POLITICAL RISK INSURANCE: AN INDUSTRY IN SEARCH OF A BUSINESS?

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Abstract

There is no common understanding of Political Risk; therefore, there is no standard definition of Political Risk Insurance. We cannot have a common definition of Political Risk because (technically) it is "uninsurable"; it cannot be expressed actuarially and its nature changes dramatically over time. Furthermore, it is a small business line in the overall portfolio of multi-line private insurers and re-insurers that hardly catches the attention of scholars and regulators.

The paper traces down the evolution of Political Risk in its major manifestations over the last decades and the main changes produced by the current crisis. In the process it addresses two key issues: (i) If Political Risk cannot be expressed statistically, how is it priced? (ii) What do agents buy when they buy Political Risk cover?

One tentative conclusion is that the Political Risk business is not an industry or, if it is, it is not about political risk and we knew that. It offers a set of products covering a wide spectrum of events, mostly cross-border and involving emerging markets.

As industrialized countries get riskier and many emerging markets stronger, it will be interesting to see how this "non-industry" will evolve in the next future.

Keywords: Political Risk, Political Risk Insurance, Foreign Direct Investment, Expropriation, Nationalization, Breach of Contract, Transfer and Convertibility Risk, Political Violence.

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[1] SACE SpA, *Chief Operating Officer*. The views expressed herein are those of the author and do not necessarily reflect the views of SACE. The author gratefully acknowledges helpful support from Alessandro Terzulli and Riccardo Rolfini and useful comments from Lawrence Chapman.
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1. Introduction

This paper develops a few ideas and issues originally discussed at a Conference on Political Risk organized by MIGA and The Financial Times[2] and held in London on December, 3rd 2009. The key point it makes is that financial risks are not actuarial; political risks even less so. Technically they are uninsurable. The second point is that political risk is an *omnibus* term and as such cannot be precisely framed and analyzed. It follows that Political Risk Insurance cannot be defined as an industry.

There is no common understanding of Political Risk (PR); therefore, there is no standard definition of Political Risk Insurance (PRI). In its latest study on political risk[3], MIGA refers to the following definition of PR: *"Probability of disruption of operations of MNEs (Multi-National Enterprises) by political forces or events when they occur in host countries, home countries, or as a result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also minority groups, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment."*[4] [5]

This definition focuses on cross-border investments in developing and emerging countries where political instability tends to be higher. The Berne Union, the major global association of insurers of risks of economic/financial/political nature, has set up a specific Committee dedicated to the issues of (foreign) Investments. As the other two Committees deal with Short Term credit and Medium-Long Term

[2] "Managing Global Political Risk. Cross-border investment in uncertain times".
[3] MIGA (2009).
[4] MIGA's definition of PRI is the following: "*Political Risk Insurance is a tool for businesses to mitigate and manage risks arising from the adverse actions - or inactions - of governments. As a risk mitigation tool, PRI helps provide a more stable environment for investments into developing countries, and to unlock better access to finance*". See: www.pri-center.com/directories/priessentials.cfm#what.
[5] Luo (2008).

export credit issues, it would seem that the difference among business lines is clear cut. However, this is clearly not the case.

Quoting from the same MIGA report, the insurance industry uses a narrower definition of PRI; one that covers the following events: i) currency convertibility and transfer; ii) expropriation; iii) political violence; iv) breach of contract by host government; v) non-honouring of sovereign financial obligations. Is this really a narrower definition? Are the two definitions simply related to different concepts of political risk?

Let us see what are the differences between the two definitions in detail. The first definition is based on MNEs (the agent); their investments (the asset); foreign countries (mostly emerging or developing: the source of the risk); the events that result from the combination of the three above variables. As such, this definition neglects other agents, other assets/transactions, other locations (industrialized countries). As an example, smaller companies, civil construction firms and financial companies are also exposed to PR and are frequent buyers of PRI. Physical assets (investments) are not the only form of exposure to PR; cross-border loans and other financial flows are also affected as are commercial and other contracts. As a result, other events (i.e. credit events) are paramount.

