An Overview of Political Risk Insurance

Kausar Hamdani, Elise Liebers, and George Zanjani

Federal Reserve Bank of New York
May, 2005

Executive Summary

In conjunction with the Committee on the Global Financial System Working Group project on foreign direct investment in emerging market financial sectors, staff of the U.S. Federal Reserve examined the market for political risk insurance (PRI) and its use by financial institutions to mitigate emerging market risks. A series of meetings were undertaken in 2003 with U.S. commercial and investment banks, and public and private insurers active in the market. This note summarizes the information gathered in those meetings, subsequent follow-up, and through other research. It provides a brief overview of the PRI product and characteristics of the market, and discusses the effectiveness of PRI as a risk mitigant.[1]

PRI provides protection against losses that result from acts of currency transfer restrictions, expropriation, and political violence. Offered by national, multilateral, and private insurers, it is used by investors to mitigate country risks associated with emerging market debt and equity investments, and lending. For insurers, PRI is a high cost but profitable business.

PRI covers only a small fraction of emerging market investment. While market participants reported widespread interest in the product, they cited several factors limiting its use. Buyers identified high prices for PRI policies and gaps in coverage as reasons for limited use. Sellers noted limited market capacity and the "uninsurability" of many transactions as restraints on PRI product penetration.

Product limitations were highlighted during recent emerging market crises, when investors suffered losses that were not covered by PRI. In some cases, ambiguities in contract language and gaps in coverage were not anticipated by investors. This resulted in claims disputes, with some participants expressing skepticism regarding private insurers' willingness-to-pay. Given the difficulties inherent in specifying the range of possible sovereign actions covered by the PRI contract, some disputes may well be unavoidable.

Despite its limitations, the PRI market has long played a role in supporting emerging market investment and is likely to continue to do so. The recent experiences may lead to refinement and standardization of contract wording, while legal precedents may clarify other ambiguities. Improved investor understanding of the benefits and limitations of PRI may also help to improve the match between buyer expectations and contract performance. However, uncertainty and ambiguity are unlikely to fully disappear, due to the inherently subjective nature of determining policy triggers.

---

[1] This note reflects the findings and judgments of the authors and not necessarily the views of the Federal Reserve Bank of New York or the Federal Reserve System.

Market participants were asked how PRI could be enhanced to better support investment in emerging market financial sectors. Buyers expressed interest in comprehensive coverage, although sellers noted that such approaches had not yet yielded a viable product. Another option noted was to expand the role of public insurers, who have historically served public policy objectives. However, all market participants noted that PRI is not a substitute for fundamental economic, political and legal reforms that are needed to attract foreign direct investment to emerging markets.

Product Description

PRI policies are insurance contracts that offer coverage for the "political risks" excluded under typical commercial insurance contracts. PRI coverage is available for investments and for trade-related transactions in emerging market countries. The market for trade-related insurance is large and has well-developed business practices. This paper will focus on the less familiar investment insurance market.

Policy Coverage

PRI provides coverage for investors making direct equity investments in projects as well as those lending to emerging market borrowers. Recently, PRI has been used as a credit enhancement when securitizing emerging market debt.

The political risks covered under these policies are typically classified into three categories:

- *Currency inconvertibility (CI)* coverage protects against losses caused by currency transfer restrictions. Typically, CI coverage applies to the interruption of scheduled interest payments or repatriation of capital or dividends due to currency restrictions imposed by the host government.

- *Confiscation, Expropriation, and Nationalization (CEN)* coverage protects against losses caused by various acts of expropriation. Coverage usually applies to outright confiscation of property or funds.

- *Political Violence* protects against losses caused by war, civil disturbance, or terrorism. Coverage is usually limited to "politically motivated" violence.

