CHAPTER THREE

THE POLITICAL RISK INSURANCE INDUSTRY

Overview

The political risk insurance (PRI)[1] industry has weathered the global crisis well. Premium revenues reported by members of the Berne Union[2] (BU)—the leading association of investment insurers and export credit agencies (ECAs) (box 3.1)—increased in 2009, in spite of the 6 percent contraction in the investment insurance portfolio. Claims in investment insurance have remained modest, particularly when compared to losses suffered on the export credit segment, and capacity remains more than adequate to cover existing demand. The private PRI market has held steady. Unlike in the aftermath of previous crises, no reduction of capacity has been reported, and reinsurance remains available. Having declined in 2009, new business reported by BU members is picking up again in 2010, partly reflecting the expected recovery of foreign direct investment (FDI) flows (chapter 1). This increase is resulting in a recovery of the maximum limit of liability, and the industry expects these positive trends to accelerate over the next few years.

Box 3.1 The Berne Union

The Berne Union (BU) was founded in 1934 in order to promote international acceptance of sound principles in export credit and investment insurance and to exchange information relating to these activities. Today, the BU has 73 members (including Prague Club members) comprising mainly export credit agencies (ECAs), multilaterals, and private insurers (appendix 9). Most ECAs and multilaterals are BU members, as are large private insurers such as AIG (now Chartis Insurance), which joined in 1999, followed by Zurich and Sovereign Risk Insurance Ltd. In October 2008, Hiscox became the first private insurer underwriting in Lloyd's to join the BU. In 2009, ECAs accounted for about 66 percent of the BU's outstanding investment PRI portfolio, private members for 29 percent and multilaterals for 5 percent.

The BU's Prague Club (appendix 9) was started in 1993 with funding from the European Bank for Reconstruction and Development. It is an information exchange network for new and maturing insurers of export credit and investment. The Prague Club supports members' efforts to develop their export credit and investment insurance facilities by hosting technical discussions at twice-yearly meetings, as well as ad hoc information exchanges. A number of Prague Club members have gone on to meet the requirement for full BU membership.

The BU plays an important role in bringing together the public and private insurers to enhance cooperation and information sharing. Members meet on a regular basis to discuss industry trends and challenges. In recent years, there has been a concerted effort on the part of the BU Secretariat to promote transparency and disclosure in the industry and to represent member interests in order to promote global trade and investment.

Source: The Berne Union.

When it comes to conflict-affected and fragile (CAF) countries, however, the PRI industry remains generally cautious. Cover for most CAF countries is limited and restrictive, reflecting the industry's risk perceptions and, in some cases, foreign policy restrictions such as sanctions. Most of the PRI underwritten in these investment destinations is provided by a small number of insurers and is concentrated in a handful of resource-rich countries, mirroring the pattern of FDI flows (chapter 2). Although the proportion of claims relative to PRI portfolio in CAF countries has largely been in line with losses in other developing countries over the past few years, the profile of losses differs: CAF countries are responsible for most civil disturbance claims, but almost none are for expropriation.

Multilateral PRI providers, because of their mandate and ownership structures, can be in a better position than private insurers or export credit agencies (ECAs) to provide cover in investment destinations considered riskier, such as CAF countries. They are, therefore, well placed to play a catalyst role in expanding market capacity for these destinations not only by providing PRI directly, but also by mobilizing reinsurance and coinsurance for investments in destinations that may otherwise not have been considered, as highlighted through a number of initiatives already in place or in preparation.

After the Crisis: Recent Trends in the PRI Industry

The PRI industry (box 3.2) continues to be well positioned to respond to growth in demand for PRI as a modest recovery from the global downturn appears to be gaining traction. Demand for PRI slumped during the financial crisis in 2009 as funding for ongoing projects was put on hold or canceled, but it picked up again in the first half of 2010, reflecting the modest recovery in FDI (chapter 1).

Demand for PRI (box 3.3) is related to FDI flows, although the relation is neither linear (figure 3.1) nor well understood.[3] New demand for PRI slowed down in line with FDI flows to developing countries, which slumped by 40 percent in 2009 (chapter 1). The ratio between investment PRI and FDI remained stable at around 10 percent in 2009, consistent with levels observed over the past few years. This suggests that the global economic downturn and the evolution of political risk perceptions (chapter 1) have not resulted in heavier reliance on PRI. The relation between FDI and PRI is similar whether flows or stocks are considered. These results clearly indicate that PRI is one of many risk-mitigation tools that are used by foreign investors. How and why it interacts with other risk-mitigation tools (anywhere from local engagement strategies to global insurance policies along other lines that overlap with PRI) is a subject of future research. It is in the context of this interaction that the idea of whether or not there is a market failure in the PRI industry has to be considered.

Figure 3.1 Ratio of PRI to FDI for developing countries

Percent

Source: BU and World Bank.
Note: Data for PRI are from BU members only.

Confirming last year's observations, the PRI market appears to have been stable throughout the financial crisis. Although many insurers have indicated that the volume of business written has declined as there has been a dearth of projects, other aspects of the market have changed little, and PRI providers remained willing, albeit more cautious, to underwrite projects.

Demand

Reflecting the decline in FDI flows, the amount of new business in investment PRI declined in 2009. Following several years of double-digit growth

Box 3.2 Overview of the PRI Industry

The political risk insurance (PRI) industry includes three broad categories of providers and covers both export or trade credit and investment insurance. For this report, PRI refers to investment insurance. The public PRI market comprises both national and multilateral PRI providers. The private market's PRI falls into two main categories: (i) political risk activities similar to that of the public insurers, such as coverage for investments in developing countries against expropriation, political violence, and other such risks; and (ii) developing country nonpayment insurance covering contract frustration and default by governments.

The National PRI Providers
The providers comprise national export credit agencies (ECAs) and investment insurance entities. They focus on cross-border trade and investment, generally for constituents in their own countries.

The Multilaterals
Multilaterals include the African Trade Insurance Agency (ATI), the Asian Development Bank, the Inter-American Development Bank, the Arab Investment and Export Credit Guarantee Corporation (Dhaman), the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), and the Multilateral Investment Guarantee Agency (MIGA). The World Bank, the Asian Development Bank, and the Inter-American Development Bank also provide risk-mitigation instruments, such as partial risk guarantees.[a]

The Private PRI Market
The private market includes about 20 Lloyd's syndicates (appendix 8) and about eight private insurance companies. The majority of private insurers are based in three insurance centers—London, Bermuda, and the United States (primarily New York City)—and several of the larger insurers have offices in Singapore; Hong Kong SAR, China; Sydney; and elsewhere. As well as traditional equity PRI, the private market offers protection for a wide variety of developing-country payment risks, either for political perils alone or comprehensive nonpayment cover. Brokers play an important role in promoting and sourcing PRI for the private market. This market segment is dynamic: over the past year, some players have exited the PRI market, while new entrants have appeared.

