CHAPTER THREE

THE POLITICAL RISK INSURANCE INDUSTRY: *A VIEW FROM THE SUPPLY SIDE*

Overview

Robust appetite for investment in emerging markets in the medium term and the rising prominence of South-based investors present both challenges and opportunities for the investment insurance side of the PRI industry. This changing global environment, combined with a greater awareness of political risks on the part of investors, places the industry in a position to expand its reach and help promote the expected rebound of FDI to emerging markets. Over the past two decades, only a small percentage of FDI to emerging economies has been insured. However, PRI—although not a key determinant of FDI flows—can play an important role in restoring investor confidence and in facilitating investments of high development impact (such as in infrastructure and extractive industries) and investments into underserved markets (such as poorer countries and conflict-affected environments).

Today, the PRI industry is well positioned to support the recovery of FDI to emerging economies. It has grown from a minimal presence twenty years ago to a well-established market today, with a size, in terms of premiums for investment insurance, in the order of $1 billion.[1] The industry is now mature and resilient, having been shaped by numerous shocks in the past two decades. Over the years, its underwriting standards and processes have strengthened, and its exposure has become more diversified and spread over a large number of well capitalized and informed carriers, both in the private and public segments of the market. These developments position the industry well for a post-crisis global investment landscape where resource nationalism, political upheavals and currency instability in certain emerging markets may continue to drive the demand for PRI.

In some segments of the private market, the crisis has led to higher selectivity and stricter underwriting conditions, and capacity has been reduced for several countries. However, the public insurers—the export credit agencies (ECAs) and multilaterals—are well placed to fill any potential gaps because they do not face the same capacity constraints as their private counterparts (see box 3.5 on the differences between public and private insurers). This highlights the role of the public insurers in providing stability and maintaining capacity in the PRI market during uncertain times. At present, several ECAs are being encouraged by their governments to support their national investors and play an enhanced role in both trade credit and investment insurance to support the global economic recovery. Going forward, continued cooperation between the public and private segments of the PRI market will become increasingly important, suggesting a strong role for the Berne Union (BU), as the leading association of investment insurers and export credit agencies, in bringing these groups together (see box 3.1 on the activities of the BU).

The changing dynamics of world investment, with the rising power of South-based investors and their concerns over political risks, presents both opportunities and

challenges for the PRI market. The industry is already reaching out to this fast-growing investor base. Some of the South-based national public insurers that had traditionally focused on export cover are expanding their PRI for investment, while the private market is extending its global reach in places such as Singapore, which is developing into a regional insurance hub. But the industry still needs to promote its services and improve investor awareness of the PRI product in emerging economies. It also needs to continue adapting its product offerings to meet the evolving demands of investors in a post-crisis investment landscape.

Political Risk Insurance and FDI

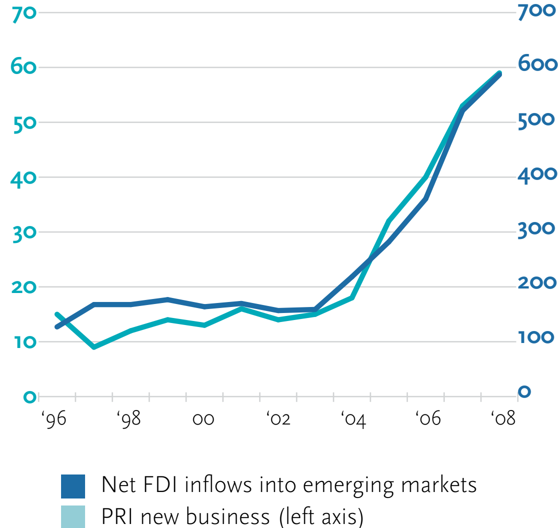
The rise of FDI to emerging markets over the past decade has encouraged the expansion of the PRI industry, which has grown particularly rapidly since 2003 (figure 3.1).[2] The growth of PRI is not just related to levels of new foreign investment in emerging markets but to a host of other factors as well that affect both investors' decisions to use PRI (chapter 2, box 2.2) and the insurance industry's ability to provide the needed coverage.

Historically, investors have sought increased levels of PRI for certain countries and sectors following global crises and high profile claims that have shaken confidence and heightened awareness of political risks. In the early 1980s, PRI for emerging market investments increased in part due to concerns arising from the financial crisis at the time and from the wave of expropriations in the late 1970s, such as those linked to the rise of the Sandanistas in Nicaragua and the fall of the Shah of Iran. PRI covered around 20-25 percent of emerging market FDI then, as shown in figure 3.2, which covers PRI provided by BU members only.[3]

Since the late 1980s, FDI has been on an upward trend while the portion of FDI covered by PRI has been on a downward trend, suggesting a growing confidence in emerging economies as investment destinations. The decade of the 1990s saw a steady increase in FDI to these markets as a result of globalization, liberalization and the opportunities created for foreign investment by the wave of privatizations, but the proportion of FDI covered by PRI was considerably smaller than in the early 1980s. In the latter half of the 1990s, project financing from banks grew to support investments in infrastructure, fuelling the demand for PRI. Although this encouraged the growth of the private insurance market, the proportion of FDI covered by PRI from BU members (largely ECAs at the time) was on a downward trend (boxes 3.3 and 3.6).

The rapid growth of FDI to emerging markets between 2003 and 2008 generated further demand for PRI (figure 3.1). However, although PRI provided by BU members increased in absolute terms (and this included a significant portion of private insurers who had become members by that time), the ratio of PRI to FDI remained low at around 10 percent. The decline in the PRI/FDI ratio reflected the extent to which the overall investment environment in emerging economies was viewed as benign, even though there was some country differentiation based on concerns about resource nationalism (particularly in parts of Latin America and Africa) and political violence in certain parts of the world.

Figure 3.1 FDI flows and New PRI of Berne Union Members
$ billion



Source: World Bank 2009 and Berne Union 2009.

Although FDI to emerging markets declined significantly in 2009 (chapter 1), it is still expected to be high compared to historic levels and to rebound in 2010. This continued interest in investing in emerging markets, combined with a changing awareness of risk as the global economic downturn weighs on investors' minds, suggests that PRI in relation to FDI could potentially rise. A significant minority of investors surveyed for this report (chapter 2) expressed an interest in risk mitigation tools as a result of the crisis. Whether this potential demand translates into more insurance coverage going forward depends on how both governments and the PRI industry respond in a post-crisis environment.

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 (see annex 6).[4] 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, Sovereign Risk Insurance Ltd. and then Chubb in 2004. In October 2008, Hiscox became the first private insurer underwriting in Lloyd's to join the BU. 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.

Box 3.2 Political Risk Insurance and its Benefits

PRI captures most, but not all, non-commercial risks. It covers political events, including the direct and indirect actions of host governments, which negatively impact investments and are not promptly or adequately compensated for. PRI refers to a broad range of product lines that include both trade credit and investment insurance. For the purposes of this report, it is applied exclusively to investment insurance.

In addition to providing compensatory value in the event of claims, PRI can help investors access finance and often on better terms, 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. PRI can also help deter harmful actions by host governments, help resolve investment disputes and provide access to best practices in environmental and social standards.

