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Insurance of outward FDI in Germany

Information note prepared for the CGFS working group „FDI in the financial sector“[*]

1. Introduction

In Germany the possibility to purchase public FDI insurance from the public sector against political risks in the host country dates back to 1960. It has, however, been increasingly used by enterprises over the last decade. Responsibility for its provision lies with an inter-ministerial committee headed by the Federal Ministry of Economics and Labour (BMWA) , which decides on the coverage and the development of the insurance scheme. The actual business is undertaken by two firms – PwC Deutsche Revision AG and Euler Hermes Kreditversicherungs AG – which are mandated by the Federal Republic of Germany. Besides this avenue, insurance can also be obtained from private insurance firms located abroad, e.g. Lloyds, or from multilateral agencies like the Multilateral Investment Guarantee Agency (MIGA).

2. Legal Aspects of FDI Insurance

Risks

Every enterprise that has its seat in Germany and that conducts cross-border business has the possibility to take out an insurance or obtain a guarantee covering the following political risks:

a) nationalisation, expropriation or other acts that in their effects are equivalent to expropriation;

b) breach of legally binding commitments made by the host country government if they are specified in the letter of guarantee;

[*] This note relies heavily on the Information Memorandum on the Assumption of Federal Guaranties for Investments Abroad (attached) and the Annual Report 2001 on the Investment Guarantees of the Federal Republic of Germany, both published by the Federal Ministry of Economics and Labour (BMWA).

c) war and other armed conflicts;

d) payment embargoes and moratoriums;

e) impossibility of converting and transferring amounts deposited with a solvent bank for transfer to Germany.

Eligibility

A multitude of regulations spell out the details under which conditions an investment may be eligible for the purchase of insurance and the terms under which losses will be covered by the insurers. The two basic requirements stipulate that the insurance must be acquired before the investment is undertaken and that at the time of purchase of the insurance the host country must offer sufficient legal protection, e.g. an investment promotion treaty between the host country and Germany.

Concerning the eligibility of investments, equity investments, endowment capital, quasi participation loans and rights under exploration and production sharing agreements (EPSA) may be insured. The insurance extends to the original capital spend on an investment and may also – with the exception of endowment capital and rights under ESPA - cover the returns from the investment. In principle, all types of investment - be it in the production sphere or in services - may be eligible, and the investments can either be in cash or in kind. The insurance typically covers up to fifteen years and may be extended by another five years. There are no upper limits on the investment values that may be insured. However, to be eligible the investor has to demonstrate additionally that the investment is deserving. In practice this means that the investment should have an expected positive effect on the host country either through the transfer of know-how, the supplementation of capital or by raising environmental standards. Investments which consist solely of the acquisition of shares within an enterprise are generally not deemed to be deserving and can thus not purchase the publicly offered insurance.

Compensation of Losses

Once a loss occurs for the cited political reasons, the insurance may cover the incurred losses if it was covered by the purchased insurance. An important distinction must be made between the loss of property rights and the loss of assets. In the case of assets, say machinery, the loss has to be total and thus in effect equal the expropriation of the investor. A partial loss, which in principle would allow the investor to keep the business going (if on a smaller scale) does not trigger the insurance. In contrast, politically induced losses in property rights, where the investor loses some of the legal rights associated with the investment can be covered in full or partially. In the case of investment-like loans a partial compensation is also feasible if the loss is caused by expropriations, moratoriums or contingencies relating to the conversion and transfer of deposits.

The amount that will actually be covered by the insurance is limited by the contribution the investor made to the investment plus 10% of the principal per annum with a maximum coverage 50% for equity and 100% for loans for all of the returns from the investment over the insured period. The maximal indemnity will, however, be lower than the sum of contribution value and returns. First, a mandatory self-participation element of 5% of the covered loss must in any case be borne by the investor. Second, the amount covered by the insurance will be further reduced, should the actual value of the investment at the time the political risk manifests itself be lower than the contribution value originally made, e.g. due to repatriations or sales of part of the investment. A reduction in coverage will also occur if the investor has received any other compensations from other sources for the damage incurred. Additionally, the costs of purchasing the insurance must be deducted. From a project size from EUR 5 million upwards, these amount to a yearly fee of 0,5% of the covered investment, whereas a reduced premium of 1/6 of the regular premium is charged on anticipated investments. On top of this a processing of maximal EUR 10,000 per application has to be borne by the investor.