The Reinsurers
Reinsurance companies write PRI-related coverage for both trade and investment. Reinsurance is an underlying factor driving both pricing and capacity in the private market. Some of the top reinsurers include Munich Re and Hannover Re of Germany, Swiss Re of Switzerland, and Berkshire Hathaway/General Re of the United States. ECAs and multilaterals also participate as reinsurers of PRI, although on a smaller scale.

Source: Data on national providers are from Berne Union, and data on private providers are from Gallagher London.

a A partial risk guarantee covers private lenders against the risk of government failure to honor contractual obligations relating to private projects.

Box 3.3 Political Risk Insurance and Its Benefits

Political Risk Insurance (PRI) captures most, but not all, noncommercial risks. It covers political events, including the direct and indirect actions of host governments that negatively impact investments and are not properly compensated for. This report focuses on investment insurance.

In addition to providing compensatory value in the event of claims, PRI can help investors access finance—often on better terms, thus increasing the tenors and size of available loans. Investors are often required to get this insurance in order to obtain financing from banks. For lenders, PRI can provide regulatory relief from country risk-provisioning requirements. When provided by multilateral and large national insurers, PRI can also help deter harmful actions by host governments, can help resolve investment disputes, and can provide access to best practices in environmental and social standards.

Motivations driving the public and private segments of the market are fundamentally different, which is partly reflected in the cover they are able to provide. National insurers have strict mandates from their authorities to serve constituent interests and are bound by foreign policy considerations. Multilateral providers ensure that their activities are consistent with broad developmental goals. Private providers, however, are motivated by the need to make profit. As a result, public and multilateral providers are usually able to offer longer tenors and higher capacity than can private insurers, but private providers can be more responsive to customer needs for product variations or complementary products.

The following are the political risks commonly insured by the PRI industry. There are differences in the terminology and definitions used by the various insurers, particularly between the public and private insurers.

Expropriation
PRI protects against losses caused by host government actions that may reduce or eliminate ownership or control. It covers outright confiscations, expropriations, and nationalizations, as well as losses resulting from a series of acts that over time have an expropriatory effect.

Currency Inconvertibility and Transfer Restrictions
PRI protects against losses arising from an investor's inability to convert local currency into foreign exchange and to transfer it out of the host country. It also covers excessive delays in acquiring foreign exchange. Typically, this coverage applies to the interruption of interest payments or repatriation of capital or dividends resulting from currency restrictions. It does not cover devaluation risk.

Political Violence (War, Terrorism, and Civil Disturbance)
PRI protects against losses resulting from the damage of tangible assets or business interruption caused by war, insurrection, rebellion, revolution, civil war, vandalism, sabotage, civil disturbance, strikes, riots, and terrorism. Coverage usually applies to politically motivated acts. Certain insurers offer terrorism coverage on a stand-alone basis to supplement property insurance policies, which have largely excluded terrorism as a peril since September 11, 2001. Terrorism insurance increasingly offers cover against broader political violence risks.

(figure 3.2), members of the BU—the largest grouping of PRI providers—underwrote only $36 billion of new business in 2009, a decline of over 38 percent from 2008. Lloyd's new activity in that line has been estimated at another $40–50 billion.

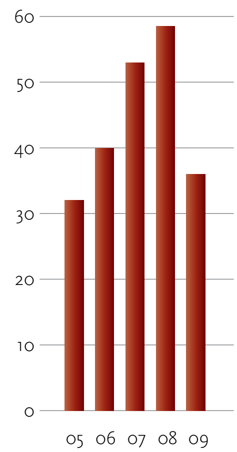
New business recorded by BU members is picking up strongly, however, reflecting in part the modest recovery in FDI (chapter 1). It increased by over 80 percent in the first half of 2010 compared to the same period in 2009.

Sixty-five percent of the BU's new business in investment PRI in 2009 and 74 percent in the first half of 2010 was underwritten by public insurers. Their share in BU new business has been growing steadily from 50 percent in 2005, and the increase in 2009 and 2010 is the result of the underwriting of a few large projects. Over this period, the share of multilaterals has remained constant at about 3 percent, while private providers' share has declined.

The volume of liability held by BU investment insurers dropped to $137.1 billion in 2009, a decline of almost 6 percent compared to 2008. During this period, however, it also appears that fewer investors chose to terminate their insurance contracts early. Reflecting the recovery in new business, the maximum limit of liability totaled over $142 billion as of June 2010, an increase of 7.7 percent in 12 months and close to the 2007 level. About two-thirds of the portfolio was held by public PRI providers.

Figure 3.2 New PRI of BU members

$ billion



Source: Berne Union.
Note: Berne Union members only.

Breach of Contract/Arbitration Award Default
PRI protects against losses arising from a host government's breach or repudiation of a contractual agreement with an investor. Claims are usually payable only after an investor has invoked a dispute resolution mechanism (such as arbitration), has obtained an award for damages, and the host government has failed to honor the award.

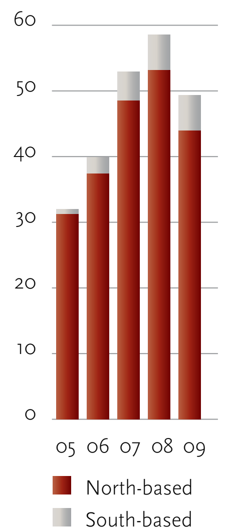
Non-honoring of Sovereign Financial Obligations
PRI protects against losses resulting from a government's failure to make a payment when due under an unconditional financial payment obligation or guarantee given in favor of a project that otherwise meets an insurer's requirements. It does not require the investor to obtain an arbitral award. This coverage is usually applicable in situations when a sovereign's financial payment obligation is unconditional and not subject to defenses.

Source: MIGA and market consultations.

Some PRI providers, particularly private insurers that are based in key insurance markets such as London, reported an uptake in the number of inquiries for investment insurance, especially for expropriation and non-honoring coverage. These inquiries have come primarily from the power and extractive industries sectors. For the majority of underwriters, this uptake has not yet translated into new business. This finding can be partly due to the lead time required by projects in these sectors and the stage during the project cycle when the PRI provider becomes involved, as well as the time required to underwrite the projects. Conversely, a number of insurers, particularly ECAs, indicated that there had been little to no demand for PRI and that they had not underwritten any new projects during 2009 and into 2010. Surveyed PRI providers did not report any increase in policy cancelations, however.

Figure 3.3 New PRI business of North- and South-based investment insurance providers

$ billion



Source: Berne Union.
Note: Berne Union members only.

As the global financial and economic crisis continues to unwind, investment is expected to recover (chapter 1) and access to credit—although still tight—to slowly ease. As a result, the number of PRI inquiries translating into operational projects should increase, and most insurers contacted for this report expect the demand for investment PRI to pick up over the next 12 to 36 months.

The share of PRI provided by BU members from developing countries is expected to continue rising (figure 3.3), reflecting the emergence of South-based investors (chapter 1) and active policy from Sinosure, China's ECA, to promote outward FDI. In 2009, PRI providers from developing countries accounted for 11 percent of the BU's new business, up from 2.5 percent in 2005.