The following are the political risks commonly insured by the PRI industry. It is important to note however, that 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 due to 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 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 due to currency restrictions. It does not cover devaluation risk.

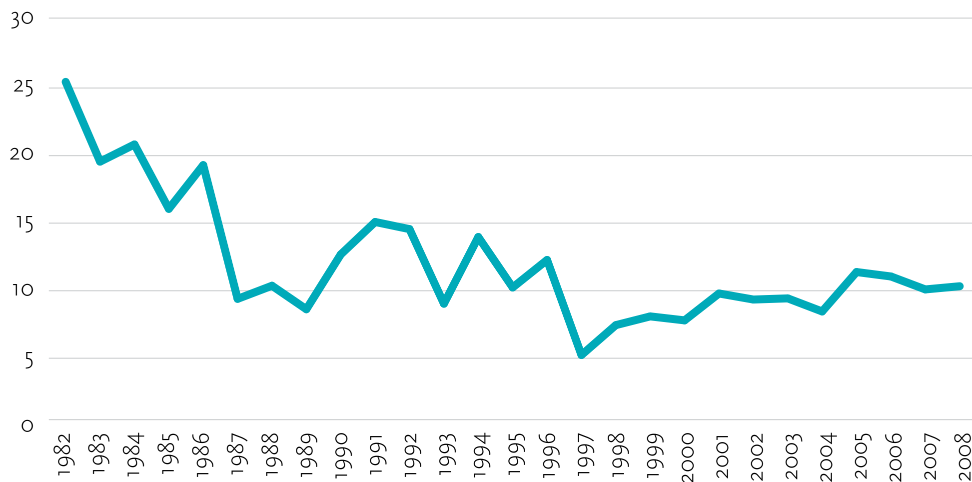
Political Violence: (War, Terrorism and Civil Disturbance): PRI protects against losses due to the damage of tangible assets or business interruption caused by war, insurrection, rebellion, revolution, civil war, vandalism, sabotage, civil disturbance, strikes, riots and terrorism. Coverage usually applies 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.

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), 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.

Figure 3.2 Ratio of PRI to FDI for Emerging Markets

Percent



Source: World Bank 2009 and Berne Union 2009.
Note: Figures relate to new PRI from Berne Union members only and to net FDI inflows each year.

Trends in the PRI Industry

The PRI industry is well positioned to respond to any potential growth in demand for insurance when the post-crisis recovery takes off. It is now mature and resilient having grown significantly since its modest origins around the time of the Second World War. Today, the market is well diversified with a broad range of products. It has been shaped by numerous crises and events over the past decade, which have informed better practices within the industry, refined the product offerings, improved monitoring and indemnity standards, and strengthened underwriting procedures (see box 3.6 on the evolution of the PRI industry).

In the late 1990s, the surge in privatization activities in emerging economies, particularly in infrastructure, encouraged the growth and diversification of the private market—new entrants stimulated competition and started offering long tenors to cover large, complex projects. This increased the market share of private providers and gave rise to improved cooperation between public and private insurers through reinsurance and coinsurance arrangements. Such collaborations increased capacity in the marketplace. The Asian and Russian financial crises of the late 1990s, as well as an increase in investor disputes and claims caused by the failure of governments to honor their contractual obligations, highlighted product weaknesses and eventually put pressure on insurers to refine product offerings and provide new coverages to meet investor needs.

A few years later, September 11 and the Argentine crisis demonstrated the extreme loss potential for the industry resulting from terrorism and a country's economic meltdown. The events of September 11 transformed terrorism insurance into a catastrophe product and made the availability of reinsurance a key determinant of private market capacity. The Argentine crisis raised questions about the value of PRI, but also demonstrated that the industry paid claims, and highlighted the ability of the BU to represent its members' interests (box 3.4).

The PRI industry's historical development, as well as its experience with claims, has helped make it more resilient over time. It has been able to build reserves in good years to meet potential claims in tougher times. Historically, there have been very few claims each year and they have represented a small portion of the maximum limit of liability of BU members. Between 1996 and 2008,

BU members paid total claims of around $795 million.[5] Recoveries of claims for BU members over this period averaged around 45 percent. Lloyd's syndicates are reported to have paid about $608 million in expropriation claims during the same period.

In addition to being resilient, the PRI industry has adapted its products over the past decade to respond to investor demands. The private market has been through a significant phase of product refinement with regard to political violence policies, particularly since September 11. These policies now encompass, in combination, all political perils spanning terrorism through to riot and civil disturbance, insurrection to rebellion, and war on land to civil war. More recently, insurers have responded to pressure from investors to cover more than just arbitral awards (required under breach of contract cover). Today, many insurers provide non-honoring or non-payment cover for sovereign guarantors and borrowers without requiring investors to go through arbitration. Insurance policies are also becoming increasingly focused on identifying and defining investors' rights as the legal framework for FDI changes with improved bilateral and multilateral investment treaties. In spite of these innovations however, the PRI product has not always been fully understood nor has met investor expectations in the event of actual claims (as during the Argentine crisis discussed in box 3.4) This suggests a continuing need for product evolution and refinement.

The public and private segments of the PRI market have played complementary roles over time, although there have been some concerns about competition and crowding out. While the private PRI market is susceptible to sharp reductions in capacity, the public insurers are generally not constrained by this, so they can play an important role in stabilizing the market during uncertain times (box 3.5). The early 2000s highlighted the "cyclicality" of private PRI availability and the role of public insurers. It showed the contrast in the appetite for business in the late 1990s (when profits were high and attracted the capital needed to create capacity) with the post-September 11 period when initially the major losses eroded capital and decreased capacity in the Lloyd's segment of the private market, before reversing track again some years later (figure 3.4). Throughout this period, the public insurers, who are largely insulated from the broader property-casualty market cycles, helped dampen the amplitude of the cycles in the private market by maintaining adequate capacity, stable prices and tenors.

Today, ECAs and multilaterals can play an important role in augmenting the capacity of the private market to support the resurgence in FDI flows to emerging economies. They can potentially fill any gaps caused by reduced capacity for certain countries in the private market and can provide capacity for large projects through

Box 3.3 Overview of the PRI market

The PRI market includes three broad categories of providers and covers both export or trade credit and investment insurance. For the purposes of 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 those of the public insurers, such as coverage for investments in emerging markets against expropriation, political violence and other such risks; and (ii) emerging market non-payment insurance covering contract frustration and default by governments.

The National PRI Providers: They comprise national ECAs, export-import banks, export credit guarantee agencies and investment insurance entities, which focus on cross-border trade and investment, generally for constituents in their own countries. Euler Hermes—PwC (Germany), NEXI (Japan), OeKB (Austria) and Sinosure (China) account for about 38 percent of the market share of BU members.