What definition is more compelling? And if the definition does not fit reality, do we change the former or the latter? Following the market implies acknowledging that what the market does is quite broad: it goes well beyond MNEs and the events that might impact on their operations; it encompasses several sources of risks to the point of including trade financing (structured trade credit programmes) and outright credit risk. Originally confined to the so called "non-honouring of financial obligations", credit risk insurance offered by private insurers has broadened overtime to cover straight credit risk by sovereign, sub-sovereign, public and even private

borrowers. As a result, insurers following under different categories do overlap significantly in their activities: the borderline between short term credit insurers, political risk insurers, export credit insurers is blurred. Everybody is making forays in new business segments. In a previous paper I stated that “Export Credit Agency is a misnomer”[6]; the misnomer actually runs much broader: the whole industry is a mess (as far as definitions go).

Why the Berne Union is not starting to clear the mess by rethinking its own Committees? The Investment Committee includes private and public insurers. In reality, private members do very little “investment insurance”; only a few public insurers are specialized investment insurers (i.e. OPIC in the USA and PWC-Hermes in Germany). Other public members are not particularly worried about isolating the PR business as it is housed within a broader organization and offered along with many other products. It so happens that those other products are the same offered by their private sector peers, but only with a different label: compare “non-honouring of financial commitments” and “structured trade risks” with the boring and downbeat “export credit business”. Bonding and surety businesses are also offered by both players, without any need for relabeling.

This confusion is not without consequences. In its October 2009 reinsurance Report (and subsequent updates), under the heading Political Risk, Aon Benfield states: *“potentially the biggest single problem involves BTA bank in Kazakhstan…..trade finance exposure to the bank is suggested to be as high as US$3.5bn, although it is not clear what part of this is placed on the insurance market….in addition to the BTA problem, there are worries at defaulting exposure in the Ukraine. There are many bank-to-bank transactions which could lead to initial (gross) claims”*. Why is a private bank that goes bust considered political risk in Kazakhstan but not in Iceland or in the USA?

[6] See Ascari (2007).

Should we worry or be casual about this lack of definitions? If we do not define what we do, we will have a hard time to manage it (pricing and provisioning for example). For the time being, this problem receives benign neglect: after all it is a relatively small business line in the overall portfolio of multi-line private insurers and re-insurers. It only accounts for maybe one or two percent of the property/casualty insurance market, a small fraction of the overall insurance industry. Even lumped with credit insurance risk (i.e. short term commercial credit), bonding, and surety it remains a small business. As such, it ranks low in the priority list of regulators, researchers and scholars. As for public players, they mostly run their businesses on their States' accounts, and can afford to do that without sophisticated risk control tools that would require sound analytical and methodological frameworks based on precise definitions.

The second issue is that PR is an …uninsurable risk. **It is hard to define something that escapes definitions.** PR in its "core" dimension can hardly be defined statistically. We know everything about events behind political risk, but we cannot actuarially link them to expected losses. Even when available, historical data are of little use to predict losses. A political risk is a discontinuity in the trend; it is the passage from one state of the World to another. We can analyse elements that make a situation unstable and make heroic assumptions to come up with a probability number; still the outcome is highly subjective and dependent on how we assume variables will interact. Substantially, PRs are not insurable, from a theoretical point of view, because there can be no probability distribution of relative risk generating events.

Finally, PR changes dramatically over time: what you define today will change tomorrow, in form, shape or relevance. Unlike a fire or a car accident, PR can take almost infinite and unpredictable forms. Over the long run, this business appears to

have been profitable for underwriters, notwithstanding it hardly qualifies as an insurable risk. OPIC's experience seems to indicate that PRI loss ratio has been historically low and premia have remunerated risks. This record however applies mostly to the CEN (Confiscation, Expropriation, Nationalization) category. Very little of this business is being underwritten these days. PRI has been extended to new forms of risks (breach of cover, non-honouring of obligations, trade-related, etc.), for which it is difficult, if not impossible, to derive statistical information on loss ratios and few historical series are available. Even when they are, the past is of little guide to the future. What we experienced in 2008 for example is much deeper than a negative cycle or recession, and it follows almost two decades of recurring crises. Crises have become more frequent and deeper; the evidence that the world is not functioning along a "Bell curve" is compelling.