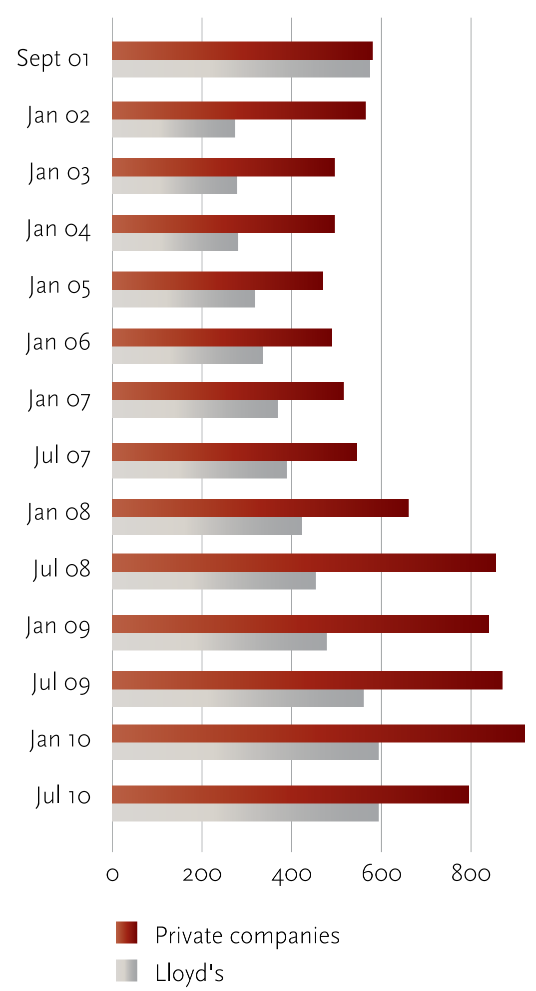
Capacity

According to both public and private insurers, there has been very little, if any, change to capacity available to underwrite investment PRI during the past 12 months. In addition, very few anticipate any change in capacity in the short term. Given the low levels of losses in the investment insurance segment compared to trade credit insurance, PRI underwriters did not face the same requirement to reduce cover to try to minimize losses. The longer-term, noncancelable nature of PRI contracts, compared to trade credit insurance, results in more stability, as providers have little flexibility to modify existing contracts in the event of an economic downturn or the rise of political instability.

Industry data for the private PRI market indicate that the capacity in this market segment increased from $1.2 billion to $1.3 billion per project in 2009.[4] In the first half of 2010, Lloyd's capacity remained constant. During that period, Chubb—a major private provider—exited the PRI business, while another company halved its capacity, resulting in a $125 million reduction in the company segment of the private market (figure 3.4). Chubb's exit reduced insurance supply for longer tenors (up to 10 years) in the private PRI market, where close to 60 percent of capacity is available for five years or less.[5] The lower demand for PRI and the emergence of new entrants, such as Ironshore and LUA, however, softened the impact of these changes. In July 2010, the private market was still able to underwrite $1.2 billion worth of PRI per project, similar to the level observed in July 2008. Unlike in the aftermath of the attacks of September 11, 2001—which led to a crisis in the general insurance market and a subsequent squeeze on PRI capacity—the general insurance market has weathered the global financial crisis relatively well, and current conditions have been relatively benign for the PRI segment. As a result, capacity in the private segment of political risk insurance has not declined significantly (as figure 3.4 illustrates, the Lloyd's market has remained stable, and the remaining private markets have fallen off slightly).

Figure 3.4 Available private market capacity, total possible maximum per risk

$ million



Source: Gallagher London.
Note: The private market total is lower than the sum of private companies' and Lloyd's capacity, because several providers are able to underwrite projects with either their companies' or Lloyd's lines and are counted in both.

Public and multilateral PRI providers do not appear to have modified their overall capacity either. BU members surveyed for this report indicated that they did not expect any changes in the near to medium term.

Given the lower level of new PRI contracts issued, the volume of overall capacity—both public and private—currently exceeds the level of demand. This finding could have implications both in terms of pricing and the cover offered, because investors may seek to negotiate more favorable conditions in their PRI contracts. At the same time, insurers do not expect any significant changes in the type and scope of coverage they are able to provide.

Although capacity is available, some PRI brokers report that, in practice, insurers' willingness to provide cover has declined in specific countries where political risk is perceived to have deteriorated.

Reinsurance

How much PRI providers are able to underwrite, in particular in the private segment of the market, is largely determined by the availability of reinsurance. The reinsurance market demonstrated its resilience during the worst of the financial crisis and has remained relatively stable. Although some reinsurers suffered losses during the crisis—particularly those with higher exposure to business lines relating to trade credit, structured finance, and credit default swaps—and reduced some lines as a result, those markets have begun to stabilize and show signs of positive growth. In addition, the PRI segment did not suffer similar loss levels, and reinsurers were able to keep their PRI offer relatively stable. Swiss Re, which had cut back its supply following significant losses incurred in non-PRI–related instruments, has now brought some of its reinsurance lines closer to pre-crisis levels.

PRI providers indeed report that they have been able to conclude the renewal of their reinsurance treaties without any significant change and are, therefore able to maintain the capacity they can offer to investors.

Claims

Unlike the trade credit and structured trade segments of the insurance markets, where claims in 2009 more than doubled compared to 2008, the PRI segment experienced few losses. BU members reported $24.2 million of claims in 2009—or only 3 percent of premium revenues, among the lowest levels in the last 15 years (figure 3.5).

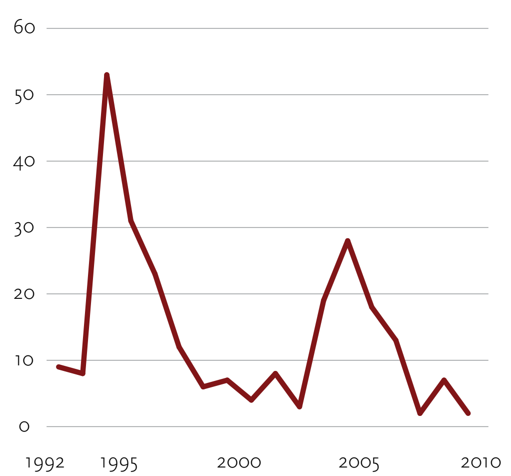
Most of the losses in 2009 were relatively small, and recoveries have been significant at $9.5 million, resulting in lower levels of net losses. PRI, unlike trade credit insurance, does not cover commercial risk and, therefore, has not suffered losses due to defaults and non-payment resulting from the global downturn.

Although losses did spike somewhat in 2008—mainly due to one large claim in the Philippines—they were down significantly in 2009. At the same time, premium income continued to grow during the same period, in spite of the decline in new business and overall portfolio: BU members generated an estimated $955 million in premiums, an increase of about 12 percent from 2008.