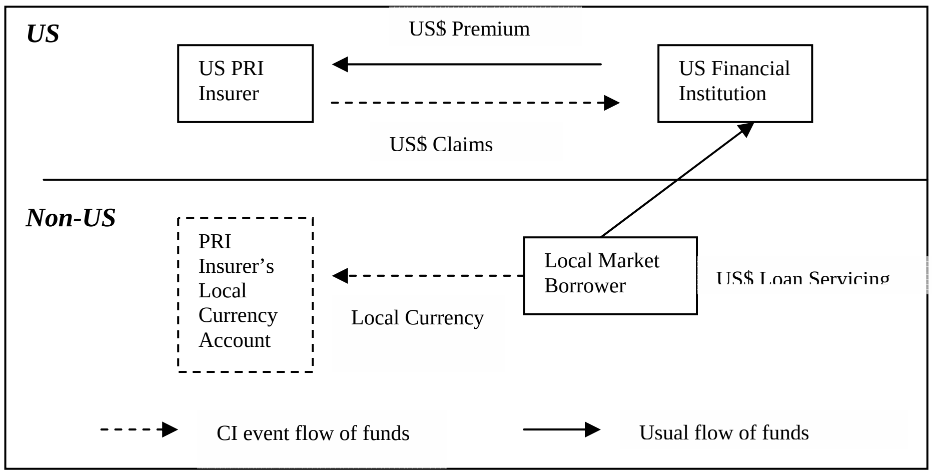
As with other insurance contracts, the coverage trigger hinges on a loss occurrence connected with a specified insurance peril. CI policies are triggered when (i) currency transfer restrictions are imposed and (ii) the borrower has demonstrated the ability to pay by depositing funds in the local account of the insurer.

Triggers under Political Violence and CEN coverage are less straightforward. It can be difficult to determine if a loss was directly caused by an act of political violence. Likewise, difficulties can arise in determining whether CEN coverage is triggered, especially in the case of "creeping" expropriation---where a government undertakes a series of actions that are, in sum, *de facto* expropriation, even though none of the individual actions is sufficient to trigger the coverage.

Example of Cash-flows Under Typical Insured Transactions

To illustrate the role of coverage triggers and the cash-flows that ensue, the following diagram provides a schematic of cash-flows under a typical CI policy covering a crossborder lending arrangement. The example is simplified. In practice, contracts are highly customized and have cash-flows structured to meet the specific needs of the transaction.

Currency Inconvertibility Event
Schematic of Cash-flows



In this example, a local market borrower has been funded by an U.S. institution. The U.S. financial institution pays a premium to the insurer. In the event of currency transfer restrictions, a credit event for the local borrower must first be ruled out by his continued payments into the PRI insurer's local currency account. As long as money continues to be deposited into that account, the insurer is obliged to make regularly scheduled payments to the U.S. financial institution on the loan. In practice, there is typically a waiting period of several months before payment to the financial institution begins. This delay is to avoid invoking coverage in the case of transient events that are of too brief a duration to have real economic impact.

Cash-flows under CEN and political violence coverage are similar and more straightforward than under a CI policy. Again using the above example, under a political violence policy the insurer would pay the U.S. financial institution the insured portion of the principal and interest payments in default as a direct result of damage to the assets of the local market borrower caused by war and civil disturbance. In the case of CEN coverage, the U.S. institution would be paid in the event that the local market borrower's real assets were expropriated. As with CI, such payments would only be made after a waiting period, which can range from 6 months to a year to allow for the documentation and filing of the loss. In addition, the insurer could take ownership of damaged or expropriated assets and could try to recover costs through salvage efforts.

Other Policy Terms and Conditions
Although contract terms and conditions are tailored to specific projects, there are some common themes.

- Policy tenors range from 3 to 20 years, with most private providers in the shorter end of the range. Policies are typically renewable annually after the first several years.

- Premiums may be billed as a single lump sum or in periodic installments throughout the life of the policy.

- Cancellation of coverage by the insurer is typically limited to situations where the insured is found in breach of contract. Contract breach can result from nonpayment of premium or when the insured's project fails to meet specific guidelines established in the contract. The latter guidelines are more often associated with public insurers, which require insured projects to adhere to environmental standards or other eligibility criteria in order to qualify for coverage.

- Cancellation of coverage by the insured is typically permitted, although there are sometimes restrictions in the first few years of a long-term policy.

- Co-insurance clauses are typical, with the exact level reflecting the insurer's preference for risk sharing with the buyer. Such clauses may refer to a deductible or percentage of loss to be paid by the policyholder.

- Salvage and subrogation clauses require the policyholder to cede ownership of imperiled assets to the insurer in the event of a total loss. This feature allows insurers to recoup losses to the extent of their ability to salvage value in the assets.

- Waiting periods of 30 days or more may be applied before claims are eligible for payment. This feature provides an opportunity for clarity and resolution of the event before the insurance is triggered.

Pricing

Market participants characterized PRI as an expensive product. Although detailed claims data are available only for public insurers, it is widely acknowledged that PRI has historically been a profitable business.