2. The evolution of PR events over the decades

PR is, to many, the risk of running investment operations cross-border and especially in countries with weak institutional, legal, political frameworks. Key among those risks is the underlying concern of asset expropriation. This risk was especially high in the seventies and eighties, when many emerging and developing countries were still centrally planned economies, the private sector was marginalized, and foreign investors, when (very rarely) allowed in the country, were subject to high levels of interference by the State. With the fall of the Berlin Wall and the liberalization of many economies, the risk diminished overtime and almost disappeared until a few years ago. At some point, private insurers were looking at Venezuela as one of the few remaining showcases for pitching PRI.

Table 1. An impressionistic view of Political Risks over the decades*

	1970s	1980s	1990s	2000s
Confiscation, expropriation, nationalization	XXX	XXX	X	X
Creeping expropriation	X	X	XX	XX
Breach of contract	N.R.	N.R.	XX	X
Political violence	XXX	XXX	X	XX
Transfer and convertibility	XXX	XXX	X	X
Non-honouring of financial obligations	XXX	XXX	X	XX
Trade-related financing	N.R.	N.R.	X	XX

* X is the lowest intensity of the events in the relative decade; XXX the highest. The grade is the result of a purely subjective and impressionistic analysis. N.R. means that in the period the risk of the event or the insurance of the event was "not relevant".

Creeping expropriation was still a possibility, but rarely a major threat. The spike in the oil price in the new century led some governments in resource-rich countries to

renegotiate signed contracts with foreign companies, often using strong political pressure. This late turn of events, identified as "resource nationalization", seemed to anticipate the revival of expropriation risk, but in reality this risk remained confined to a few countries and mostly to the resource sectors.

As outright expropriation has become a lesser concern, breach of contract (also called Regulatory Risk) has come to the fore, especially in the nineties when many governments started to privatize public enterprises and invite foreign investors to take a larger role in their economy, by purchasing assets, managing services, and so on. During the sale process and even later on in the phase of ownership or servicing, the State remained committed to some obligations, and as such foreign private players started to seek breach of contract or regulatory changes cover. Government in emerging countries started to regulate many of the newly privatized sectors and economic activities but a weak administrative system and unstable economic environment meant that changes in the regulatory framework could be sudden and profound.

Transfer and convertibility of foreign exchange was also most intense in the seventies and eighties for similar reasons. The lack of economic liberalism implied that the exchange rate was controlled: often fixed or with a strong peg. When foreign reserves dwindled, countries would try to control the exchange rate through foreign currency controls and rationing; i.e. triggering transfer and convertibility measures. When the controls did not suffice, a deep devaluation would become inevitable. Today many more economies have introduced floating exchange rates and the adjustments in the current account imbalances occur through movements in the exchange rate rather than through administrative controls. In a few instances, transfer and convertibility risks have been associated with breach of contract (the collapse of the Argentine Peso in 2002, for example), and the market has had a hard time in disentangling the two-risk events.

Political violence as a PR event has changed dramatically overtime; in the seventies and eighties the key concerns were civil unrest and wars, as they characterized many emerging and developing countries, often ruled by dictatorship or weak democracies in a highly unstable and unpredictable political cycle. Today political violence risk is associated with countries exiting from phases of high instability but with high potential, especially in resource-based industries (Iraq, for one). In the so-called “Failed States” conditions are so dire that foreign investors simply are not prepared to operate, thus generating no demand. In the new century one of the main concerns has become terrorism. However, insurers often struggle with the definition of what terrorism is (domestic terrorism, international terrorism, civil war, foreign acts of war, etc) and to what extent and form it is insurable. Those uncertainties are difficult to tackle and often the policy wording does not provide the necessary clarity.

Areas of PR that have grown in importance lately are what private insurers call “non-honouring of financial obligations” by the State and “structured trade” or “trade-related financial obligations”. These credit risks were traditionally covered by ECAs under their export credit insurance schemes. As the global framework has improved, private insurers have progressively stepped in, compensating the drop in the demand for CEN by taking on the non-payment risk of sovereign, sub-sovereign and other public borrowers, as well as trade-related risks. This broadening of the spectrum of activity by private insurers brings them in what used to be the exclusive territory of public insurers.

Political risks are subject to long trends: their nature changes over time. For this reason, estimating historical performance is difficult while predicting future evolution is almost impossible. Table 1 highlights how the most important PR events have changed intensity over the past decades. This impressionistic illustration seems to find some empirical support by analyzing OPIC historical series (Table 2).