The Multilaterals: The multilateral PRI providers include the African Trade Insurance Agency, the Inter-Arab Investment Guarantee Corporation, the Islamic Corporation for the Insurance of Investment and Export Credit, and the Multilateral Investment Guarantee Agency. Other multilateral agencies such as the World Bank, the Asian Development Bank, and the Inter-American Development Bank also provide risk mitigation instruments, such as partial risk guarantees.[6]

The Private PRI Market: The private underwriting market includes about 18 Lloyd's syndicates and about 10 private insurance companies. The majority of private insurers are based in three insurance centers—London, Bermuda and the United States (primarily New York)—and several of the larger insurers have offices in Singapore. The private PRI market forms part of a wider insurance market that offers protection from political perils either as "stand-alone" cover, or in combination with commercial credit risk cover. Due to the complex nature of the private market, brokers play an important role in promoting and sourcing PRI. Chartis Insurance (USA), Zurich (USA), Sovereign Risk Insurance Ltd. (Bermuda) and Chubb (USA) account for about 43 percent of the market share of BU members.

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 USA. ECAs and multilaterals also participate as reinsurers of PRI, although on a smaller scale.

Source: Data on national and private providers from the Berne Union.

Box 3.4 Lessons from the Argentine Crisis

In the 1990s, Argentina was amongst the top recipients of FDI to emerging markets. Although the amount of total new FDI covered by PRI during the decade was low (figure 3.2), many PRI providers were close to reaching their maximum capacity for Argentina. By end 1999, however, the Asian and Russian crises had exposed the weaknesses of the Argentine economy, particularly the one-to-one peso to dollar peg that had been introduced in 1992. In the following years, after failing to engineer a recession-induced price realignment that would keep the peg in place, the economy deteriorated to such an extent that political and social pressures led to the fall of the government, followed by a period of political instability. Between November 2001 and January 2002, the government froze all bank deposits and passed an "Emergency Law" that allowed it to implement a series of measures to prevent foreign capital outflows. This law revoked the dollar peg and established a new, lower exchange rate. It converted all domestic loans denominated in foreign currency into local currency at the post-devaluation exchange rate, and froze bank deposits after converting them to pesos at the pre-devaluation parity (which became known as "pesification", whose asymmetric treatment of banks' balance sheets meant that the financial sector essentially became insolvent overnight). The law also required prior approvals for transfer of foreign currency for any purpose, including servicing foreign loans. In addition, the law declared that all public contracts that included adjustment and indexation clauses based on foreign currency were no longer in effect, but required tariffs to be frozen at the pre-devaluation exchange rate.

Argentina's economic and political crisis became a test case for the PRI industry, as many insurers were faced with claims and disputes. For the first time, a country's economic meltdown had triggered disputes and potential claims under different covers, including breach of contract, expropriation, transfer restriction and civil disturbance. Delays on loan repayments, due to the freezing of bank deposits and the need to obtain government approval to service foreign loans, resulted in transfer restrictions claims, and the revocation of the Convertibility Law gave rise to expropriation claims as investors argued their investments were no longer viable. A high profile example was the case of Ponderosa Assets Pvt. Ltd, which triggered the payment of a claim by OPIC. Ponderosa had to write off its investment in Argentina after the tariffs it charged for gas distribution were frozen and set in pesos using an overvalued exchange rate. The company obtained an arbitral award from the International Centre for Settlement of Investment Disputes (ICSID), which ruled that the Argentine government had breached the "fair and equitable standard" contained in the BIT between Argentina and the United States.

The consequences of the Argentine crisis on the PRI industry were significant. For transfer and convertibility coverages, the industry was able to obtain an exception for all BU members from the Central Bank, thereby allowing borrowers whose foreign loans were insured by BU members to convert local currency into dollars. This enabled them to service their loans on time. At the same time, however, the market faced many claims from banks in Argentina that were not paid, because the borrowers lacked the necessary local currency to effect a valid inconvertibility claim. These losses were considered by many insurers to be commercial in nature and therefore not within the scope of most PRI policies. Many banks began to question the value of PRI in the aftermath of the Argentine crisis, which led to increasing demand for comprehensive cover.[7] Despite some disputes with insureds, claims were paid; it is estimated that about $124 million was paid out between 2002 and 2006.[8] Finally, and more importantly for expropriation and breach of contract coverages, the crisis tested the strength of BITs, which protect investor rights more broadly than traditional PRI contracts. Forty-eight treaty cases, involving either expropriation and/or breach of contract coverages, have been filed against Argentina since 2001—45 cases with ICSID and three under the United Nations Commission on International Trade Law (UNCITRAL) Rules. With 19 cases still pending, almost $1.2 billion has already been awarded against Argentina, including $508 million for claims that pre-date the emergency regulations. In cases where the arbitration has found in favor of the investor, however, the government has mostly failed to comply, leading to claims payments. It is also worth noting that in some cases, ICSID rejected submissions for expropriation (under the argument that the measures taken by authorities were not "expropriatory takings" but breaches of contractual obligations) that had been accepted by PRI providers, but awarded on the basis that the fair and equitable treatment provisions contained in BITs were breached. Since this discrepancy comes from the coverage language, as well as some of the case particularities, these examples are another reason why insureds have increased their demand for comprehensive coverage.

Sources: Berne Union 2009; Brown (2004).

coinsurance and reinsurance arrangements. They can also encourage investments into countries that are perceived to be high risk—where private insurers may not take exposure on their own—through such arrangements.

Impact of the Global Financial Crisis

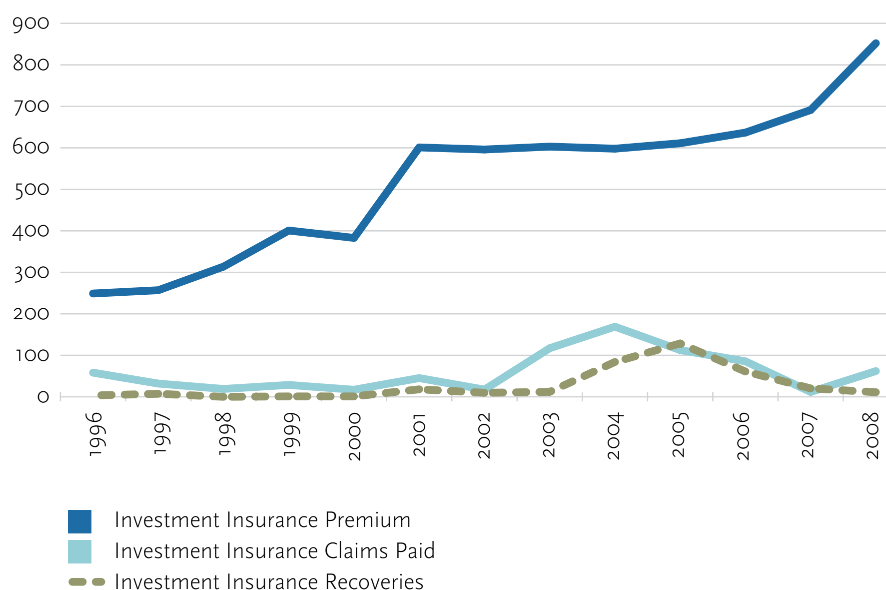
The current global financial crisis has brought about a greater awareness of risk, and in mid-2009 certain segments of the PRI industry had taken a more conservative view of the new risk landscape. For example, Lloyd's mirrored the changing environment in a report issued in June 2009, which highlights some key points, namely that: (i) continuing economic turmoil could have a significant impact on the levels of instability and political risk for global businesses, and this may outlast the recession; (ii) investment climates in emerging markets may appear more investor-friendly in the short term, but expropriation risk may well rise in proportion to the severity of the recession; and (iii) investors and lenders must continue to assess expropriation risk on a country-by-country basis.[9]

Although losses for some private market participants in certain non-PRI lines of business have influenced the PRI industry's outlook, the market as a whole has functioned relatively well in the face of the global downturn.[10] BU members' investment insurance activities continued to expand in 2008; they booked $59 billion worth of new business, bringing their outstanding portfolio or maximum limit of liability in investment insurance to about $146 billion. However, almost all BU members saw new business decline in the first half of 2009 compared to 2008. Comparable figures are not available for the Lloyd's syndicates.