This trend is expected to continue through 2010. Although claims spiked to more than $61 million in the first half of 2010, this amount was modest compared to premium earned. In addition, most of the losses suffered in 2010 were concentrated in one country (República Bolivariana de Venezuela) and were mainly caused by a single large expropriation.

Figure 3.5 Loss ratios

Percent of premium income



Source: Berne Union.

Global developments over the past few years have had an impact on PRI providers' political risk perceptions. Last year, a number of insurers expected that claims for expropriation and non-honoring of sovereign guarantees would rise over the next few years. Providers interviewed this year still believed that fiscal strains resulting from the impact of the global crisis and economic rescue packages, as well as the rise of resource nationalism in some regions, could translate into more losses in the future. However, it appears that such claims have not yet materialized on a large scale.

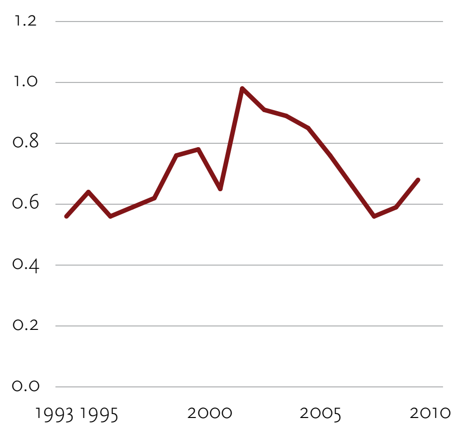
Pricing

Following the softening of PRI prices in the period 2004–2007, the PRI market hardened in the midst of the financial crisis. Following an increase in 2008, premiums continued to rise during 2009. As a result, BU members' revenues in 2009 were about 12 percent higher than in 2008, even though total exposure declined. As contracts with lower premium rates expired and were being replaced with new policies carrying higher prices, average premiums earned, which accounted for 0.6 percent of average maximum aggregate liability in 2008, increased slightly to 0.7 percent in 2009, equivalent to levels observed in 2006 (figure 3.6). Premiums seem to have stabilized during 2010 because insurers report no real increase in rates this year. With the weak real demand for PRI cover, rates may soften somewhat until an increase in the projects going through the complete underwriting cycle is realized.

Although some amount of innovation and product development has taken place within the PRI industry,[6] PRI remains a niche product covering a small percentage of FDI to developing countries. The nature of political risk is constantly evolving, sources of perils have multiplied, and the delineation between political and other risks is often blurred (chapter 1). As a result, some investors argue that the industry lags behind the fast-evolving nature of political risk and the ever more complex type of perils they face.[7] The PRI industry covers only part of the political perils that investors face in developing countries, and the gap is perhaps nowhere more pronounced than in CAF investment destinations.

Figure 3.6 Ratio of premiums to average maximum limit of liability for BU members

Percent



Source: Berne Union.

Political Risk Insurance in CAF Economies

Most investors involved in CAF countries surveyed for this report choose not to pursue PRI (chapter 2). Only 13 percent of respondents to the MIGA-EIU CAF Investors Survey reported seeking PRI, and fewer still ended up contracting it.

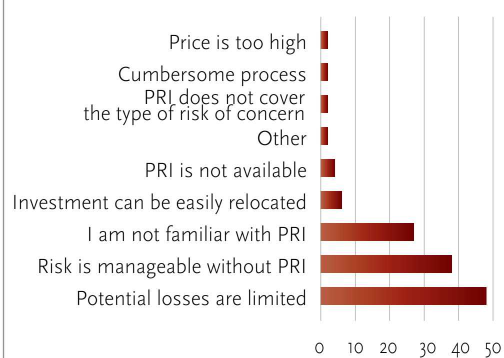
The main reasons cited for not using insurance are that potential losses are small or that risks are manageable without it (figure 3.7). This finding suggests PRI is a niche product used primarily to avoid catastrophic losses or is useful for certain types of risk. This use could also mean that investors involved in CAF countries may have a higher tolerance for risk or ability to manage it, that investments in those destinations tend to have quicker payback times or are smaller than in other developing countries, or both. This could also suggest that potential losses in these destinations are expected to be related to political violence, which typically are more contained than are those caused by expropriation or breach of contract. A significantly higher proportion of medium and large companies, as well as North-based investors, invoked the two main reasons for not using PRI compared to respondents from multinational enterprises (MNE) that were either smaller or were based in developing countries.

Consistent with these results, close to 90 percent of respondents said that whether PRI is available or not does not have influence on their decision to invest. This finding is consistent with the theme that PRI's interaction with the wide array of risk-mitigation tools available to investors is not well understood.

Small companies were marginally more likely than large ones to take PRI into account in their investment decisions. MNEs from developing countries were also four times more likely than were those from industrialized countries to reconsider their investment if insurance were not available.[8]

Figure 3.7 Main reasons for not using political risk insurance

Percent of respondents



Source: MIGA-EIU CAF Investors Survey.

Similarly, about a third of investors in financial services say they would halt investments if insurance were not available, whereas no respondent in the primary sector would. This result is in line with last year's survey findings, which suggested that investors in financial services were the highest users of PRI in relative terms, whereas those in the primary sector were the least likely to rely on insurance. As noted earlier, investors in financial services often get provisioning relief[9] when obtaining political risk cover, which makes PRI particularly attractive. Investors in extractive industries, conversely, face more limited choices when it comes to investment destinations (chapter 2). Because investors often must operate in countries perceived as riskier, assessing and managing political risk has become part of their core business.

Although interest in insurance—or the lack of it—is related mainly to a perception that risk is manageable and losses are limited, about a quarter of respondents—whether North- or South-based—also reported that they are not familiar with PRI. This finding raises questions about the PRI industry's outreach and awareness-raising efforts, especially toward smaller firms, for which lack of familiarity appears more pronounced.

At the same time, a significant minority of investors—particularly those from developing countries—reported shortcomings in supply: insurance either was not available, did not cover desired risks, was considered prohibitively expensive, or was too cumbersome to obtain (figure 3.7). Insurers often perceive CAF countries as riskier, and cover for these destinations, although available, appears relatively limited.

Multilateral PRI providers, which are in a better position to provide cover in investment destinations considered riskier, can play a catalyst role and can expand market capacity for these destinations by generating reinsurance and coinsurance from other PRI providers (see the section on multilateral initiatives). Yet, the impact of PRI on its own is limited: the political and security situation, as well as business opportunities, weigh far more heavily on investors' interest and risk appetite. Indeed, the main reasons surveyed investors were not deterred was that they consider that business opportunities in the CAF countries where they invest outweigh political risks, and that risks are perceived as manageable. These results were consistent regardless of investors' sectors, company size, or geographical origin. Until conflicts are resolved, short-term trade transactions and local investment are likely to dominate.

PRI Supply: A Market Failure?