Tab. 2 Political Risks claims by decade and type of risk*

Type of risk	Unit	2nd Half 60s	70s	80s	90s	2000s*
Inconvertibility	Number of cases	3	40	123	8	1
	Mln USD	0	19	84	8	3
Expropriation	Number of cases	2	25	20	6	15
	Mln USD	3	335	29	55	209
War damage	Number of cases	3	6	5	0	0
	Mln USD	0	1	2	0	0
Political violence	Number of cases	0	0	3	18	17
	Mln USD	0	0	0	27	4

*2000s up to 2009.
Source: SACE calculations on OPIC data.

The economics of the insurance industry is measured over time; for economic risks, this means over the business cycle. In the past decade, risks have been magnified by globalization and integration of world economies affecting the nature of cycles and crises. The impact of the current crisis has been different for different lines of the insurance business. In the credit insurance business, largely covered by private players and focused on industrialized markets, the current crisis has caused an increase in loss ratios and a collapse in profitability for all major private players, the exit of key re-insurers, the reluctance of shareholders to allocate capital to the industry. In the export credit industry (longer-maturity transactions mainly in emerging markets), mostly publicly-run, the level of defaults is nowhere near that of the credit insurance industry. This seems to run against common sense. Who would have predicted it?

Over the same period, if we look at more narrowly defined PR, such as CEN, the crisis seems to have had less of an impact: occurrences of defaults have been experienced mostly in countries like Venezuela or in the context of resource nationalization measures. Contract frustration has affected contractors for the construction projects in Dubai (i.e. the Dubai World troubles). Trade-related defaults

have occurred mostly in CIS countries, as a result of banking failures in Ukraine and Kazakhstan. The pattern across risks is not homogenous: events are different and so is their magnitude.

PR means different things to different people. The narrow definition would limit PR to CEN events, primarily in the context of FDI. Economic agents however tend to associate it in general with the risks of cross-border business (i.e. transactions that take place in a different political and economic environment) and lump together political risk, country risk, counterparty risk. For this reason the perception and sensitivity to PR is extreme in countries with the weakest economic fundamentals and the most fragile institutional structures: they go by the name of emerging or developing countries.

The current crisis has however made clear that cross border risk is not a prerogative of emerging countries. Industrialized countries are also exposed to economic cycles and crises; in the current crisis they have been the most affected. They are also prone to changes in the "rules of the game" through legislation (affecting the interest of important investor groups) and simple government interference. As a result, lobbying groups and firms are more established and effective in mature economies than in developing ones. No insurer would nonetheless be prepared to cover PR in an industrialized country. Why is it so?

The table below, for example, shows the changes in Transfer and Convertibility risk ratings between 2007 and 2009. It shows that, overall, the situation has worsened for the better rated countries while improving for some of the lesser-rated countries.

Tab. 3 Transfer and convertibility risk rating transition matrix (*number of countries*)

		End 2009																
		AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+
Half 2007	AAA	35																
	AA+	2	5															
	AA			3	1		1											
	AA-		1	2	3													
	A+					3	1	1		1								
	A						3	1										
	A-							4	2	1								
	BBB+								1	1								1
	BBB								1	2		1						
	BBB-		1						1	1	11							
	BB+											6	1					
	BB												3	2			2	
	BB-													7	2	1		
	B+													2	3			
	B															1	1	
	B-																	
	CCC+																	1

Source: SACE calculations on S&P's data.

From textbooks we know that the definition of risk entails both a downside and an upside. The market however seems inclined to neglect upside movements. In reality, Political Risks can move upwards, and we can call that Political Enhancement. This is the case, for example, when State intervention in industrialized countries provides an enhancement to the risk profile of many banks. Depositors, bondholders, buyers of protection have certainly benefitted from the State enhancement, or outright repayment, of their claims. Often, the political risk for somebody is the political enhancement of somebody else.

The concept of Political Risk Enhancement by the States is so true that Moody's in a recent report on banks states that: "*Financial crisis brings banks in greater alignment with Government risk*"[7]. What this means, is that banks are as good as the

[7] Moody's Investors Service (2009).