The PRI industry's size, risk diversification and robust underwriting standards and processes have helped ensure that the impact of the crisis has been absorbed by the market and that losses have been manageable so far. In some segments of the private market the crisis has led to higher selectivity and reduced capacity for certain countries. However, ECAs are playing a more active role in both trade credit and investment insurance to support the global economic recovery. The industry as a whole is therefore well positioned to respond to any increase in demand for PRI.

Claims. While there have been trade credit claims from all over the world since late 2008, investment insurance claims have so far been limited. Even the expropriation

Figure 3.3 Claims Paid, Recoveries and Premiums of BU Members
$ million



Source: Berne Union 2009.

of investments unrelated to the crisis—such as the well-publicized ones relating to the extractive industries sector, particularly in Latin America—have not significantly impacted the PRI industry, partly because many of these investments have not been insured against political risks. As of June 2009, claims paid by BU members were low compared to the same period in previous years. However, several insurers have indicated that they could see an increase in claims in the near term. Claims for currency inconvertibility and transfer restrictions are more likely than other categories of insurance claims during a financial and economic crisis and there may be some claims in this area, particularly in Eastern and Central Europe where the financial sector has been severely impacted by the crisis (chapter 1). A questionnaire administered by MIGA and the Global Trade Review (GTR) to Lloyd's syndicates in mid-2009 to assess the impact of the crisis on the London underwriting market suggests that the trend in claims for expropriation and non-honoring of sovereign guarantees has been increasing in the past few years and may well continue in the medium term.

Demand. The post-crisis investment environment could translate into an increased interest in PRI products for emerging markets, as suggested by the investor survey discussed in chapter 2. This would be consistent with historical patterns, which show that investors and lenders have sought PRI in the aftermath of global or regional crises. For example, in 1999 when Asian economies started to recover after the Asian crisis, new PRI business reported by BU members increased in absolute terms. In a questionnaire completed by insurers and brokers from the London insurance market in June 2009, more than half of the respondents noted that interest in PRI across all risk covers had increased by up to 10 percent since the beginning of the current crisis. But it is important to note that this does not necessarily translate into increased

Figure 3.4 Available Capacity per Risk in the Private Insurance Market
$ million

Source: FirstCity Partnership Ltd 2009.
Note: Table shows the total possible maximum capacity per risk in the private PRI market. Capacity shown is for CEN (Confiscation, Expropriation, Nationalization); a proxy for PRI risk. 2001 figures are for September, and 2009 figures are for January and July. All other figures are for January of the listed year.

actual business right away. As noted earlier, BU members reported a decline in new PRI business for the first half of 2009; this could be related to a number of factors including that new investment plans may have been on hold during the past several months. About 70 percent of the respondents polled in a BU survey of September 2009 noted that actual demand for investment PRI was unchanged in the past three months, whereas 10 percent reported an increase of 10-20 percent.

Interviews with brokers and insurers in Singapore in September 2009 revealed that in many cases, interest and applications for PRI were on the rise, but that this had not necessarily translated into increased new business yet.[11] While the crisis initially shook investor confidence, this now appears to have largely returned, and Asian investors are looking more optimistically at a post-crisis environment and are in a relatively strong position to explore opportunities for investments such as in infrastructure and other sectors in the region. Countries such as China, India and Indonesia also present huge domestic markets with attractive investment possibilities. Risk tolerance for investments within the region appears to remain high, but the crisis has created a better awareness of the potential for political and country risks. Banks are much more cautious about providing project finance, and there is much greater scrutiny of project proposals. Therefore, demand for PRI from banks will be limited on the one hand, but on the other, PRI will likely be sought for project finance deals that do go forward. Under Basel II,[12] banks using PRI may benefit from lower provisioning requirements, but the extent to which this will be achieved still remains to be seen.

Globally, many investors have been seeking coverage for existing investments. It is estimated that a significant portion of the new cover requested and extended in some segments of the London underwriting market as of mid-June 2009 was for existing investments, principally because there were fewer new project finance undertakings as a result of the global economic downturn. Investors already have significant exposure to emerging markets with the stock of FDI totaling $4 trillion at end-2008. As only a fraction of this is covered by PRI, demand for existing investments could increase further.

Capacity. As noted earlier, capacity is not generally an issue in the public PRI market, but it is one very measurable aspect of the private market. This has so far held steady in the private market despite the crisis. While the tougher economic environment slightly reduced the political and commercial risk capacity for trade transactions, the PRI market capacity for political risks covering investments rose slightly from a maximum of $1.08 billion per risk ceiling in early 2008 to $1.32 billion by early 2009. However, some private insurers, notably those that suffered significant losses in trade-related PRI, have reduced their capacity in all PRI-related business lines.

Box 3.5 Public versus Private Insurers

The motivation that drives the public and private markets is fundamentally different. National insurers have strict mandates from their governing authorities to serve constituent interests, and multilateral institutions ensure that their activities are consistent with broad development goals. Public insurers are not subject to shareholder pressures for profitability and many have relatively high capacity ceilings. Unlike their private counterparts, they largely maintain their capacity and tenors for insuring emerging market investments during times of crisis, and therefore tend to provide stability in the market. However, as their activities are usually governed by fairly rigid mandates, their ability to provide PRI may be limited not so much by capital but by policy considerations.

Unlike their public counterparts, the private insurers are driven by the need to make profits and are free from government-dictated mandates. The commercial profit orientation of private insurers allows them to be more responsive to customer needs for product variations or complementary products (e.g. credit, bonds, property and casualty etc.), but it also means that they react (in terms of the supply of PRI) when market conditions deteriorate. Their overall capacity is directly influenced by their capital, the profit and loss potential of each insurance line and the availability, conditions and cost of reinsurance. Since capital is fungible, the availability of capital to write new PRI policies is affected by losses not only in their PRI line of business but by other insurance lines as well. As their capital is allocated purely on a risk-return basis, capacity can be withdrawn from PRI in order to seek more profitable or safer returns in other business lines.

Box 3.6 The Evolution of the PRI Industry

From the Second World War to the 1980s

The global PRI market for investment has grown significantly since its modest origins dating back to the activities of credit insurers and state-owned ECAs around the time of the Second World War. One of the first extensions of PRI investment cover came with the Marshall Plan in 1948, when the US government began a program of issuing PRI to encourage US investments for the rebuilding of post-war Europe. The concerns of investors at the time were the likelihood of currency controls, the threat of Soviet communism and socialist movements in Europe, and the possibility of another war. So the risks insured were currency inconvertibility in 1948 (the first policy issued was against inconvertibility of the British pound), expropriation in 1951 and political violence in 1956. The program was subsequently expanded to include developing countries and transferred to OPIC in 1969. The years following the Second World War also saw a significant increase in the number of official ECAs providing PRI.