Although CAF countries attracted about 6.2 percent of FDI flowing into the developing world during 2005–2009 (chapter 2), they accounted for 10 percent of new investment PRI underwritten by BU members[10] over the same period. Yet, new PRI business in CAF countries shrank by over 21 percent in 2009, while FDI to these destinations declined by 13 percent. The decline in new PRI business for investment in all developing countries was even more pronounced (38.5 percent), but it was largely in line with the 40 percent decline in FDI flows to developing countries. In the first half of 2010, however, $4.9 billion worth of new business was underwritten in CAF countries—more than in the full year of 2009 and close to 18 percent of the BU's new business—mainly because of large transactions in Myanmar and Papua New Guinea.

The BU reports outstanding PRI cover in almost all CAF countries. Yet, insurance is heavily concentrated in a handful of resource-rich investment destinations, which absorb over 60 percent of the exposure.

Similarly, most PRI coverage in CAF countries has been underwritten by a relatively small number of BU members: five private insurers have accounted for over half of the BU's outstanding portfolio in CAF countries over the past five years—significantly higher than their 35 percent of the BU's maximum limit of liabilities for all developing countries. Although the bulk of private PRI by value is concentrated in resource-rich countries, the outstanding portfolio includes a wide range of CAF investment destinations. Most of the cover in CAF countries, whether resource dependent or not, appears to be concentrated in activities related to the extractive and energy sectors, which offer attractive opportunities for private PRI providers. In some cases, the involvement of these private PRI providers in a wide range of CAF countries also reflects, although to a much lesser extent, their ability to offer worldwide or multicountry PRI policies and, therefore, to underwrite cover in riskier countries as part of a broader package.

Over the same period of time, public PRI providers accounted for only 39 percent of the BU's outstanding portfolio in CAF countries, the bulk of which was underwritten by only four insurers: KEIC (Republic of Korea), NEXI (Japan), OPIC (United States), and Sinosure (China). A number of ECAs rely on ratings compiled under the umbrella of the Organisation for Economic Co-operation and Development (OECD) (box 3.4) to determine availability, cover, and pricing for investment insurance. As of July 2010, the overwhelming majority of CAF countries was assigned the riskiest rating or not rated at all,[11] resulting in scant PRI availability. Following sovereign debt relief provided to low-income countries, many of which are considered fragile or affected by conflict (chapter 2), ECAs have also committed to ensure that the provision of official export credits to public or publicly guaranteed buyers in these countries should reflect sustainable lending practices (box 3.5).[12] As a result, ECAs' provision of PRI for the non-honoring of sovereign guarantees for CAF countries has been subject to added scrutiny.

PRI providers surveyed for this report say they receive demands for insurance in CAF countries; private insurers, in particular, appear to be solicited for a much broader range of destinations than ECAs. Supply, however, appears to be falling short. As noted earlier, a substantial minority of investors involved in CAF countries and surveyed for this report argue that they do not rely on PRI because it is not available, is inadequate, or is too expensive. A quarter of respondents involved in CAF countries also reported they were not familiar with PRI.

Most ECAs are either off cover for CAF investment destinations, or they offer highly restrictive cover. The main reasons cited are risk, OECD ratings, and foreign policy considerations (such as official sanctions or embargoes).

However, private providers appear more nimble and willing to consider cover on a case-by-case basis, according to their own risk assessment, investors' experience, and sectors involved. Previous claims, whether on the insurance or export credit side, do not in themselves seem to weigh heavily on the investment insurance decisions. Some products offered on the private market—such as worldwide or multicountry insurance policies—also allow private insurers to bundle riskier underwriting. Private insurers report that reinsurance is available for CAF countries and usually not a constraint, even if amounts are limited. When insurance is offered, however, conditions and carve-outs are often very restrictive.

Box 3.4 OECD Country Risk Ratings

OECD country ratings are designed to set guidelines to price the default risk on export credit and to set minimum premium rates charged by participating ECAs. The ratings came into effect in 1999 as part of rules known as the Knaepen Package,[a] which is integrated into an arrangement seeking to create a level playing field for official support of export credits and encourage the convergence of premium rates.[b] The ratings provide a system that classifies countries into eight categories, ranging from zero (least risky) to seven (riskiest).

The rating primarily assesses the ability of a country to service its external debt. It is based on two components: (i) a quantitative model of country credit risk that is based on payment experience and on the country's financial and economic situation, and (ii) a qualitative assessment that seeks to integrate relevant elements not quantified into the model, such as political factors. The final classification is reached by consensus of country risk experts from participating ECAs, and ratings are reviewed at least once a year. Participating ECAs are from Australia, Canada, the European Union member countries, Japan, the Republic of Korea, New Zealand, Norway, Switzerland, and the United States.[c]

Although the ratings were created to price export credit insurance, they are also taken into account for the underwriting of investment insurance.

a OECD, *Minimum Risk Premium: the Knaepen Package.* (http://www.oecd.org/document/34/0,3343,en_2649_34171_1830178_1_1_1_1,00.html).

b OECD *Arrangement on Officially Supported Export Credits*, January 2010 Revision. (http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=TAD/PG(2010)2&doclanguage=en).

c See the OECD website for the full list of participating ECAs. (http://www.oecd.org/countrylist/0,3349,en_2649_34169_1783635_1_1_1_37431,00.html).

Multilateral and regional insurers, as required by their developmental mandate, are in principle more amenable to consider cover in investment destinations considered difficult. Because of their ownership structure, they are in a better negotiating position than is the private market to avert potential claims caused by government intervention, or to recover losses from host countries' authorities when such a claim has occurred. Member countries of the African Trade Insurance Agency (ATI), for instance, are legally required to reimburse any claims paid by the agency except those arising from political violence. Multilateral insurers, however, are bound by their country membership and a limited product range, as well as their own risk assessments.

Risk perception, therefore, remains a significant obstacle. When the potential for loss is too high or is deemed inevitable, the risk is considered uninsurable.

While CAF countries have been responsible for 60 percent of the value of BU's claims since 1990, this is due primarily to two very large losses related to wars in the Persian Gulf and the Balkans. Without taking into account these two claims, claims related to CAF countries have accounted for about 13 percent of all BU claims over the same period.

Over the past five years, however, CAF countries have not appeared to generate significantly more claims than other developing investment destinations. CAF countries are responsible for 9.6 percent of claims paid by BU members since 2005—in line with their average share of new business (10 percent), and only slightly above their portion of maximum liability (7.7 percent) over the same period. The ratio of recovery for claims paid in CAF countries over the past five years (58.2 percent) is also broadly in line with what has been observed in other developing countries (62.4 percent).

Box 3.5 The Nonconcessional Borrowing Policy

To avoid the re-accumulation of external debt in low-income countries having benefited from Multilateral Debt Relief Initiative, the World Bank's International Development Association (IDA) introduced the nonconcessional borrowing policy (NCBP) in July 2006, which was updated in April 2010. The policy is meant to promote financing of low-income countries on concessional terms by encouraging creditors to take into account debt sustainability in their lending decisions, as well as establishing minimum grant elements for future borrowing from IDA countries.