3. Recent developments of investment insurance in Germany

Regional trends and project characteristics

Demand for FDI insurance comes typically from large investors. Over the last years their share has consistently exceeded 60% of all applications for insurance. While large projects also dominate the volume of insurance granted, about half of the applications for insurance regularly concern projects with a value below EUR 2 million. Considering the period from 1995 onwards, Eastern and Southern Europe has typically been the most prominent region, due to a number of large projects in Turkey and Croatia. However, as single large projects can in any one year significantly alter the distribution, these trends should only be viewed as indicative. In 2001 for instance the largest underwriting volume was done for Projects in Asia (50%), followed by Eastern and Southern Europe (23%), South and Central America (19%) and Africa (11%). Interestingly enough, even though Argentina has been among the more important countries in terms of project coverage, no losses leading to indemnity being paid out, have occurred there over the course of the last years.

According to the number of underwritten projects in 2001 the majority belonged to equity holdings, in terms of volume almost 50% were accorded to investment-like loans, however. The most prominent German sectors in terms of received guarantees in 2001 were infrastructure and transport (31%), services (27%) and car industry (17%). Within the service sector, the bulk of demand came from financial services such as leasing and sales financing. Here, banks performed a dual role. On the one hand, they sought insurance for investment-like loans they have extended to their clients. On the other hand, insurance was demanded for their own genuine FDI projects. Interestingly, the first activity dominated the second by far. Consequently, of the stock of insurance coverage purchased by financial enterprises, which stood in mid-2003 at about EUR 4.9 billion, nearly the whole amount, namely EUR 4.8 billion, was connected with investment-like loans to enterprises. Regarding the break-up in capital and returns, slightly more than 55% were allotted to capital insurance and the rest to the insurance of returns. Apparently, the low insurance cover for investment in affiliates (EUR 120 million) is mainly due to a lack of demand on behalf of the financial direct investor.

Development of project approval and covered losses

In 2001, 112 projects were approved, this is 15% below the average over the last ten years and similar to the results in 2000. However, the volume of EUR 2.7 billion realised in 2001 is by historical standards still rather large. This is in line with the upward trend; of the total sum of EUR 27.1 billion of all insurance guarantees since 1960, more than EUR 20 billion were granted during the last ten years.

The majority of investors that sought to purchase insurance have been able to do so. From a total volume of applications of EUR 45.2 billion since 1960, the German government approved approximately 60%. Only 0,3% of the applications in volume terms were rejected. This small figure is due to the screening process that takes place before a formal evaluation is undertaken. Apparently, a large number of projects is withdrawn already at this early stage. But withdrawal of projects also remains high after applications have been submitted, reaching roughly 22% of the applications submitted since 1960.

From its inception in1960 until 2001 the German government has paid out EUR 95,4 million to individual enterprises. The by far largest amount of this was accorded to claims concerning projects in former Yugoslavia. So far the ability to meet the claims was ensured solely through fees, premiums and recoveries from host countries. Including the provision of the institutional infrastructure, there have thus been no extra budgetary outlays associated with the insurance of FDI against political risks. It is nonetheless noteworthy that the maximum amount the German government may be held liable for, i.e. the worst case scenario, has increased more than fivefold over the last ten years (see Table).

Applications, Policies and Liabilities, 1992 - 2001

Year	Applications		Policies		Maximum Liability (cumulative)	
	Number of Projects	EUR Million	Number of Projects	EUR Million	Number of Projects	EUR Million
1992	234	884.3	86	421.5	742	2,910.4
1993	263	1,592.2	120	454.6	727	3,005.9
1994	327	1,749.9	147	776.9	779	3,458.2
1995	311	2,619.2	139	876.1	865	3,799.3
1996	352	3,528.4	138	2,402.6	878	5,507.4
1997	239	5,330.3	172	3,316.9	923	7,639.9
1998	245	3,361.6	150	2,350.5	964	8,218.0
1999	249	5,313.7	139	2,808.1	973	9,876.6
2000	161	4,000.7	109	4,217.3	963	13,407.6
2001	167	4,684.0	112	2,671.5	927	14,313.6

Source: Investment Guarantees of the Federal Republic of Germany, Annual Report 2001, Federal Ministry of Economics and Technology, pp.52-54.

<u>Attachment</u>