The cost of PRI reflects several factors. One important consideration is the unpredictability of losses. The infrequency and uniqueness of political events means a lack of credible data and "off-the-shelf" statistical models on which to base actuarial estimates of future losses. Furthermore, PRI losses exhibit significant volatility from year to year: Not only is there the potential for significant losses associated with political developments in a single country, but events may well be correlated in time across countries. Hence, a single event may wipe out many years of profits. Given this potential for catastrophic loss, as well as the difficulties in assessing the underlying risk, prudent insurers need to hold large amounts of equity capital in anticipation of such potential losses and need to obtain an adequate return on this capital. As a result, it is not surprising that PRI, like other insurance lines with catastrophe potential (e.g., earthquake), exhibits prices well in excess of expected losses.

Another factor contributing to the high cost of PRI is the expense involved in underwriting the policy. Insurers do a significant amount of information gathering and due diligence prior to underwriting the policy. Local country information used in pricing is reported to be costly to acquire, and PRI underwriting expertise is scarce and expensive to retain. All these factors add to the insurer's cost of providing PRI.

PRI prices vary based on country, industry sector, nature of the investment and the coverage selected. Public insurers disclose their prices, which form a benchmark for buyers when seeking coverage. Because of this disclosure, as well as the tendency for public insurers' prices to vary less by country and project than private insurers' prices, private insurers are said to "cherry-pick" the more desirable risks and underwrite them at lower prices than the public benchmark.

Loss Control and the "Halo Effect"

The risk mitigation benefits offered by PRI go beyond cash indemnification in the event of loss. Some PRI insurers have considerable influence with foreign governments and are successful in preventing adverse events from occurring or in securing preferential treatment for investors when adverse events do occur. This advantage is especially true for public insurers, whose ability to shield investors from loss is referred to by market participants as the "halo effect" associated with their policies.

Examples of this effect are the exemptions from currency controls that were granted to certain investors during the Russian and Argentine crises. In the latter crisis, this exemption was extended to clients of all members of the Berne Union (which includes public and private insurers). The halo effect can also be useful in facilitating the salvage of assets ceded to the insurer after a loss has been paid.

PRI insurers also offer expertise in structuring deals to make them *ex ante* less susceptible to loss. However, it appears that few clients avail themselves of this service. One insurer noted that most deals are "well-baked" before they see them.

Market Overview

Despite growth during the 1990's, PRI covers only a small fraction of total capital flows to emerging markets. While data are scarce, PRI provided by Berne Union members (which include the major insurance underwriters for U.S. investors) covered only about 10 percent of emerging market FDI in the 1990's.[2] During 2001, Berne Union members insured only $17 billion of investments.

Per-deal capacity in the market is limited. Market participants estimated that the PRI market could supply about $1 billion to $1.5 billion for any one deal in 2003, which is not sufficient to cover investments in certain sectors or many infrastructure projects. For example, some energy sector projects may be too large for the PRI market to easily absorb.

Today, both public and private insurers underwrite PRI and, in some instances, they participate in the same transactions. While PRI's origins reportedly go back to the Lloyd's of London marketplace, public insurers appear to have been the major players

---

[2] Gerald T. West (1999), "Political Risk Investment Insurance: A Renaissance," *Journal of Project Finance*, vol. 5, issue 2.

for much of the latter half of the 20th century. As private insurers capitalized on the surge in demand that accompanied rising foreign direct investment in the 1990's, their participation has risen.

New ways of using PRI are also emerging. The use of PRI as credit enhancement on emerging market bonds and securitizations of these bonds is a relatively new development that seems to be sparking market interest. The rating agencies have recognized this value and noted that corporate issues enhanced with PRI, in principle, may qualify for improved ratings under some circumstances.

Public Insurers

Public insurers include both national and multilateral institutions. These insurers typically have mandates to support the policy goals of their sponsoring entity, such as fostering development in certain emerging markets. These mandates may also place restrictions on the types of investments that are eligible for coverage. Such restrictions may address environmental issues, the nationality of the investors, the nature of the investment (e.g., only new, as opposed to seasoned, investments may be eligible), or other issues derived from the sponsor's policy objectives.

Some public insurers' guidelines require them to act as an "insurer of last resort" rather than as a direct competitor with the private sector. In such cases, the public insurer requires potential investors to receive a certain number of declinations in the private market before considering their projects for underwriting. As a result, public insurers may support some higher risk projects that were not readily insurable by the private market.

Private Insurers

There are a relatively small number of niche players in the private market who are typically affiliated with large international multi-line insurance companies. Unlike their public counterparts, the private insurers are free from charter-based eligibility restrictions. As a result, private insurers have greater flexibility in the types of projects they may underwrite and the breadth of coverage they can offer. Barring legal prohibitions, private insurers may underwrite in any country. In practice, however, they restrict coverage in high-risk markets as prudent risk management.