As a result, an increased number of creditors are committed to adhering to the NCBP. The OECD Working Group on ECAs, for instance, has adopted a set of guidelines discouraging the provision of official export credits for expenditures considered unproductive, and ensuring that minimum IDA concessionality requirements are observed. The guidelines also require members to report details of official export credit transactions to IDA countries and to review them on an annual basis.

Sources: World Bank, 2010, IDA's *Non-Concessional Borrowing Policy: Progress Update*, April 2010, Washington, DC: World Bank; International Monetary Fund, 2010, "Concessionality and the Design of Debt Limits in IMF-Supported Programs in Low-Income Countries" (last updated in March 2010). http://www.imf.org/external/np/pdr/conc/index.htm.

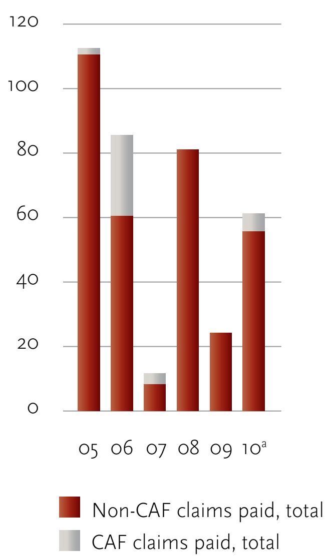
The claims profile for CAF countries seems indeed vastly different from the rest of the developing world. These countries account for 78 percent of BU claims paid for losses caused by political violence over the past five years. However, they contributed a minuscule proportion of losses caused by expropriation—which accounts for the largest share of BU members' total claim payments with almost 60 percent.

These five-year averages mask substantial annual swings. While losses in 2005–2007 were responsible for a deterioration of CAF ratios, no claims were paid for these countries in 2008 and 2009 (figures 3.8 and 3.9).

In addition, losses over the past five years have been concentrated in only five countries. The number of claims has also been small, with one large claim for breach of contract in 2006 heavily tilting the balance.

Figure 3.8 Claims paid by BU members

$ million

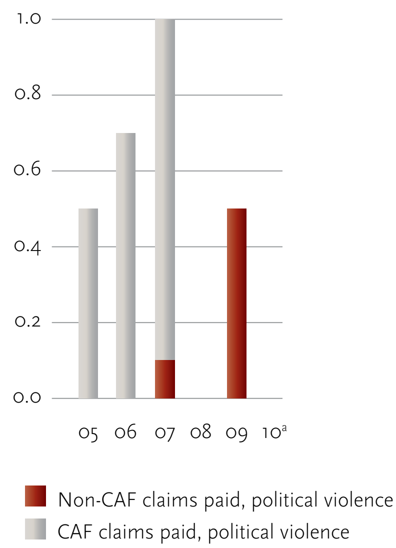


Source: Berne Union.
Note: a= First half.

Although losses caused by political violence have been more frequent than any other losses in CAF countries, payments have been small in absolute terms: $2.1 million out of a total of $36.1 million for the past five years. Losses related to this type of political risk are often partial; expropriation and breach of contract, however, can wipe out entire investments and often result in much larger claims. Claims paid for political violence losses, moreover, are far more difficult to recover than those related to government intervention, because responsibility is difficult to assign.

Figure 3.9 Claims paid for losses caused by political violence by BU members

$ million



Source: Berne Union.
Note: a= First half.

Multilateral CAF Initiatives: Rising to the Challenge

Given most fragile countries' limited local savings capacity and ability to tap into international financial markets, FDI is a critical component of private sector development and economic growth in these economies (chapter 2). Yet, most CAF countries—especially those poorly endowed in natural resources—struggle to attract foreign investment (chapter 2). As highlighted in the previous chapter, part of the problem is the level of perceived political risk. Although PRI cannot in itself generate FDI, it can in some cases encourage it and, therefore, contribute to economic recovery in CAF countries.

Given the limitations of the PRI industry highlighted earlier in this chapter, a number of initiatives have sought to fill the gap not only by directly covering FDI inflows into CAF countries, but also by generating more PRI capacity in the rest of the market through coinsurance and reinsurance. The multilateral nature of these initiatives, which as noted earlier provides some deterrence against adverse government intervention, has helped convince other PRI providers to join in and extend cover for investments in destinations they may not have otherwise considered. A selection of such initiatives is highlighted next.

The African Trade Insurance Agency (ATI)

ATI was created to address a market in risk-mitigation products in Africa. Launched in 2001, the agency provides insurance and reinsurance for both investment and trade related to African member countries.[13] Since its inception, ATI has supported over $2.1 billion worth of trade and investments across the region. Although the initiative was not specifically designed to focus on CAF countries, a substantial portion of ATI's PRI portfolio has been underwritten for projects in its more volatile members, covering all perils. ATI has successfully helped create additional insurance capacity for these countries through reinsurance arrangements, in particular with Lloyd's. Insurance partners have been particularly keen to get involved in reconstruction projects, which often involve support from donors or development financial institutions and are, therefore, perceived to provide additional deterrence against adverse government interventions. More recently, ATI also started offering reinsurance to commercial insurers in East Africa, allowing them to offer property cover against damage caused by political violence, terrorism, and sabotage. The agency reports that although African investors tend to have lower risk perceptions than those from industrialized countries, when it comes to projects on the continent, they face higher hurdles mobilizing finance for these projects.

Within ATI's first three years of operation, demand for insurance in Burundi had outstripped the agency's capacity. More funding had to be raised to expand the agency's ability to provide cover. Much of the portfolio has been concentrated in construction, telecoms, and manufacturing, and no claim has been recorded so far. Burundi accounts for 3.7 percent of ATI's gross PRI portfolio.

The Democratic Republic of Congo, however, accounts for over one-third (38.7 percent) of ATI's gross PRI exposure, in spite of the country's long history of political and economic instability, as well as its devastating civil war. ATI has been very successful in mobilizing reinsurance for investments in the Democratic Republic of Congo, and most of its gross portfolio has been ceded to other PRI providers. Although most of the PRI underwritten is concentrated in the mining sector, the agency has also supported projects in construction and information technology (IT). As a result of escalating risks, in particular in extractive industries, ATI's premiums in the Democratic Republic of Congo have risen by about 40 percent since 2009,[14] and longer tenors have become more difficult to obtain. Although no PRI claim has yet been paid, a request for compensation has been presented for a mining project.

ATI's presence on the ground in both countries facilitates risk assessments, as well as claim prevention. The agency is currently seeking approval to increase its project and country limits.

The Islamic Corporation for Insurance of Investment and Export Credit (ICIEC)

ICIEC was established in August 1994 to boost economic ties among Islamic countries. A subsidiary of the Islamic Development Bank, ICIEC now has 40 member countries in the Middle East, Africa, Asia, and Europe. Eleven ICIEC member countries are considered CAF for the purposes of this report, and they account for over half of ICIEC's total outstanding portfolio for PRI.