As the colonial era ended during the 1960s and 1970s, many of the newly independent and socialist-leaning developing countries emphasized indigenous industrialization and import substitution. This began a wave of confiscations, nationalizations and expropriations, which led foreign companies to seek protection through PRI. The rise of the Sandinistas in Nicaragua in the 1970s and the fall of the Shah of Iran in 1979 led to further expropriations and increased demands for PRI. As ECAs could not adequately respond to the demands of investors due to their restrictive mandates, private insurers stepped in, even though they had limited capacity, wrote policies of short tenors and could not cover land-based war risks or project financiers lending to foreign enterprises. By the late 1970s, PRI had become an established class of business in the London underwriting market with Lloyd's syndicates taking the lead, followed by AIG in 1979. In time, the private market began building a business that public insurers could not provide, but since they only offered insurance for up to 3 years compared to the 15-20 years provided by the public insurers, the latter continued to dominate the PRI marketplace until the late 1990s.

In the 1980s, the private PRI market was maturing, but still remained small. The decade started with the recession of 1980-83, which hit developing countries worse than their industrialized peers and spawned an international debt crisis. With many Latin American countries in default, commercial banks began reducing new lending, which triggered a wider decrease in both debt and FDI flows to developing countries and a fall in demand for PRI. In the wake of this crisis and against a backdrop where FDI was seen as a solution to supporting emerging economies, a number of governments took the initiative to create MIGA in 1988, giving it a mandate to promote FDI.

The PRI Boom of the Late 1990s

Over the 1990s, FDI flows to emerging economies steadily increased as a result of globalization, liberalization and particularly the privatization of public infrastructure. This opened up tremendous opportunities for foreign investment, giving rise to increased demand for PRI. For BU members, the decade saw an almost three-fold increase in the total outstanding exposure of investment insurance, rising from around $24 billion in 1992 to about $61 billion by 1999, with new business per year increasing from $7 billion to $14 billion over the same period. In the private PRI market, regulations changed to allow Lloyd's syndicates to provide insurance to banks to cover project finance for foreign investments, and by 1995, the first long-term PRI policy was placed at Lloyd's for a power project in a developing country. In 1996, AIG started offering longer tenors for PRI and by the end of the decade several new private insurers were offering comparable tenors. Sovereign Risk Insurance Ltd. of Bermuda, backed by Ace and XL, was established in 1997, and the following year, Zurich started providing PRI with long tenors. The Lloyd's syndicates also altered their line structures to keep pace with the new corporate players.

The private PRI market landscape had fundamentally changed by the early 2000s. Coverage capacity for a single risk grew from $250 million in 1992 to more than $1 billion in 2000 and tenors lengthened from 3 to 15

years. The private market had not only survived the crises of the early 1990s, such as the Gulf War and the break-up of the Soviet Union, but was now able to compete against the public insurers with clear advantages in terms of eligibility, speed, flexibility and even pricing. As a result, projects that would previously only have found PRI cover in the public market were now being insured privately, often by underwriters with global offices. The private market had grown to become a significant presence by 2000. This period of high growth with modest claims stimulated competition and innovation as existing insurers tried to improve their offerings to maintain market share and meet demand, while new private entrants tried to keep pace.

The expanding marketplace gave rise to increased cooperation among insurers, which not only increased capacity in the market, but enhanced the deterrence benefits for both insurers and their clients. The late 1990s also brought on new demands from investors and lenders for improvements in PRI products. These demands arose not only as a result of the financial crises in Asia, the Russian Federation and Latin America, but also because of an increase in investor disputes and claims in the late 1990s, caused by the failure of governments to honor their contractual obligations or to uphold regulatory regimes. For example, in 1997, Pakistan repudiated power purchase agreements, and in 1997-98 Indonesia cancelled several power projects under construction.

The events of September 11, 2001 and the Argentine crisis fundamentally changed perceptions of risk for both investors and insurers. These events represented a watershed in the evolution of the PRI market with far-reaching consequences. The terrorist attacks resulted in the largest insurance loss ever recorded—estimates range from $40-$100 billion in claims across multiple classes of coverage. This resulted in a dramatic reduction in reinsurance capital, leaving the industry in shock and causing some reinsurers to exit the PRI market completely. Even though the primary PRI market did not suffer direct losses from the attacks, capacity—as measured by the maximum coverage available for any single transaction—decreased dramatically, while tenors of policies shortened and premiums increased. Significantly, the availability of reinsurance emerged as a key determinant of private market capacity and tenor in the post-September 11 period. The terrorist attacks highlighted the extreme loss potential of political risk for the insurance market, and reinforced an intense debate within the industry as to whether terrorism on this scale could be insured. What had previously been viewed as a relatively minor risk by the private insurance industry was now seen as too large and unpredictable to be taken on as unlimited liability, and most property underwriters began excluding it from their general insurance contracts.

The PRI market was also hit by elevated claims in the wake of the Argentine crisis, which was triggered by the collapse of the peso after the government abandoned the currency's peg to the US dollar. Losses stemming from the events of September 11 and the Argentine crisis eroded capital, particularly in the private PRI market. Many private insurers were forced to shorten their tenors and amounts of coverage per risk. The Lloyd's syndicates' market share dropped significantly by 2002 (figure 3.4). By the end of 2003, corporate scandals, such as those that engulfed Enron and WorldCom, further diluted confidence in major international companies and the global economy, causing private PRI capacity to shrink further. All through this period, the public insurers played a stabilizing role by maintaining capacity, as well as stable prices and tenors. FDI into emerging markets started growing again in 2003 and by 2006 it started accelerating with an accompanying increase in demand for PRI. By then, the major reinsurers had been able to rebuild their balance sheets, leading to signs of recovery in the private insurance marketplace. The aggregate per risk PRI capacity offered in the private market went back up to over the $1 billion mark by 2008.

Sources: Moran (2004); Heppel (2005); Meron (1976); Salinger (2004); Berry (2008); Bailey (2004).

The overall increase in capacity followed a steadily rising trend in the past several years, from a low of $733 million per risk ceiling in 2002 after the events of September 11. For BU members, a survey conducted in the first half of 2009 revealed that two-thirds of them either maintained or increased their risk capacity for PRI.

