

POLITICAL RISKS

Political risks continue to rise the world over, largely as a result of pressures generated by the global financial crisis.

In emerging markets, where politics matter at least as much as economics,¹ investors face a unique exposure: political risk. Today, that risk grows steadily, as unprecedented global economic misfortunes fuel civil unrest, political instability and pressure on governments to revert to protectionist practices. The resulting ominous combination of economic trouble, global interdependence and uncertain political environments makes Political Risk insurance (PRI) for equity investments a highly valuable source of protection.

So far, 2009 has been a year of contrasts for the Equity Political Risk market, as the global economy has proven itself to be a double-edged sword. For buyers, rising exposures have been countered by budgetary constraints. Comparable conflicts exist for the carriers, as their hunger for new, sustainable business relationships has been tempered by rising claims, financial stress and an uneasy reinsurance climate. In contrast to 2008, which saw softer market conditions, rising interest in Political Risk insurance from buyers in 2009 has battled a contraction in the number of markets able to underwrite aggressively.

WHAT IS POLITICAL RISK INSURANCE 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 and economic risks that could – in the long run – undermine the viability of the investment.

RISKS ADDRESSED BY PRI PRODUCTS

- 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

SUPPLY

The Political Risk market for equity investors has hardened since 2008. The change is attributable to three interlinked forces: claims, reinsurance pressure and capacity constraints.

CLAIMS

While PRI has traditionally been a low-frequency, high-severity market, current trends are pointing to higher frequency. Extremism in one country seems to encourage extremism in others, and weakened multinationals, often lacking domestic political backing, are seen as easy targets. Since early 2008, political risk claims have come from countries as diverse as China, the Ukraine and Venezuela. Coupled with the significant rise in Trade Credit claims borne by many Political Risk insurers, these claims have driven carriers into more conservative underwriting standards, particularly as the risk of loss from political activity continues to rise in many countries.

REINSURANCE PRESSURE

Insurers are under pressure to generate premium, not least because of rising PRI reinsurance premiums. The deterioration in their Credit insurance business means PRI insurers are more dependent on their other leg – Equity Investment insurance. This has opened a window to good deals in the PRI market. This window may close, however, as losses worsen, reinsurers withdraw (Swiss Re) and insurers suffer (AIG, Atradius). Senior managers, with a view to enterprise risk management, may also turn against PRI, given the losses and potential for more, and decide instead to reduce their exposure to political risks. Further market tightening could follow in 2010. Rather than look back to the more benign 2008 market, buyers might be better off moving quickly in case of a rougher road ahead. The availability of non-cancelable policy terms of up to 15 years (a typical policy period being in the three- to five-year range) is of particular benefit when viewed from this perspective.

MARKET CAPACITY

INSURER	RATING	MAXIMUM CAPACITY EXPROPRIATION RISKS (MILLION \$) ²
ACE	S&P A+	80
ASPEN (LLOYD'S)	S&P A	70
ATRADIUS	S&P A-	65
AXIS	S&P A+	65
CATLIN	Moody's A	90
CHARTIS (EX-AIG)	S&P A+	120
CHUBB	S&P AA	75
COFACE	Fitch AA+	65
KILN (LLOYD'S)	Moody's A-	60
LANCASHIRE	AM Best A-	200
QBE	S&P A+	50
SOVEREIGN (100% ACE)	S&P A+	125
ZURICH	S&P AA-	150



There are additional company markets, but beyond this group the focus is increasingly on Lloyd's (S&P A+).

Political risk market capacity – around \$1.4 billion in total for the private market – took a hit with AIG's decline in 2008. Long a leading market in this field with a per-risk capacity of \$120 million, AIG (now Chartis) was suddenly a difficult name for corporates to consider. However, Chartis (which often writes on the S&P A+ rated National Union Fire Insurance Company of Pittsburgh, PA paper) continues to write Equity Political Risk business, and in 2009 seems to have benefited from an easing of buyer concerns. Some of this is due to the government support it has received, although it is no doubt also due to the carrier's long-standing presence in the market on a large number of buyers' other insurance lines.