Most of ICIEC's insurance underwritten in the countries that form the basis of the analysis presented in this report is concentrated in Sudan, the Islamic Republic of Iran, Pakistan, and the Republic of Yemen. Demand for cover in these countries has been on the rise, reflecting both increased investment and trade flows, as well as heightened risk aversion. Most of ICIEC's capacity in the Islamic Republic of Iran and Sudan has already been utilized for trade transactions, however, leaving little spare capacity for investment PRI. At the same time, there has been very little or no demand for other CAF countries.

Obtaining reinsurance for CAF countries, such as the Islamic Republic of Iran and Sudan, has been increasingly difficult, limiting ICIEC's ability to meet insurance demand for investments over its $81 million project limit. In addition, although ICIEC provides all kinds of cover for CAF countries, restrictions may apply in some cases, in particular when it comes to war and civil disturbance. For instance, ICIEC may not offer insurance against political violence in regions considered high risk. Prices also reflect the perceived higher risk.

Projects in Sudan generate the most demand by far, accounting for 28 percent of ICIEC's total exposure.[15] Insurance has sometimes been a necessary condition for projects to go forward, even for investors and financiers from the Gulf, whose perception of political risk in Sudan is usually lower than those from industrialized countries (box 3.6). ICIEC has reached its capacity ceiling for both Sudan and the Islamic Republic of Iran, but attempts to establish special funds to expand PRI supply in view of growing demand have been unsuccessful, due to the global financial crisis and international sanctions.

So far, ICIEC has not received any claim in its investment insurance operations.

The Multilateral Investment Guarantee Agency (MIGA)

Besides directly covering CAF countries that are members, MIGA has been involved in a number of special initiatives:

EU Investment Trust Fund for Bosnia and Herzegovina

With the war that ravaged the country ending in 1995, developed countries were keen to support the reconstruction of Bosnia and Herzegovina and to prevent a return to conflict. NATO troops were stationed in the country, and foreign assistance poured in.

In 1997, the European Commission, in partnership with MIGA, established a $12 million investment guarantee trust fund to support a resumption of FDI in the country. A presence on the ground greatly helped promote the fund's services with potential investors and assess risks. Some European ECAs did not cover Bosnia and Herzegovina, prompting investors to turn to the fund.

The fund was fully utilized, issuing PRI for projects such as the establishment of a dialysis clinic in Banja Luka and the expansion of a soft drink plant. Most of the investments covered, however, were in

Box 3.6 Oil Exploration Project in Sudan

In 2005, a midsized Emirati oil and gas company was awarded a contract to undertake oil exploration for a local joint venture company owned by the China National Petroleum Corporation, Petronas of Malaysia, and the government of Sudan. Three Gulf Banks, one from Saudi Arabia and two from the United Arab Emirates, agreed to finance the $14.2 million project, but only on the condition that they could obtain political risk insurance.

The three banks approached ICIEC, which provided the needed cover against the risks of transfer restrictions, expropriation, and war and civil disturbance. The project was located at Adrael near Malakal in southern Sudan, a region with a history of long-running conflict with northern Sudan. Thanks to ICIEC's insurance, the banks funded the project, and the loans were repaid without any incident or claim. The project created many jobs in a country that has been through the longest running armed conflicts in Africa.

Source: ICIEC.

financial services, because foreign banks were keen to establish branches in Bosnia and Herzegovina and were one of the largest sources of FDI. In addition, the fund generated additional capacity through co-insurance and reinsurance with other PRI providers.

FDI to Bosnia and Herzegovina ballooned from $1 million in 1997 to $177 million in 1999 and $710 million in 2004.[16] A number of factors combined to attract foreign investors. The heavy presence of NATO troops in a relatively small country mitigated the risk of a return to conflict. Bosnia and Herzegovina's economy was relatively well developed and offered promising business prospects. In the heart of Europe, the country was also a familiar environment for most investors in the immediate region. In addition, banking reform introduced became instrumental in attracting foreign investment in financial services. Investment in other sectors did not enjoy the same advantages, however, and were much

Box 3.7 Supporting Local SMEs in the West Bank and Gaza

The European Palestinian Credit Guarantee Fund (EPCGF)—sponsored by the German Financial Cooperation, the German bank KfW under mandate from the European Commission, and the European Investment Bank—was created to stimulate lending to local small and medium-size enterprises (SME), which face substantial liquidity problems. The facility backs five-year loans of up to $100,000 provided through eight local banks to companies with fewer than 20 employees. The guarantee covers 60 percent of the amount borrowed. Since it was launched in late 2005, the credit guarantee fund's local partner banks have extended around 900 loans worth over $26 million.

In July 2007, the Middle East Investment Initiative (MEII), a nonprofit organization that partners with private and public entities to offer specialized financial products, launched a $160 million loan guarantee facility focused primarily on Palestinian SMEs, which compose nearly 90 percent of all Palestinian businesses. Local lending to SMEs had become virtually non-existent because of the risk of default. The facility supports lending through local banks by providing guarantees of up to 70 percent of loan amounts. This facility is transforming traditional Palestinian lending practices from a collateral-based system (sometimes as high as 200 percent of the loan amount) to one based on cash flow. The program was set up in partnership with the Overseas Private Investment Corporation (OPIC)—the U.S. agency that facilitates US private investment in developing countries—and the Palestine Investment Fund (PIF). MEII works with CHF International, an aid agency, in providing training and technical assistance to local bank managers and loan officers to improve and expand lending services. So far, more than 300 loans worth more than $60 million have been guaranteed.

Palestinian banking officials and local business leaders also expressed interest in insurance for local businesses against trade disruption and political violence. MEII is now developing a new political risk insurance facility, in cooperation with OPIC and the Ramallah-based National Insurance Company (NIC). The facility, primarily targeting Palestinian exporters, would insure against losses resulting from trade disruption caused by border closing or delays, as well as asset damage resulting from political violence. Besides technical assistance, OPIC and MEII would provide NIC with more than $1 million in reinsurance. Now in the pilot stage, the Palestinian Political Risk Insurance is expected to launch in 2011.

Sources: KfW, MEII, and OPIC.

slower to develop, butting against weak business laws, a divided country, and a local government that was barely functioning.

In 2007—over a decade after the conflict ended—Bosnia and Herzegovina attracted over $2 billion in FDI, equivalent to 14 percent of its GDP.[17]

The West Bank and Gaza Investment Guarantee Trust Fund

The political trajectory in the West Bank and Gaza has been disappointing for investors. The West Bank and Gaza Investment Guarantee Trust Fund was created in 1997, when the Oslo agreement seemed to herald a resolution to the political crisis in the region. The trust fund became operational in 1998, with a $20 million capacity financed by the Palestinian Authority (with an IDA grant), the European Investment Bank, and the Japanese authorities.

