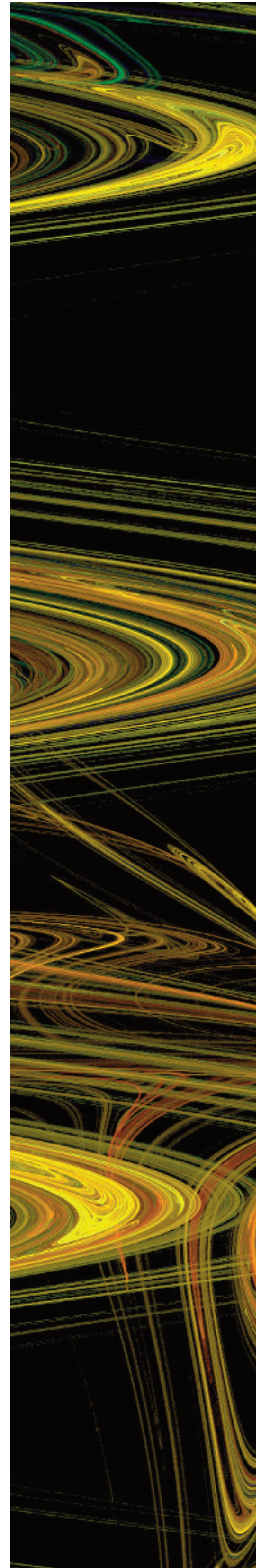
POLITICAL RISKS

PRI FOR EQUITY INVESTMENTS

Political Risk insurance (PRI) boasts numerous products. Some focus on the risks associated with equity investments in emerging markets, while others include the risks associated with lending in such markets by financial institutions. This review focuses on the former, for which we see an upswing in demand.



The rising demand for PRI for equity investments is driven by a heightened awareness of risk levels and is supported by a market hungry for new, sustainable business relationships. Perceptions, and indeed incidents, of political risk are on the rise.

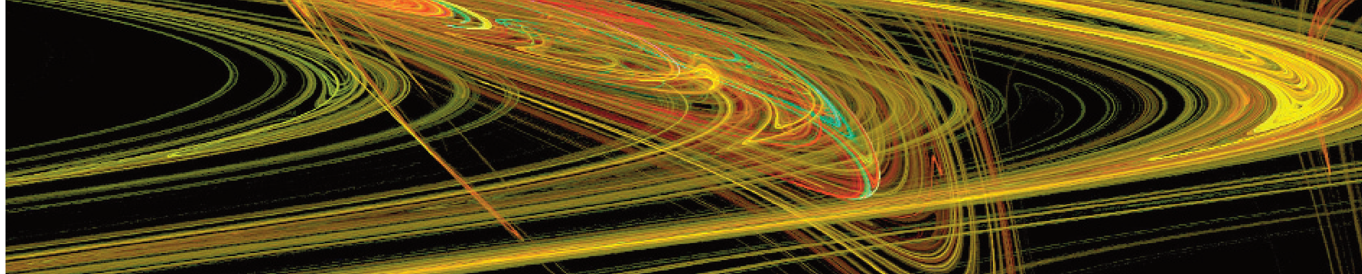
Expropriations and nationalizations persist in Latin America – particularly in Bolivia, Ecuador and Venezuela – riling investors and disproving optimistic predictions of political stability and an improved business climate. Political violence the world over, from terrorist bombings in India and Pakistan to a Russo-Georgian war with wider geopolitical implications, continues to mount. Meanwhile, the specter of default looms over a faltering Argentine economy. As a recent op-ed piece in *The New York Times* declared, "Today's high degree of global economic interdependence, which can be sustained only if all major governments act sensibly, is more fragile than we imagine."[1]

THE FIRST HALF OF 2008

The story of the first half of 2008 in the PRI market was the soft market, which brought lower pricing, an increase in market capacity and a more liberal approach to wording.