Reinsurers

Reinsurance is utilized by private insurers, and, to a lesser extent, by some public insurers. As is the case in the direct insurance market, the number of reinsurers that underwrite PRI is small. In the early 2000's, the availability of reinsurance declined as reinsurers refocused their business strategies following poor investment returns and significant underwriting losses in other business lines. The decline in reinsurance capacity reportedly resulted in higher prices and less availability in the direct PRI market.

Capacity and Underwriting Cycles

Capacity in the PRI market is a function of the underwriting cycle in the insurance industry. Insurers control capacity through a combination of pricing, underwriting criteria, risk sharing, contract exclusions, country limits and other decisions about the type and amount of risk they are willing to underwrite. During "hard" markets, private capital may be withdrawn from the PRI market and re-deployed to other business lines of insurance. The result is higher prices and less capacity in the PRI market, even if there has been no PRI claims activity.

PRI market capacity declined in 2001, partly as a reflection of the cycle in the broader property-casualty market. The September 11 attacks shook the property-casualty industry at a time when the market had already started to harden, leading to widespread restriction of capacity (and price increases) across many lines of insurance (including PRI). The PRI market was also hit by the incidence of claims associated with Argentina and issues at specific companies, which led to some problems in the availability of reinsurance.

Despite the reduced capacity in the PRI market, prices did not increase significantly. Market participants attributed this stability to reduced demand for PRI coverage resulting from the falloff in emerging market investment. In addition, some noted the presence of public insurers, which are largely insulated from the broader property-casualty market cycles since their capital is committed by mandate. Public insurer prices and contract terms tend to be more stable than their private analogs, and the presence of public insurers may serve to dampen the amplitude of underwriting cycles in the PRI market.[3]

Product Effectiveness in Managing Political Risk

PRI's usage has been modest, reflecting its current limitations as a risk transfer tool. Among important limitations, coverage in high-risk markets is not consistently available, although public insurers have tended to play a larger role in providing capacity to these markets. Where coverage is available, it may be expensive and reflect insurers' limited appetite for assuming such risks. Other important elements limiting the effectiveness of PRI include contract language ambiguities, coverage gaps and concerns regarding insurers' willingness-to-pay.

Low Product Utilization

Today, only a small amount of total emerging market investment carries PRI protection. In particular, some large global institutions eschew PRI because their ability to diversify across geographic regions makes self-insurance, perhaps coupled with other risk mitigants, a more cost-effective option.

Other potential users turn to self-insurance after finding either unfavorable terms or a dearth of underwriter appetite in the marketplace. One market participant estimated that only 10 percent of buyers who come to the private market eventually buy insurance. About half of the buyers do not receive quotes, implying that their projects in their current form may not be insurable given underwriting standards. The remaining 40 percent do not accept the quotes that they receive.

These data suggest broader interest in PRI than its modest usage would indicate. In some cases, investors test the PRI market as a part of a due diligence process. For example, the availability of insurance at a reasonable price might confirm the investor's internal risk assessment of the project. However, the tendency of investors to go forward with emerging market investments without PRI also suggests that PRI coverage, while beneficial, is not essential to many investment decisions. Indeed, one market participant noted that PRI tends to be cut when a risk management budget is under pressure.

---

[3] More recent data indicates a rebound both in PRI demand and capacity, starting in 2004 (see, e.g., Green, M. (2004), "A Whole New World: As U.S. Companies Increase International Investing, Political Risk Insurers Take Advantage of New Coverages and New Markets," *Best's Review* 104 (11), p. 54).

Another reason for low usage may be that many buyers of PRI take advantage of the option to cancel their coverage after the first few years of the policy. Thus, PRI appears to be most in demand in the early stages of projects when the uncertainties are the highest and the ability of the insured to influence the local political environment is the weakest. It is also possible that PRI provides some initial advantage, such as more favorable assessments from rating agencies, that is of less value in the later years of the investment. Some insurers estimated that the first five years of a project are the riskiest years when issues are likely to arise. Not surprisingly, market participants reported less interest in purchasing PRI coverage for "seasoned" projects.

Contract Language Ambiguities and Gaps in Coverage
An inherent challenge in drafting PRI contracts is that covered events must be described with sufficient specificity so that occurrence is readily identifiable, yet with sufficient generality to avoid making the contract too narrow or cumbersome. A common source of insurance litigation is whether or not a covered event has actually occurred; indeed, occurrence determination is inherently subjective. Such disputes foster investor concerns regarding insurer willingness to pay, as well as insurer frustration that investors do not understand the coverage.

