2012, for example), likely because of the market and political turbulence in many parts of the world. Indeed, James Gregory, Regional Director of Aon Risk Solutions' Crisis Management group in Toronto, says that the general interest level for PRI insurance is up, but the market for it is soft due to a surplus of insurance capacity in all but the most difficult areas. MIGA attributes the soft premiums to the supply side, noting there are more product lines offered, policy terms have gotten longer, and there are more insurers providing it. Canadians' interest in PRI falls somewhere between that of European companies and U.S. companies, according to Gregory. "I think Europeans' appetite for PRI is greater because European's tolerance for risk is lower, while American companies' tolerance seems higher," he says.

According to the World Bank Group, the primary reasons more businesses don't take out PRI is because the need for it is not perceived and because many businesses don't know it's available. As well, some particularly large companies that may conduct business in emerging markets self-insure, according to Graham MacLachlan, Managing Partner of Global Trade Credit, a brokerage that specializes in PRI and trade credit insurance.

Risks Beyond the Headlines

Because we get news faster and from further afield than ever before, it's easy to have a general sense of what's going on in the world. But, beyond having a perception of the possible political risks in a given place, the number of factors that PRI insurers consider – and continually monitor – for their risk profiles of countries and regions goes way beyond what most folks think of as political violence.

Aon has a political risk map that it officially updates annually, with interim upgrades and downgrades to specific countries as warranted. Aon's country ratings are based on its own analysis, combined with the analysis of Roubini Global Economics (a research firm founded by economist Nouriel Roubini), and the opinions of over 20 Lloyds syndicates that write political risk insurance. Each emerging country on the map has an overall risk rating on a scale with six levels that range from low to very high.

In determining the overall country risk, Aon considers the following nine separate categories:

• **Exchange Transfer** – this relates to the risk of being unable to make hard currency payments as a result of currency controls. In assessing this type of risk they consider numerous economic factors, including any de-facto exchange rate and foreign exchange (f/x) reserves, since countries sometimes institute restrictions if they become concerned with not having sufficient f/x reserves.

• **Legal and Regulatory Risks** – for this category they consider measures of government effectiveness, the rule of law, and so on.

• **Political Interference** – this category encompasses the risk the country might intervene in a political or economic fashion that adversely impacts foreign business interests. The most vivid example of this is nationalization of industries or assets.

• **Political Violence** – related to this category are various things you'd expect, including rebellion, revolution, insurrection, coup d'etat, as well as strikes, riots, sabotage, and malicious damage.

• **Sovereign Non-payment** – in assessing this category they look at the country's fiscal policy, as well as its willingness and ability to pay.

• **Supply Chain Disruption** – this category encompasses the flow of goods and services into and out of the country and the risk related to that flow in light of political, social, economic, and environmental stability.

• **Risks of Doing Business** – to assess this category they consider regulatory obstacles to establishing a business and operating in the country.

• **Banking Sector Vulnerability** – for this category they consider the capitalization and strength of the banking sector, trade performance, and labour market rigidity.

• **Risks to Fiscal Stimulus** – for this category they consider the government's fiscal credibility, the country's reserves, debt burden, and government efficiency.

Aon has created icons representing each of the nine risks and for each country rated on the map, icons applicable to the particular risks that are of concern for that country are shown. The icon indications may surprise many. Some countries have just one or two icons (for example, on the 2015 map Hong Kong, Macau, Taiwan, and Panama show only one icon: banking sector vulnerability, while the Philippines has two: Supply Chain Disruption and Political Violence, and the Bahamas and Bermuda both have three: Exchange Transfer, Banking Sector Vulnerability and Inability of Government to Provide Stimulus). Most have a mix of multiple icons, with many having six or more. The map provides a snapshot of the risks a Canadian considering doing business or investing in an emerging market should at least consider.

Who takes out PRI?

Because PRI is meant to safeguard investments and assets in overseas markets, it can be used to protect equity investors, exporters deploying assets to a foreign country, lenders, and companies doing business directly or through joint ventures or partnerships overseas. The key to keep in mind is that PRI is meant to protect against specific actions by a government (including sub-levels of government, such as the customs authorities or central banking authorities).

"Historically, most of the demand for PRI insurance came from companies involved in the extractive industries, who were doing business in emerging markets. But now, as Canadian companies in all sectors begin to seek business opportunities in foreign markets, we can expect a broadening of the PRI market. PRI is for any business that holds interests abroad – whether equipment, inventory, debt and equity investments, or even cash accounts," says Chantal Brazeau, Lead Underwriter and Senior Advisor, Political Risk Insurance at EDC. "Companies who are performing multi-year contracts in a foreign country typically maintain local operating cash accounts. Our customers are interested in protecting their cash from confiscation or from any foreign exchange controls that might impede their ability bring their cash back home," she explained.

MacLachlan of Global Trade Credit agrees that PRI isn't necessarily more commonly sought by certain types of companies. What MacLachlan does find, however, is that very often it's the financing of a project or investment that drives the decision to take out PRI. "What many companies don't realize is that PRI can help companies doing business in developing countries and potentially risky places access financing, or can help improve financing terms," explains MacLachlan. "In fact, it's not unusual for the policy to be payable directly to the bank," he says.
PRI Coverage

PRI policies are tailored to cover equity and debt investments, physical assets, projects, or specific activities carried on by an insured in a foreign country. For example, the type of coverage needed by a Canadian company that is exporting equipment into a foreign country with the intention of repatriating the assets at some point in the future will be different from the coverage sought by a commercial bank that's providing project funding to a foreign government.

A policy can be country-specific, for example, if a company has multiple projects or assets in one country; it can be project specific; or it can be issued on a regional or world-wide basis. "Global portfolio policies that cover assets in multiple jurisdictions are common, but more so with insurers in the private sector than insurers in the public sector," says EDC's Brazeau.