The second Political Risk insurer to face hardships recently was Atradius Trade Credit Insurance, which was downgraded to S&P A-, negative watch earlier this year. Most recently, Atradius's rating was affirmed by S&P at A-, and its negative watch revised to a negative outlook. The avoidance of a downgrade below the A- level is an encouraging sign, and hopes remain that the worst has passed.

DEMAND

Even as the market has hardened, corporates involved in single, key projects in emerging markets, or in a multitude of emerging markets, have renewed policies or successfully entered the market as first-time buyers. These buyers, attentive to the political risks they face, have been able to secure capacity and favorable terms.

EXTRACTIVE INDUSTRIES

The extractive industries are among the most vulnerable to political risks in emerging markets. Due to their importance to host economies, projects in the extractive industries (such as mining, oil and gas) can easily become flashpoints for nationalist debate, often leading to governmental expropriations, license cancellations and contract "reviews." These experiences are familiar to commodity producers in many countries, especially as resource nationalism resurfaces: Shell and BP in Russia, Glencore in Bolivia, several companies in Venezuela, Occidental in Ecuador, BHP and Rusal in Guinea-Conakry, CalEnergy in Indonesia and Union Resources in Iran have faced these pressures. Meanwhile, extractive projects often become targets of political violence and terrorist threats as a result of their easy association with home governments. In other cases, the presence of wealth-producing assets in destitute areas can lead to bombings and other attacks as local ire is directed against the symbolic assets.

RENEWABLE ENERGY

Growth in the renewable energy field has led to new interest on the part of groups sponsoring projects in emerging markets. This growing demand has not fallen on deaf ears, and it is being met by innovations from Political Risk carriers.

For instance, Zurich in early 2008 released a new dimension to its existing Political and Trade Credit product suite, now offering cover for carbon credits (also known as certified emissions reductions, or CERs) generated by renewable energy products. CERs can either be insured by a Trade Credit policy (covering the income stream from their sale), or by a Political Risk policy (covering expropriation, confiscation or deprivation of use by the host government).

CONSUMER MANUFACTURING

The market for manufacturers with assets in multiple countries has hardened somewhat in the past year, yet retains its excellent value. Corporates with plants, equipment, inventory and other assets in a multitude of locations – sometimes as many as 75 countries – are well served by a Political Risk policy that protects all of their emerging market locations, or in some instances, all of their international locations.

The mere presence of so many foreign exposures leaves companies in this sector – traditionally not as frequently targeted as the energy, power or extractive sectors – at heightened risk, especially as a geopolitical risk issue in one country could spread regionally and affect others in the portfolio. Such portfolios, often containing countries as diverse as China, Colombia and Croatia, expose manufacturers to an array of risks that can be covered by a broad Political Risk policy that includes any combination of perils, including Expropriatory Acts, Political Violence, Business Interruption and Currency Inconvertibility. A single portfolio policy with sublimits for each peril and country is an excellent risk management tool for companies that face, for example, the threat of expropriatory acts in China and India, the risk of political violence in Sri Lanka and Colombia, and the specter of currency inconvertibility in Argentina. Forward-thinking multinationals, seeking to protect themselves against all of these political risks, have been showing interest in the Equity Political Risk product.

COUNTRY BY COUNTRY

Political risks continue to rise the world over, largely as a result of pressures generated by the global financial crisis. Indeed, Willis' thrice-yearly Political Risk Index notes that the investment climate in 25 of the 40 countries analyzed have been downgraded, while only four have registered an improvement. Many of the "usual suspects" (e.g., Venezuela) continue to exhibit high risk. The following key countries have displayed heightened risk to investors:

CHINA

Economic troubles have raised the risk concerns within the market, primarily related to the possible devolution of what is sometimes described as a tacit contract between the Chinese government and its people: support for the government in return for jobs and economic prosperity. Indeed, with millions of migrant workers losing their jobs, the potential for civil unrest has risen. In January 2009, a state-controlled newspaper warned of a coming "peak period for mass incidents," and the potential for "more conflicts and clashes that will test even more the governing abilities of all levels of the Party and government."³

COLOMBIA

Numerous bombings over the past year damaged transit systems and retail outlets, including an explosion at a Bogota Blockbuster store earlier this year later attributed to an extortion attempt. Meanwhile, war risk with Venezuela remains a concern after that country's build-up of troops at the Colombian border in early 2008. One encouraging risk mitigant is Ecuador's recent pronouncement that it will not let Venezuelan president Hugo Chavez drag it into war with Colombia.