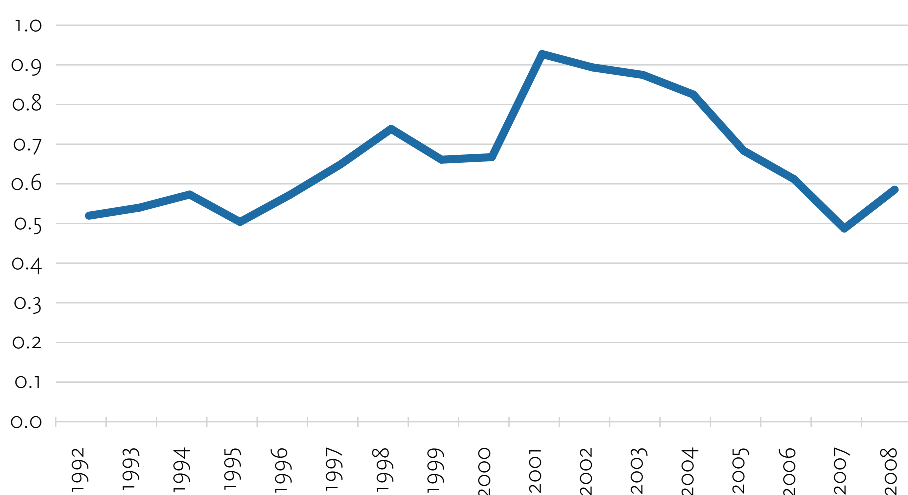
Although overall capacity in the private market does not appear to be a major concern so far, there are some countries where market appetite is limited because of the past level of demand, the level of potential claims or the perceived increase in risk. In some cases, increased trade credit insurance has built up significant country exposures, limiting the ability of insurers to write new policies for investment PRI. However, capacity in the overall PRI market is not expected to be a major issue going forward, especially as public insurers generally do not face similar constraints. In Asia, for example, they are seen as potentially playing a role in supporting the vast infrastructure development requirements of the region, which the private insurers would be unable to handle on their own.

Reinsurance. The reinsurance market has proved resilient during the global financial crisis, demonstrating the strength of reinsurer capital and liquidity management processes. Reinsurers continued to provide capacity for the primary PRI market during 2008 despite the fact that the crisis brought about major losses to some reinsurers, stemming from exposures to business lines relating to structured finance, trade credit insurance and credit default swaps. For example, Swiss Re, one of the three largest reinsurers of PRI, suffered major losses on exposures to non-PRI related structured finance instruments and therefore reduced exposure to some of its other lines of business.[13] However, there were no indications that Munich Re and Hannover Re, the two other largest players, had planned reductions in capacity for PRI as of mid-2009.[14]

Although the global economy is stabilizing and confidence in future economic growth is returning, the extent to which reinsurance capacity is available for the coming years will inevitably depend upon the primary insurance market's results and how it performs in terms of claims. As the financial crisis has not been as protracted as expected, and there has been a relatively rapid recovery in some key financial indicators, reinsurers may leave capacity intact for the coming year, but this will not be known until the reinsurance renewals are determined by early 2010. The crisis has resulted in far greater scrutiny of risks by both insurers and reinsurers, and an enhanced interest of market participants to assess and monitor closely the ability of counterparts to honor their obligations.[15]

Pricing. The increasing perception of political risk in emerging markets has had some impact on the pricing of insurance since 2007, reversing the downward trend which started in 2001 when average premiums earned

Figure 3.5 Ratio of Premiums to Maximum Limit of Liability for BU Members
Percent



Source: Berne Union 2009.

accounted for around 0.9 percent of the total exposure (maximum limit of liability) assumed by BU members; by 2007, this ratio was around 0.5 percent (figure 3.5). Tight financing spreads during the years preceding the financial crisis may have put downward pressure on the price of political risk. By 2008, however, pricing adjusted upwards and the ratio of average premiums to total exposure went up to 0.6 percent, but was still well below the levels observed in the early 2000s. The response of the PRI industry to the current economic and financial environment is still evolving and could further impact pricing[16] (see annex 7 for a list of selected factors affecting the pricing of PRI).

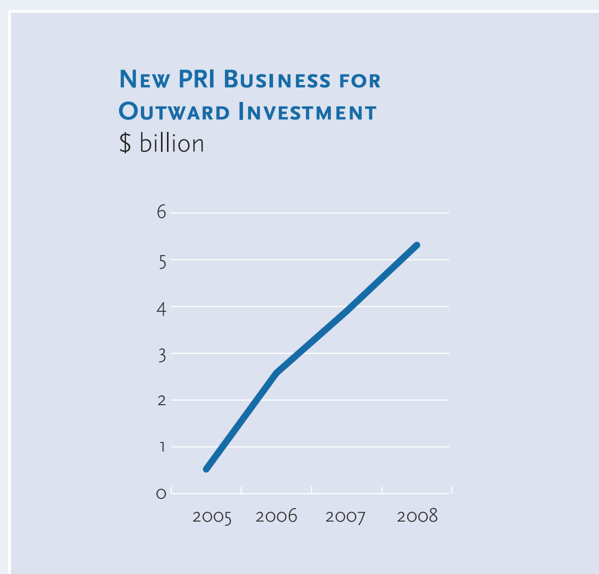
Political Risk Insurance and South-based Investors

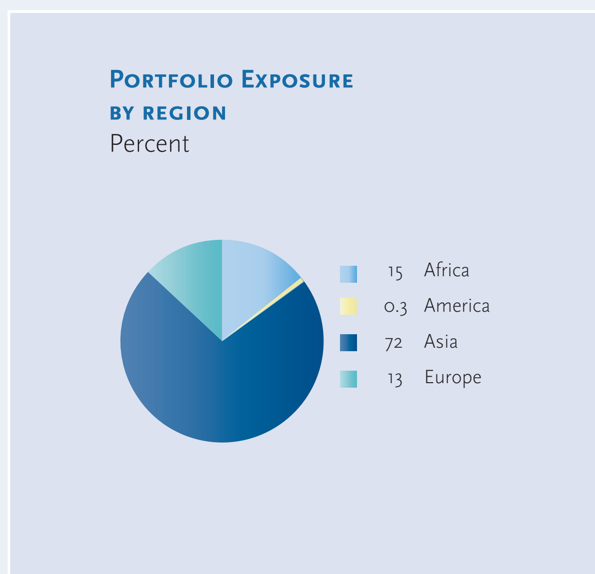
Over the past several years, South-based multinationals, particularly from the BRIC countries, have become a growing source of FDI to emerging markets, as highlighted in chapter 1. While these companies remain optimistic about their future investment plans, political risk features prominently in their concerns about developing countries (chapter 2). In Asia, as in some other parts of the world, these investors retain a strong risk appetite despite the global crisis, but this is tempered with a greater awareness of political and country risk.

Box 3.7 China: Sinosure's Growth in Investment Insurance

With China's tremendous economic growth of the past two decades has come an increase in outward investment flows, encouraged by the government's "going global" strategy, which supports domestic enterprises investing abroad. Various measures have been introduced across government agencies to support this strategy, including new regulations, fiscal incentives and financial assistance. Today, the Chinese are very proactive overseas investors—FDI outflows from China have steadily increased from $11.3 billion in 2005 to $53.5 billion in 2008.

Sinosure plays a key role supporting this strategy, in particular as Chinese investors expand their activities to South-East Asia, Africa and South America and diversify investments beyond trade-related industries and manufacturing. The agency was established in 2001 to promote exports and cross-border investments through export credit and investment insurance, covering both outward and inward investment. Sinosure's portfolio exposure grew an impressive ten-fold from 2005 to 2008 as did new PRI business supporting outward investment, which reached $5.3 billion in 2008. The agency's total PRI portfolio exposure is $6.6 billion, with the highest regional allocations in Asia at $4.7 billion, followed by Africa at $1 billion.





