WORLDLY WISE

The international business climate and a changing socio-political environment have resulted in an increased demand for political risk insurance. Stuart Anderson examines the political landscape

Viktor Yushchenko commanded top-billing in the foreign pages of newpapers worldwide for several months either side of his dramatic election to the Ukrainian presidency last December, and was widely hailed as the greatest hope for reform of his country's beleaguered economy. As part of that reform he is currently pushing through a review of privatisations, mainly within the petroleum and commodities sectors, carried out by his controversial predecessor Leonid Kuchma.

The beneficiaries of the contracts under review are predominantly Russian companies, and the likely outcome will be renegotiation or new auctions rather than outright renationalisation. The process nonetheless serves as a timely reminder of the ability of democratic governments to revisit and, should they wish, cancel contracts awarded by previous administrations.

In the case of Yushchenko we have a Western-leaning leader advocating the prosecution of exactly the same policies against Russian companies as the West was terrified would be imposed upon theirs in Brazil when the socialist Lula da Silva was elected with a 61 per cent majority back in 2002. The latter spree of confiscations and renationalisations has, however, never materialised. It just goes to show that, when it comes to political risks to trade and investment in emerging markets, there are no certainties.

Such reminders that the climate for international business is not always benign are, in 2005, combining with renewed interest in foreign investment to produce increased demand for political risks insurance (PRI).

After a significant hardening of premiums post-September 11 (as much a result of reinsurers pulling capacity from specialist lines in order to concentrate on property/casualty as of any perceived increase in risk) rates are now, according to Ian Haynes, head of political risk at Marsh, "not hugely dissimilar to 2000".

"Rates went up dramatically in 2001-02 and have been falling by about 10 per cent per year since," he continues. This is partly due to recent increases in market capacity and also a result of lending banks, which make up 70 per cent of the overall market for PRI, seeing their margins squeezed by high levels of liquidity and, in what is increasingly becoming a buyers' market, exerting pressure on their insurers to reduce premiums.

PRI is split into two lines: investment and trade. Investment covers misappropriation of the assets of a venture and physical damage as a result of political violence, while trade insurance provides protection against the frustration of contracts and inconvertibility of currency consequent on political actions. Those actions do not necessarily have to be carried out by the host government – were the UK to impose an embargo on a particular country then all British contracts in that territory would be subject to frustration as a result of our government's decision.

New capacity coming into the market has been focused on the trade side. Here, according to Haynes, 10-15 per cent of additional capacity has been provided over the past year or so. This has predominantly come from new entrants including Quanta, Atradius and Hardy Underwriting Group, a member of the London market.

London has become one of the best places in the world to place short-term political risks business, as Michael Silas, vice president of the global markets financial solutions division of Willis explains: "It has to be because it can't offer coverage of longer than three-to-five years." Longer coverage is available in the US but it comes at a price and, in order to compete, the Lloyd's market is currently offering attractive deals for those willing to accept a shorter duration policy.

Insurers are also likely to be keen to retain the business that they already have. "If underwriters like a deal then they may be persuaded to reduce rates on renewal," says Charles Keville, director of Aon Crisis Management. "Otherwise new players could come in, undercut them on rate and undo all their hard work."

Although rates are softening, demand is forecast to increase. One factor in this is the expansion of capacity in companies' insurance budgets. Silas says, "In recent years companies have allowed what they perceived to be non-essential covers, such as political risks, to lapse as pricing hardened for their core property and casualty policies. Those lines are now reducing their premiums and freeing up budgets for specialist insurances."

Another demand-side driver identified by Silas is that, "After a lull of about four years the banks are hiring again in project finance." This, he believes, presages a significant increase in investment in emerging markets.

Banks do not only drive demand for PRI in terms of direct foreign investment. According to Peter Hornsby, director of the political and credit risks division at Alexander Forbes, "Companies that invest in overseas projects are normally risk-takers who are willing to get burned – it's a balance sheet risk for them. What often happens is that their lenders push them to take up insurance."

This, he concedes, is only true of investment insurance – contract frustration or currency inconvertibility, which fall under the banner of "trade" cover, threaten a company's profit-and-loss account, and therefore its cash flow and share price, making them a higher priority for many finance directors.