The fund underwrote only one tourism investment in 1999 for $5 million; the policy was canceled the following year. The political situation in the region deteriorated significantly from 2000 onward. As a result, foreign investors' interest in the small economy waned, FDI flows declined from $218 million in 1998 to $9 million in 2002,[18] and preliminary applications for PRI from the trust fund evaporated. Attempts to harness reinsurance and coinsurance were unsuccessful. Although FDI somewhat recovered in 2004–2005, it plummeted once again in 2006 because of political developments, and it still remains well below levels observed in the late 1990s.

In 2008, the fund expanded its reach to include local investors, a broader range of debt, and existing investments. The modification appears to have had little impact on demand for cover: local investors' main worry when it comes to political risk is business interruption for periods of 2–5 days, which is significantly shorter than those covered by the fund (30 days). In addition, many local investments are on a very small scale, making PRI relatively less attractive and more cumbersome.

A presence on the ground, which proved so crucial in other initiatives (see earlier), has now been established to explore better ways to tailor the fund's services to local needs. In addition, a business development plan has been formulated for the facility, and a public awareness campaign has been initiated. These efforts appear to be bearing fruit: by the end of September 2010, six applications had been received for both new and expansion investments.

Non-MIGA initiatives in the West Bank and Gaza focusing on local lending and credit guarantees, rather than on foreign investors, have been more successful (box 3.7).

The Afghanistan Investment Guarantee Facility

The $12 million Afghanistan Investment Guarantee Facility—sponsored by the Afghan government (through an IDA grant), the UK Department for International Development, and the Asian Development Bank—was created in 2005. From inception, the facility was designed to heavily leverage its own capacity to generate additional cover from the PRI market through coinsurance and reinsurance.

So far, the fund has underwritten $3.5 million worth of cover for six investments—including a $60 million telecom deal and six small projects—resulting in total cover of $107 million after reinsurance and coinsurance, from both MIGA's own account and the private market. One claim related to the war and civil disturbance cover has been received and is currently being evaluated.

Activity has significantly slowed down in the past few years, however, because of a deterioration of the political and security situation in Afghanistan. In 2009, the number of preliminary applications was less than a third of those received in 2006. Activities are still ongoing, however, and MIGA has received applications for an infrastructure expansion project and a greenfield investment in agribusiness.

The CAF States Facility

To further encourage economic activity in CAF countries, MIGA is working to establish a multi-country facility offering PRI for both trade and investment. The facility will be structured as a public-private partnership with a total insurance capacity of $500 million. Though the project is still in its initial stages, MIGA hopes to launch the facility in 2011.

Conclusion

Although modest, the anticipated rebound in FDI flows, added to the growing weight of the developing world as an investment destination and to persistent concerns over political risk in developing countries from both North- and South-based investors, bode well for PRI providers. The PRI industry on the whole remained largely stable throughout the crisis, and prospects for a rebound in new business appear promising for 2010 and beyond, as credit constraints ease further and FDI recovers.

Yet, PRI is likely to remain a niche product among risk-mitigation techniques. In the short term, concerns over the pace and sustainability of the global economic recovery dominate. The onset of the global crisis and the constant evolution of political perils do not appear to have resulted in heavier reliance on insurance, even though investors in both developing and CAF economies are most concerned about adverse government interventions. Although PRI has a role to play in fostering investment in CAF states by mitigating some political risks, other factors such as business opportunities, market size, and reform in these countries weigh heavily on investment decisions.

The low ratio of FDI to GDP in CAF economies is in line with their economic weight. PRI, although unlikely in itself to significantly increase investment flows, can potentially help diversify FDI flows to these countries beyond the extractive industry. Provided the business environment is supportive, the availability of PRI is more likely to make a difference for investments in sectors more prone to be deterred by conflict and fragility, such as financial services. Yet, a significant minority of investors report either that they are not familiar with PRI, or that available stand-alone PRI products are inadequate.

In a context of constantly changing political risks, the PRI industry needs to keep evolving to remain relevant. Although traditional cover remains pertinent as perils such as resource nationalism, fiscal imbalances, or exchange rate tensions reappear, the emergence of new perils, as well as persisting concerns over political risks usually not covered by insurance, also require constant innovation. In CAF countries, where economic recovery often holds the key to future stability and where FDI plays an even greater role given the dearth of other sources of private capital, multilateral PRI providers have a unique role to play mobilizing supply and adjusting products to these economies' specific needs.

Chapter three—endnotes

1 PRI refers to a broad range of product lines that include both trade credit and investment insurance. For this report, any reference to PRI applies exclusively to investment insurance. See box 3.3 on the benefits of PRI for investors.

2 Because Lloyd's syndicates do not publish PRI data, quantitative industry trends were largely extrapolated from data published by the BU, the association of public and private sector providers of export credit and investment insurance, and Gallagher London (an insurance broker). To complement its market analysis for this chapter, MIGA surveyed private PRI providers from the London market through a roundtable discussion organized in May 2010, questionnaires, and interviews. Findings from this exercise have been taken into account to complement market trends suggested by BU and Gallagher London data.

3 See MIGA, 2009, *World Investment and Political Risk 2009*, Washington, DC: World Bank for more details on the relationship between FDI and PRI.

4 Gallagher London, July 2010, *Political Risk Insurance (PRI)*, *Report and Market Update*, London: Gallagher.

5 Ibid.

6 Raoul Ascari, 2010, "Political Risk Insurance: An Industry in Search of a Business?" Working Paper No. 12, SACE, March.

7 Patrick Garver, 2009, "The Changing Face of Political Risk," in Kevin W. Lu, Gero Verheyen, and Srilal M. Perera, eds., *Investing with Confidence, Understanding Political Risk Management in the 21st Century*, Washington, DC: World Bank, 81.

8 The MIGA-EIU CAF Investors Survey did not investigate whether answers might change should comprehensive coverage be offered.

9 PRI allows financial institutions, in some jurisdictions, to utilize the insurers credit for loan-loss provisioning purposes rather than the country-specific provisioning requirement, resulting in overall lower levels of provisions.

10 Kosovo is not included in BU data.

11 OECD, 2010, Country Risk Classifications of the Participants to the Arrangement on Officially Supported Export Credit, July 2. http://www.oecd.org/dataoecd/47/29/3782900.pdf.

12 OECD, 2008, Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Official Export Credit to Low Income Countries, May 22. http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=TAD/ECG(2008)15&doclanguage=en.

13 Full member states include Burundi, the Democratic Republic of Congo, Kenya, Madagascar, Malawi, Rwanda, Tanzania, Uganda, and Zambia. In addition, Benin, Côte d'Ivoire, Djibouti, Eritrea, Gabon, Ghana, Liberia, and Sudan are in the process of completing their memberships.

14 "Mine Dispute, Poll Fears Raise Congo Risk Premiums," Reuters, May 18, 2010. http://www.miningweekly.com/article/mine-dispute-poll-fears-raise-congo-risk-premiums-2010-05-18.

15 Both trade and investment insurance.

16 World Bank estimates.

17 Ibid.

18 Ibid.