CAPACITY

Traditional PRI capacity – such as that provided by export credit agencies, multilaterals, and Lloyd's – was supported by additional injections of capacity in the U.S. and Bermuda markets in 2008. Bermuda-based Catlin's maximum Confiscation, Expropriation, Nationalization (CEN) line was $50 million in Q4 2006; by Q2 2008, the line had increased to $90 million. Zurich's maximum CEN/Political Violence (PV) line increased from $80 million at the end of 2006 to $125 million in Q2 2008. AIG recently upped its maximum equity line to $120 million. Meanwhile, in London, Lancashire can now offer up to $100 million of CEN/PV cover. These are but a few examples that illustrate a trend of increased market capacity. The only carrier to recently exit the market is XL Insurance Company.



PRICING

As usually happens when capacity increases and competition is stimulated, pricing dropped considerably in the first half of 2008; in one instance, a syndicated global program renewal secured a 40% rate reduction while simultaneously broadening coverage and significantly liberalizing policy wording.

LIBERALIZED WORDING

Disputed claims negotiations, increased competition in the marketplace, and the advent of new banking regulations have put policy wordings on the bargaining table. Wordings on syndicated placements no longer need to follow the lowest common denominator, and in 2008 buyers could push insurers to compete to provide the most comprehensive and client-friendly wording allowed under their reinsurance treaties.

Innovative work continued this past year with banking clients to eliminate traditional market exclusions. New banking regulations have caused banks to look more carefully at their policy wordings and omit exclusions for events outside of their control. We have placed a significant number of deals using these improved wordings with a variety of carriers, marking a change in the marketing landscape.

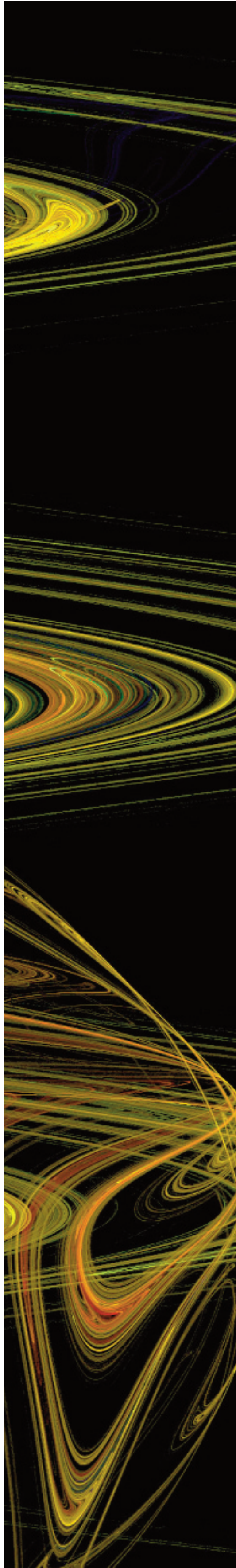
One exclusion we have been successful in eliminating from many equity programs is the Five Great Powers exclusion. This exclusion releases carriers from indemnity concerns in the event of losses arising from a war between any of the five powers seated at the U.N. Security Council: China, France, Russia, the U.K. and the U.S. Given the amount of investment directed towards China and Russia, and given the U.S. security stances towards Taiwan, the Korean peninsula and the Former Soviet Union (FSU) countries, the Five Great Powers Exclusion has no place in a Political Risk policy that includes Political Violence coverage aimed at indemnifying insureds in the event of an outbreak of war. Most markets have agreed, and buyers can usually eliminate this archaic exclusion from their equity Political Risk policies.

WHAT IS PRI FOR EQUITY INVESTMENTS?

Many companies have a wide array of investments abroad. These take the form of manufacturing subsidiaries, build-own-operate or transfer projects, mobile assets used in construction projects and joint ventures with foreign governments. Foreign investments will prosper, however, only as long as the host countries tolerate them. However prudently a company researches counterparties and monitors events, adverse political circumstances can put the balance sheet at risk. The prudent investor needs to assess the specific political risks that could – in the long run – undermine the viability of the investment.