Source: Berne Union 2009, Sinosure 2009, World Bank 2009.

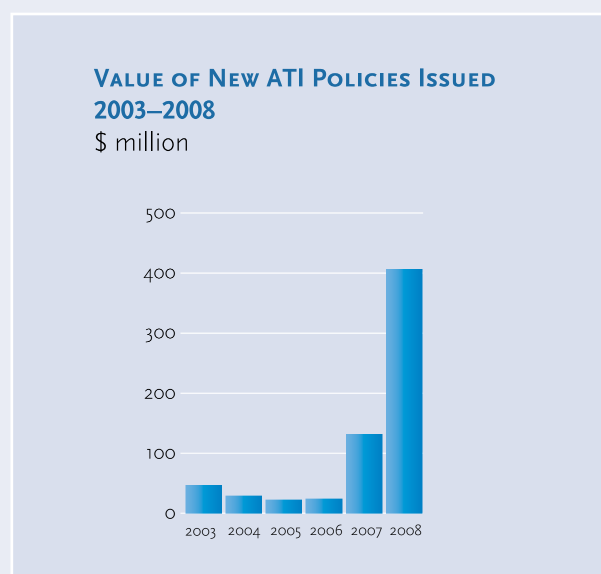
The growth of South-based investment could shape the PRI industry in the future, both in the private and public markets. Some private insurers have been setting up field offices in other countries, in part to capture cross-border business from this group of investors. And in the public market, a few national ECAs that traditionally focused on export credit have been seeing an increasing interest in investment insurance. Many have been encouraged by their governments to step in and support their national investors in the aftermath of the crisis. As South-South cross border investments increase and demand grows for PRI to support these investments, particularly in large-scale projects such as infrastructure and natural resources, the scope for greater cooperation between the public and private segments of the PRI market will expand.

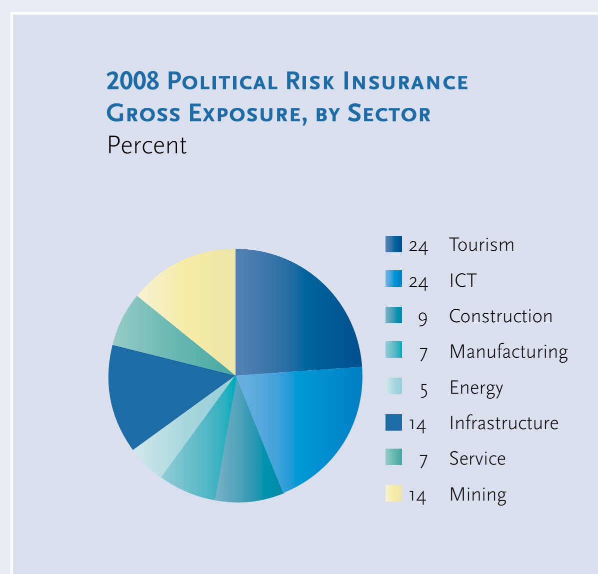
Public Insurers and South-based Investors

The evolution of ECAs and their PRI product offerings are linked with the outward investment strategies of their countries. For the most part, trade continues to dominate their activities, even amongst the ECAs of the BRIC

Box 3.8 The African Trade Insurance Agency

The African Trade Insurance Agency (ATI) was set up in 2001 to provide insurance for trade and investment in its African member countries. In 2008, the agency's new business in both trade and investment reached about $779 million, demonstrating its ability to respond to the region's needs during the global financial crisis. Investment insurance accounts for 92 percent of the agency's overall portfolio exposure. ATI has issued PRI policies for investment totaling approximately $660 million since 2003. Currently, over 90 percent of ATI's outstanding exposure in investment insurance supports South-South investment deals. South African project sponsors have been active users of the agency's insurance facilities. ATI's sector exposure in investment insurance is well balanced with tourism, technology and mining accounting for about 60 percent of the total outstanding portfolio. The agency is focused on increasing its membership and expanding partnerships with other insurance entities, both regionally and globally. As part of a growth strategy for 2009-2011, it plans to open a number of regional offices, adding to existing offices in Uganda and Zambia.



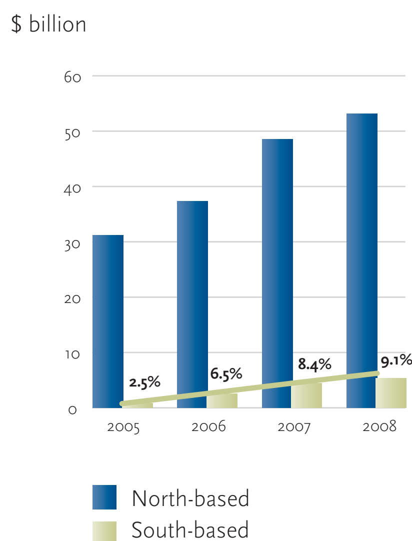


Source: ATI 2009.

countries. For India's Export Credit Guarantee Corporation (ECGC), investment insurance has accounted for a very small part of its activities in the past few years, despite the growth of outbound investment by Indian firms. This is partly because a significant amount of FDI from India is bound for industrialized countries. As Indian companies increase their investments in emerging markets, the need for PRI is expected to rise and greater capacity from ECGC or other insurers may be required to meet the potential increase in demand. In China, Sinosure was set up in 2001, and by 2008 its new PRI business supporting outward investment amounted to $5.3 billion, and its total outstanding portfolio of investment insurance was $6.6 billion (box 3.7). Brazil and Russia do not have their own national investment insurance schemes, so investors from these countries rely on private or multilateral sources.

In addition to national agencies, several multilateral organizations provide PRI for South-based investors, such as the Asian Development Bank, the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), the Inter-Arab Investment Guarantee Corporation, the African Trade Insurance Agency (ATI) and MIGA. These multilaterals play an important role in providing PRI in countries where the volume of cross-border business does not justify the establishment of national insurance agencies. ATI expects demand for PRI to continue increasing as country risk profiles change in the Africa region and prospects for long-term investments in biofuels, infrastructure and telecommunications grow (box 3.8) ICIEC provides a niche product for the Middle East region, offering insurance facilities that are in accordance with Shariah principles.[17] Although its investment insurance activity is still a small share of its total business, it has grown to comprise 16 percent of its total portfolio in 1429 H. (Islamic calendar year approximately equivalent to 2008) compared to 6 percent in the previous year.

Figure 3.6 Share of South-based Investment Insurance Providers in New Business*



* *Berne Union members only.*

Source: Berne Union 2009.

The Private Insurers Focus on South-based Investors

The private PRI market has been developing a growing presence outside of London, New York and Bermuda to capture the rising demand for both trade credit and investment insurance from South-based investors. In Asia, for example, Singapore is becoming an insurance hub with several brokers and insurers, as well as a few Lloyd's syndicates, now established there. The crisis has increased risk awareness within the region, and as higher selectivity and reduced capacity for certain countries constrain the ability of some private insurers to fully respond to potential increases in PRI demand, there is scope for cooperation with regional ECAs and multilaterals. This is particularly true for the support of infrastructure development, which presents vast opportunities for private investment in the region and may well require increasing amounts of PRI. As noted earlier, banks in particular are likely to want to protect their project finance undertakings following the crisis.