Though the exact names and the specifics of the coverage vary from insurer to insurer, the following types of perils can be included in PRI policies:

• **Breach of Contract** – this is coverage for a loss that results from government termination, or breach of, contracts without compensation. Because a claim under Breach of Contract coverage usually requires that the insured invoke the contract's dispute resolution provisions, this coverage usually provides coverage where a government fails to honour an arbitration award. Indeed, such coverage even applies to situations where the foreign government is an indirect party to a contract, as is sometimes the case on infrastructure projects, for example.

• **Contract Frustration** – this coverage applies if the terms of a contract are frustrated as a result of political events. For example, say an insured is mid-way through a custom production run for a specialised item that will not be easily re-sold and at the point the insured's client cancels the contract. Contract frustration coverage would cover 90 - 95% of the contract value.

• **Non-payment by government** – this coverage applies if a foreign government refuses or is unable to make scheduled loan payments or honour financial guarantees. Unlike Breach of Contract coverage claims, to bring a claim under a non-payment by government provision the insured need not first seek an arbitration award.

• **War/Civil Disturbance** – this coverage insures property or income losses (for example, losses caused because of business interruption) due to domestic political violence, including losses as a result of hostile actions by national forces, by revolutionary forces or civil wars, insurrections, strikes, riots, or politically motivated terrorism.

• **Repossession/Transfer Restrictions** – this covers a loss suffered as a result of a foreign government preventing or restricting the insured from repossessing or re-exporting physical assets.

• **Confiscation** – this covers losses that occur as a result of a government confiscating (expropriating) – or “nationalizing” – property owned by the insured without providing full compensation for the property.

• **Currency Transfer & Conversion** – this covers losses incurred as a result of a government imposing restrictions on converting local currency to foreign currency or transferring foreign currency back to Canada. For example, if a country`s central bank imposes foreign exchange controls that limit the amount of currency that can be converted per day, such action could hamper repatriation of funds, including interest or dividend payments.

Claims related to currency inconvertibility are more likely than other types of claims during times of financial and economic crisis.

The indemnity on PRI policies is usually up to 90% of the loss, according to Global Trade Credit’s MacLachlan. There can be separate limits on each risk, or a single limit for the policy, according to Aon’s Gregory. For example, coverage for confiscation, expropriation, or nationalization and for political violence typically pays 100%, with a deductible for the political violence coverage, says Gregory.

Premiums are based on:
• The type and number of political risks included in the policy.
• The country where the activities or investments are undertaken.
• Various peril-specific and insured-specific factors, such as the nature of the project and the insured’s reputation – its social licence vis-à-vis the country (or countries) the insured is (or proposes) doing business in. Local acceptance of the particular activities would also be considered. For example, if the insured plans on carrying out mining activities, the insurer would consider factors like local reaction toward such mining activities, as well as the degree to which the insured has engaged with the local community, and so on.

Most PRI policies are issued for multiple years (two to five years is common, though the terms can be as long as 15 years, such as with AIG) for a fixed premium paid at the start of each year the policy is in force. PRI policies are uncancellable by the insurer for the term of the policy, regardless of whether the risks in the applicable jurisdictions change. Insureds, however, can cancel the policy at any time, though they will not receive any premium refund in the event they cancel their coverage.

Proof of Claim Issues

Different waiting periods apply to the different PRI coverages, and the steps the insured must take to establish a claim also vary, according to EDC’s Brazeau. For example, as noted, claims based on breach of contract typically require that the insured invoke the contract’s dispute resolution provisions and that the insured receive an award under those provisions. In the case of a claim under currency transfer and conversion coverage, the insured could have to wait from 90-180 days, for example, and must be able to show that the funds were in a financial institution and that the funds cannot be freely converted or transferred. For a claim related to confiscation, an insured must typically wait (anywhere from 90 to 365 days) to bring the claim and the test will be whether the government`s action is selective and discriminatory and causes a permanent and catastrophic loss for which it does not provide fair compensation.

Regardless of any applicable waiting period before making a claim, the insured must notify the insurer any time there is a change in the risk profile. In other words, any time the insured becomes aware of circumstances that may result in a PRI claim, they should notify their insurer.

Other Insurance Sometimes Paired with PRI

Though this Trends Paper focuses on PRI insurance, for Canadians doing business in emerging markets there are other specialty products that may also be appropriate, depending on their activities, for example:

• **Trade Credit Insurance** – this can be Accounts Receivable Insurance or Credit Risk Loss Insurance. Like PRI insurance, trade credit insurance is often used to facilitate attracting financing terms.

• **Kidnap and Ransom Insurance** – this should be considered if the business has personnel who visit or live in countries where holding people hostage for ransom or extortion is a risk. (Interestingly, according to Aon's Gregory, Mexico – a country that is not considered an emerging market for PRI insurance – is currently the number one country for kidnapping.)

Conclusion

PRI is definitely a niche product, but it is a tremendously useful product for Canadian companies and investors doing business in emerging markets. "PRI is one of the best kept secrets in the insurance industry. Indeed, the biggest part of my job is educating companies about it," says Global Trade Credit's MacLachlan. "Companies often fail to realize that PRI is an especially useful tool for managing their financing costs," he says. EDC's Brazeau agrees that raising awareness of the benefits of PRI insurance is key. "People often don't realize that the best time to buy PRI is when the economic and political conditions in foreign markets are stable. As recent history has shown, the social and political climate of typically stable countries can change quickly and unexpectedly. PRI allows Canadian exporters and investors to pursue the many business opportunities that exist in emerging markets without putting their balance sheet at risk," she says.