RISKS ADDRESSED BY PRI

- Confiscation, expropriation or nationalization of an investor's permanent or mobile assets
- Deprivation or inability to export finished products from a foreign locale or to repatriate mobile assets
- Discriminatory governmental actions or acts of expropriation, which deprive investors of their rights or render operations uneconomical
- Export or operating license cancellation/revocation
- Currency inconvertibility, or the inability to convert and/or freely transfer dividends or other scheduled payments from the host country
- Political violence and war: physical damage to assets caused by military action, civil war, terrorism, etc.
- Forced abandonment/forced divestiture of an investment or mobile assets
- Breach of a production, concession or government agreement following political violence or war



THE SECOND HALF OF 2008

The story of the second half of 2008 in the PRI market is constrained capacity in key countries. Despite the increased market capacity in 2008, renewed interest in global programs that carry limits of liability in the hundreds of millions of dollars in key countries has strained many carriers' ability to offer large limits in those countries. The problem can become particularly acute depending on how carriers choose to apportion their country risk capacity.

DEMAND AND SUPPLY

It should come as no surprise that those countries for which there is the greatest PRI demand (and now the least supply) are the countries commonly referred to as the BRIC group (Brazil, Russia, India and China) and the TRUNK group (Turkey, Russia, Ukraine, Nigeria and Kazakhstan). Heavy levels of investment in these countries have strained carrier capacity – which can be as high as $1.5 billion for a single country. Capacity is especially scarce for Russia (the only country included in both groups). In the relatively benign of those BRIC and TRUNK countries, such as Brazil, carriers may apply for extra capacity from treaty or facultative reinsurers; however, such measures often are unavailable in Russia.

The perception of risk in several key countries has also risen since the beginning of this year, contributing to several capacity restrictions. These restrictions are most acute in the following countries and coverages.

- **Russia** The Georgian war, financial sector difficulties and government intervention in the energy sector have heightened risk perception, although the chief obstacle in this country likely remains capacity constraints.
- **Bolivia, Ecuador, Ukraine, Venezuela** Expropriation coverage is almost completely off limits, although some capacity remains for the proverbial "good deal in a bad market."
- **Argentina** Currency Inconvertibility coverage is hard to obtain; Expropriation coverage in sensitive industries (telecommunications, oil and gas) is also problematic.
- **Zimbabwe** Political Violence coverage is extremely difficult to obtain, if not completely closed.

For several of these countries, capacity was available in greater breadth or volume at the end of 2007. This underscores the risk of waiting to purchase PRI in cases where the company has significant emerging market exposures.

Where capacity is scarce and pricing reflects this scarcity, the insured and broker can consider options that include:

- Structuring a multilayered program to reduce premium and take advantage of available country capacity
- Securing a more favorable premium rate by accepting capped sublimits in certain countries

Given dwindling capacity for high-risk countries, some carriers have expressed concern regarding the opportunity cost of offering capacity for equity programs that could instead garner higher premium rates on lenders' transactions or trade credit risks. The crisis in global financial markets may render the issue moot, as the ability for banks to fund transactions may be compromised. It is also important to note that where capacity is available, global PRI programs are still being priced aggressively by some.

One more note about PRI supply and demand. One particularity of the marketplace that remains enticing to prospects is the way some carriers price global programs: they cover a multiplicity of countries at only incrementally higher rates than programs that cover only one or two countries.

LOOKING AT 2009

Considering the current volatility in the global economy, predicting a firm trajectory for foreign direct investment flow is probably impossible. We believe, however, that a global economic retrenchment will not eliminate demand for PRI products.

There are signs that such retrenchment is occurring. Protectionist and nationalist tendencies are manifesting in some key emerging markets and are being expressed by populist rhetoric. Corporations with existing investments in emerging markets will want to protect themselves, and they may already perceive an increased threat of political upheaval.

It remains to be seen if the pronounced growth in global trade and economic interdependence of recent years will continue or will succumb to the forces of retrenchment. In either case, those familiar with Political Risk markets and products will be well positioned to protect their investments from political instability. Current market penetration of the product in the U.S. remains low. The combination of economic trouble, wide-scale global interdependence and uncertain political environments may well be the formula for raising the profile of this maturing product line.

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[1] "The Great Illusion," *The New York Times*, August 14, 2008