Trends in South-based Investment Insurance

New business reported by South-based PRI providers who are members of the BU increased from about $800 million to about $5.3 billion between 2005 and 2008.[18] Although this is small compared to the BU's total new PRI business, representing just over 9 percent in 2008—it is a growing trend (figure 3.6). There are six such insurers, all of whom are public.[19] The largest by far is Sinosure, which accounts for most of the growth in the PRI business of South-based BU members.

In a MIGA survey of PRI providers carried out in 2007, the majority of respondents expected demand for PRI by South-based investors to increase in the medium term.[20] It was reported then that the key factors hindering the purchase of PRI were the lack of perceived need and the lack of awareness of PRI's benefits as a risk mitigation instrument. While the former has changed slightly in part as a result of the crisis, there is still scope for improving awareness of the product.

Going forward, changing global investment patterns, with the rise of outward investment from emerging markets, will present opportunities and challenges for the PRI industry. Cultural differences and evolving sectoral requirements underscore the need for more tailored investment insurance products. At present, many South-based investors feel there is a lack of appropriate risk mitigation tools to meet their needs and many cited factors such as cumbersome procedures and the narrow scope of insurance coverage as reasons for not using PRI (as reported in the BRIC investor survey discussed in chapter 2). Lack of product awareness and costs are also factors. The challenge for the industry will be to extend its reach and bring about a greater awareness of the benefits of PRI across a number of emerging markets, as well as to refine current product offerings to meet the specific needs of a relatively new group of South-based multinational investors.

Conclusion

The anticipated rebound in FDI to developing countries, together with concerns over political risks from investors from both industrialized and emerging markets, will continue to underpin demand for political risk insurance. PRI, however, is one option among a range of instruments used to mitigate risk, and is expected to remain a specialized product primarily used for complex projects and destinations perceived as the riskiest. The global survey indicated that the proportion of respondents using PRI for investments in high-risk countries was almost twice as high as the average (chapter 2). Yet, these destinations only absorb a fraction of FDI, most of which has been, and is expected to remain, directed at a handful of countries (chapter 1).

Insurance can only cover part of investors political risk concerns. In addition, political perils that can be covered have manifested themselves in ways that neither insurers nor insureds had expected. Events such as the Asian crisis in 1997, the Russian moratorium in 1998 and the Argentine peso's crisis in 2002 have highlighted both the strengths and shortcomings in traditional PRI cover and have underlined the need for continuous product development in order to meet investors' expectations.

Product innovation and flexibility are only some of the challenges that face the PRI industry. Much remains to be done to expand awareness of the industry and the services it provides, especially with investors from emerging markets. If they are to capture a larger share of this growing market segment, PRI providers from both industrialized and developing countries need to intensify their efforts to improve presence and tailor products to the needs of this group of investors. Developing uniform definitions and concepts, as well as improving data transparency, would help better assess the impact of the industry and promote understanding of its products and how the PRI market works.

Chapter Three—Endnotes

[1] *Information on the PRI industry has long been an issue, particularly in the private market where data is either difficult to access or simply not disclosed. The private market's size is therefore difficult to estimate and comparisons with other insurers are complicated by the fact that market definitions, categorizations and terms vary across insurers. These include differences in defining what constitutes the PRI market for investment, what activities are covered and the characterization and booking of premiums. Nonetheless, a market size of over $1 billion seems a reasonable estimate as the total premiums for BU members was $852 million in 2008, and market participants estimate that for Lloyd's syndicates it was about $60 million (GBP35 million) for policies booked under the political risk (PR) code. A few Prague Club members, who are not members of the BU, also generate some premium income. The PR code is a reasonable proxy for Lloyd's PRI premiums for investment insurance although there is a downward bias as some political risk covers are excluded (such as political violence for emerging market investments and breach of contract) because they are complicated to separate out from the cover provided for trade credit insurance.*

[2] *For the purposes of this report, the term PRI is applied exclusively to investment insurance.*

[3] *It should be noted that the available data on PRI do not capture the entire PRI market. Furthermore, it is difficult to separate out gross and net PRI figures in some cases, and there are also inconsistencies in the way data are reported.*

[4] *The Berne Union Prague Club was started in 1993 by the Berne Union with funding from the European Bank for Reconstruction and Development (EBRD). It is an information exchange network for new and maturing insurers of export credit and investment. The Prague Club supports members in developing their export credit and investment insurance schemes and facilities by hosting technical discussions at twice-yearly meetings, as well as by facilitating ad-hoc information exchanges. A number of Prague Club members have gone on to meet the requirements for full Berne Union membership.*

[5] *This does not include claims paid by private insurance companies in the earlier years, however, as they were not yet members of the BU.*

[6] *A partial risk guarantee covers private lenders against the risk of government failure to honor contractual obligations relating to private projects.*

[7] *Comprehensive cover is the term used for insurance that covers both political and commercial risk. The cover is comprehensive in the sense that it is not limited to a particular risk (e.g. political risk) or a subset of risks. Thus, a comprehensive insurance policy on a loan to a private borrower would not only protect against transfer risk, expropriation or political violence, but also against the borrower's insolvency or lack of liquidity.*

[8] *Berne Union data.*

[9] *Lloyd's and Control Risks (2009).*

[10] *Based on the views of a group of Lloyd's syndicates and London brokers at a roundtable held on June 23, 2009, organized by MIGA and GTR.*

[11] *MIGA conducted interviews with several private insurers and brokers based in Singapore in September 2009.*

[12] *The capital allocation framework commonly known as Basel II entered into effect in 2007. This framework aims at enhancing the quality of banks' lending by making capital allocation (the amount of capital that banks must set aside to cover for losses) much more risk sensitive. As compared to the previous framework (Basel I), Basel II requires less capital for investment grade credits and more capital for sub-investment grade credits.*

[13] *Swiss Re took a $1.2 billion loss on derivatives activity in 2008. The Reinsurer with a Plan to Reassure, Financial Times, July 20, 2009.*

[14] *Based on discussions MIGA staff had with reinsurers in June 2009.*

[15] *When reinsuring portfolios, primary insurers exchange insurance risk (the probability of occurrence of an insured peril) for credit risk (the probability that the reinsurer will not be able to honor its liability). In the past, insurers in other business lines have experienced unexpected losses by purchasing reinsurance from companies that could not pay their share of the loss.*

[16] *Since premium income is only reported annually for BU members, the 2009 data are not yet available.*

[17] *Among other things, these principles support mutual cooperation of policyholders, collective sharing of losses, distribution of surpluses to policyholders after meeting statutory reserve obligations, and requires exclusion from cover goods prohibited under Shariah and the accruing of interest from export credit or investment loans.*

[18] *Categorization of South-based insurers is based on the World Bank's classification of developing countries.*

[19] *These include the national insurers of China, Turkey, Mexico, South Africa and India, as well as a regional provider - the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC).*

[20] *In 2007, MIGA carried out a survey of 68 PRI providers and the overall response rate was 35 percent.*