INDIA

Protectionist leanings remain, as do bureaucratic hurdles and the influence of subnational entities. Meanwhile, the Mumbai terrorist attacks, as well as numerous other terrorist incidents, have shone a spotlight on the continuing problem of political violence within the country. War risk with Pakistan has eased somewhat, although the neighboring country's serious destabilization is of serious international concern.

INDONESIA

The experiences of Temasek Holdings and Exxon Mobil raise concerns of increased nationalist and protectionist activity, and the economic crisis may swing emphasis towards protecting local companies and interests from foreign competition. Meanwhile, Political Violence risk has steadily risen, influenced by ethnic and religious conflicts as well as civil unrest over prices of consumer goods. Strikes and demonstrations are common – in January 2009 a protest targeted a branch of the U.S.-owned KFC food chain. Finally, July's twin terrorist bombings of the Marriott and Ritz-Carlton hotels in Jakarta revived fears of broader terrorist activity.

ISRAEL

War risk with Iran remains a much-debated topic, with hard-line politicians gaining power in Israel and considering military action against Iran to prevent its development of nuclear capability. The recent re-election of Iran's President Ahmadinejad also does not bode well. Meanwhile, Israel continues to be vulnerable to rocket attacks and suicide bombings, and some underwriters are declining to write Political Violence risks for the country.

PHILIPPINES

A string of bombings and bombing attempts have been attributed to a rebel group, Moro Islamic Liberation Front, which continues to operate in the south, targeting transport hubs and department stores. In 2008, the Political Risk market paid at least one Political Violence claim to an insured whose assets were bombed by a rebel group.

SOUTH KOREA

The return to leadership of hard-liners with respect to North Korea has reignited tensions. North Korea has undertaken several aggressive moves in response, including test-firing rockets, conducting a nuclear test, pulling out of negotiated peace agreements and withdrawing from its armistice with South Korea – the armistice that ended the fighting in Korean War in 1953. (The two countries are still officially at war.) For the first time, North Korea threatened to use nuclear weaponry for offensive, rather than defensive purposes. The country also has threatened to turn South Korea into a pile of “debris.”

THAILAND

When political upheaval pushed Thailand to the brink of civil war in late 2008, some Trade Credit insurers stopped underwriting credit risks in that country due to its political risks. Although the situation has eased somewhat, some analysts believe that the conditions that nearly led to civil war remain, and that the country is by no means out of the woods.

TURKEY

Kurdish nationalists and various Islamist groups have staged a number of terrorist acts recently, causing multiple fatalities and occasionally targeting foreign businesses. The rise in terrorist acts is not likely to recede, especially given the deterioration in economic conditions.

MARKET CAPACITY IN HIGH-RISK ZONES

The following countries are proving to be the most difficult in terms of obtaining capacity from the Political Risk market, mostly due to the high political risks, but sometimes also due to

heavy demand (i.e., Russia). It should be noted that with the exception of Zimbabwe, none of these countries are “off-cover,” and capacity does exist, particularly for the right deal.

- Argentina – key risks: Expropriatory Acts and Currency Inconvertibility
- Bolivia – key risk: Expropriatory Acts and Currency Inconvertibility
- Ecuador – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Pakistan – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Russia – key risks: Expropriatory Acts and Political Violence
- Ukraine – key risks: Expropriatory Acts and Currency Inconvertibility
- Venezuela – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Zimbabwe – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility

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¹ Attributed to Ian Bremmer

² Hiscox, a Lloyd's carrier rated Moody's A-, can offer up to \$100 million per transaction for Standalone War. Similarly, Ascot, a Lloyd's carrier rated S&P A+, can offer up to \$50 million per transaction for the same peril.

³ <http://www.reuters.com/article/newsOne/idUSTRE5050F520090106>