Ambiguity as to whether a covered event has occurred is illustrated in the context of "creeping" expropriation, where it is often not clear when a series of sovereign actions triggers expropriation coverage. Another example is the case of Argentina, where it was not always clear whether or not the "pesofication" of dollar-denominated debts amounted to *de facto* expropriation. In general, claims resolution can be a complex exercise in insurance contracts that require a subjective determination of cause and effect.

Explicit gaps in PRI coverage reduce its effectiveness as a comprehensive risk mitigant. For example, lenders with CI policies are covered to the extent that their borrowers continue to make payments in the local currency account, but not in cases of non-payment due to borrower default. However, political turmoil is often associated with economic turmoil, which may result in borrower default or devaluation of local currency payments (see above cash-flows schematic diagram). PRI offers no protection from such events. Hence, much of the risk of loss in a high-risk market may fall outside the domain of political risk coverage, even though the loss is tied in some way to "political" risk.

Uninsurability
As noted, as many as half of all transactions presented to insurers are rejected as uninsurable. Uninsurability may reflect the geographic location of the project. Some insurers are reluctant to underwrite at all in areas with significant economic and political instability. Others have pre-determined country risk limits to contain their geographic concentrations and may reject transactions on the basis of those limits. Uninsurability may also reflect difficulties inherent in structuring projects in ways that meet insurers' underwriting guidelines.

<u>Outlook</u>

Looking to the future, we asked market participants how PRI could be made more effective in stimulating foreign direct investment. Product innovation and public policy support were two areas discussed.

Product Innovation

The PRI product will undoubtedly evolve as insurers and investors work together to develop solutions for managing the risks associated with emerging markets investment. Moreover, there are few alternative risk transfer mechanisms available for such risks. Lessons learned from crises in Argentina and other emerging markets may lead market participants to refine and standardize contract wording. Legal precedents established in today's court cases may also help to clarify other contractual ambiguities. In addition, an improved understanding by investors of the benefits and limitations of PRI may help resolve coverage issues.

Evolution of PRI may yield new products, as well as new applications for existing products. In particular, some market participants expressed interest in comprehensive insurance products that protect against commercial risks as well as purely sovereign risks. In addition, as noted earlier, PRI is now being used as a credit enhancement device on emerging market bonds.

However, it is unlikely that evolution and innovation in the marketplace will address all of PRI's limitations. Ambiguity is endemic to insurance property and casualty contracts, even for well established business lines such as commercial property (as evidenced by the insurance litigation engendered by the September 11 attacks in the United States). A certain level of uncertainty and risk of litigation will necessarily remain: It is fundamentally impossible to anticipate and describe all possible manifestations of country risk without creating overly-specific and unwieldy contracts. Moreover, most market participants expressed skepticism that the gaps in PRI coverage could be eliminated through comprehensive policies at a price acceptable to buyers who already perceive PRI to be expensive.

Public Policy Support

PRI offered by public insurers has traditionally served public policy goals. Toward that end, risky sectors and markets could be reached by expanding the mandates and funding of public insurers. Public insurers could also test the viability of new PRI products, which the broader market could then adopt. However, the costs and benefits of any policy changes would need to be carefully evaluated.

Financial market regulation can also affect the demand for PRI. For example, as risk-based capital frameworks evolve toward more sophisticated treatment of risk mitigants, demand for PRI may increase. Indeed, demand for PRI as credit enhancement in emerging market debt offerings has been supported, in part, by the willingness of rating agencies to recognize PRI as a risk mitigant.

Conclusion

Despite significant public and private involvement in the market, PRI currently covers only roughly ten percent of emerging market investment. PRI product innovations may facilitate risk-sharing among financial institutions, and regulatory refinements may further deepen the penetration of PRI. However, the fundamental restraints on investment in emerging markets appear to be real political risks that raise the costs of doing business in those markets.

Market participants pointed to the local investment climates as the primary determinants of foreign direct investment, with impediments to risk transfer playing secondary roles. PRI demand was clearly viewed to follow demand for foreign direct investment---not the other way around. When asked about public policy initiatives, participants suggested policies aimed at strengthening property rights and facilitating recoveries in the aftermath of political events. PRI by itself cannot be expected to substitute for the fundamental economic, political and legal reforms needed to attract foreign direct investment to emerging markets.