A final way in which banks may increase the demand for PRI is in response to the Basel II regulations on capital adequacy, scheduled for implementation next year. These may, dependent on how they are implemented in different countries and the exact wording of policies, enable banks to use PRI as a risk mitigant within their regulatory reports.

Less has changed recently in terms of the geographical regions for which political risks cover is advisable. Brazil and Argentina are now seen as less risky than they were a couple of years ago but the left-wing government of Hugo Chavez in Venezuela is still seen by the market as unpredictable and a threat to international investors. Likewise petroleum and power projects in the CIS are seen as risky while, on the whole, Eastern European countries are improving in terms of governance.

Africa, too, is seeing both increased demand for and supply of PRI. Until recently much of Africa was seen as a no-go area for insurers but now, especially for those investors who can demonstrate a good history in the country in question, cover will often be available. Oil-rich Nigeria, for instance, is now seen as less risky in terms of its ability to generate foreign currency thanks to recent trends in world oil prices. However, that rise has also effectively amplified the value of foreign investments and contracts in the country's oil industry, increasing the level of cover needed against other threats such as that of political violence.

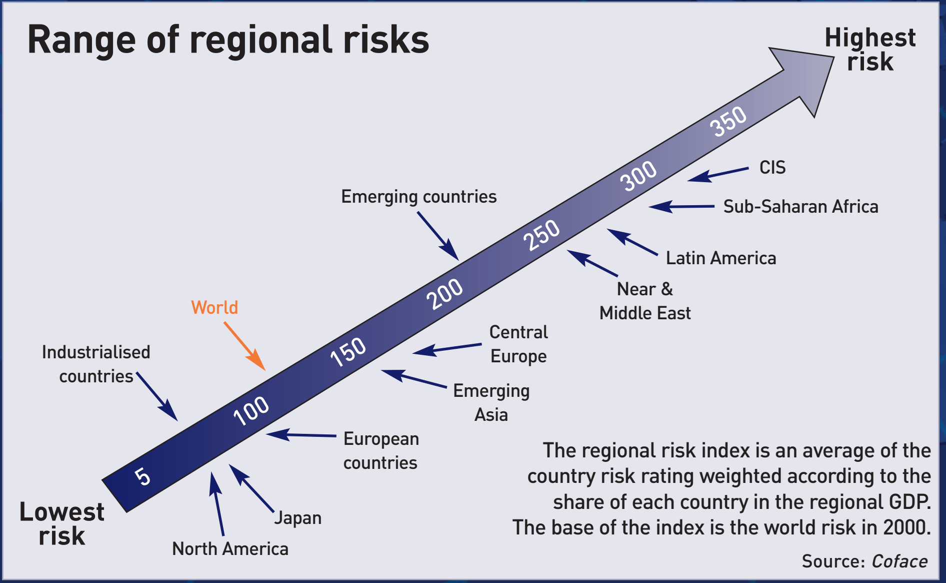
China remains, meanwhile, "the big unknown" and a source of constant demand according to Keville. At the time of writing relations with Taiwan appeared to be warming but if things were to sour again to the point at which the US became involved and embargos were imposed the effects could be very serious.

China also demonstrates the unpredictability of political risks for Keville. "Look at what happened over that Japanese history textbook," he says. "It seems to have calmed down now but for a while it looked quite scary – and it came from completely out of the blue."

It is precisely because political risks are so unpredictable that it pays to make sure the wording of your policy is exactly right. Jardine Lloyd Thompson's latest "Insurance Market Overview" points out that political and credit risk exposure as a result of the Argentine economic collapse of 2002 could have been as high as US$4 billion. In practice, it continues, actual claims paid were closer to US$600 million because: "Political risk insurance only covers default of a private company where the default can clearly and unambiguously be traced back to the defined 'political' risks set out in the policy's insuring agreements".

As with all market developments, improvements to cover across the board only occur at the expense of other people having had their fingers burned. Political risks cover is a highly complex beast, relating as it does to many different aspects of the insured's financial management, physical assets and operations. For that reason, probably more than with any other type of cover, it pays to tailor policies carefully and look before you leap.

Range of regional risks



The regional risk index is an average of the country risk rating weighted according to the share of each country in the regional GDP. The base of the index is the world risk in 2000.

Source: *Coface*