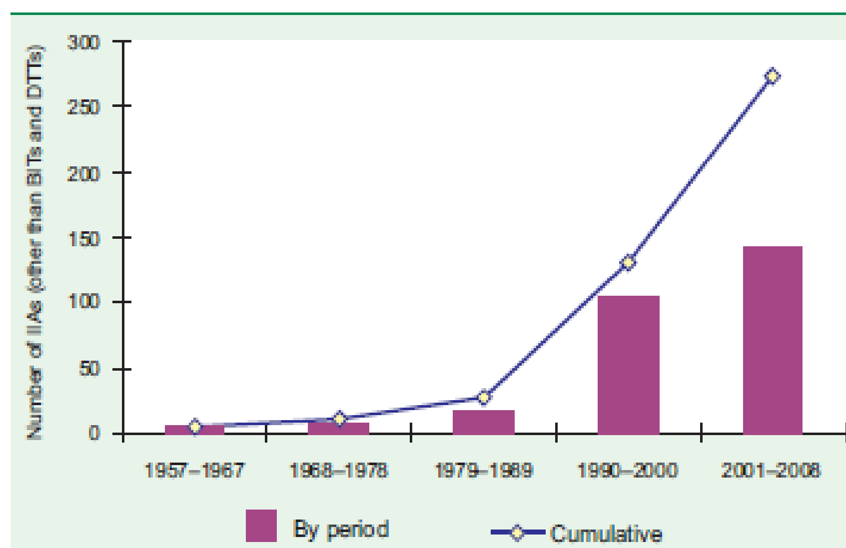
States that underpin their business through public resources. This is especially true when banks are too big to fail.

In the end, most of the time by PR we simply mean the risk of doing business in emerging markets. This implies several dimensions: the risk of counterparties (sovereign, sub-sovereign, banks, corporate); the forex risk (devaluation or controls); government interference (various forms of expropriation); changes in policies (be they discriminatory and non-discriminatory); breach of contract or wrongful acts on specific transactions; instability (terrorism, acts of war) and so on.

3. Global growth and crisis. How has risk changed?

Before we try to understand better the features of PR, let us analyze how other risks have changed over the past couple of decades. The first aspect is that, today, the world is not facing a unique source of global risk, such as the Cold War: a risk of low probability but enormous consequences. Today we are facing multiple sources of risks and instabilities: political, financial, linked to terrorism, pandemics, etc. The world is a riskier place not only because the sources are many and differentiated, but because economic agents are global, exposed to the chain of events that characterizes this globalized economy[8]. Figure 1, for example, shows the steep increase in International Investment Arbitration, witnessing the greater role of cross-border investments and also their greater exposure to government interference.

Fig. 1 Cases of International Investment Arbitration



Source: Unctad.

[8] See Ascari and Terzulli (2009).

The second aspect is that risks in the forms of global crises (rather than national cycles) are much more frequent because the world is more integrated. Yet the experiences of the past decades have not been sufficient to alert us. This "global recession" was not foreseen in its causes and magnitude; it was originated in the most advanced countries and the most sophisticated industry (the financial sector).

The third aspect is that crises are not a prerogative of emerging markets. They are a prerogative of countries with unsustainable fundamentals. Like always. Previous events in the industrialized countries, such as the bubble in the high-tech industries, the LTCM collapse and the "lost decade" in Japan, have not forewarned us. We continued to identify emerging markets as the riskiest area: the Mexico "Tequila Crisis" of 1994; the East Asian crisis of the turn of the Century, rapidly spreading to Latin America (Brazil first and Argentina later) and the CIS (mainly Russia). The risks associated with the globalization process were believed to affect mostly emerging markets.

The recent crisis has changed that perspective. Risks remain high in emerging countries, but this crisis and its long-lasting effects will affect mostly industrialized countries. The growth of advanced economies has been underpinned by high financial leverage, inability to properly measure risks, inadequate pricing for risk, complex (and faulty) risk management systems, insufficient capital to cope with risks when they turn sour. Above all, it has been underpinned by unethical behaviour and weak moral standards.

The culprit of the crisis has been the financial industry, which prior to the summer of 2007 seemed a sort of mythical world, with investment banks (many of them now defunct) like magical fairytale kingdoms: CEOs with super-human abilities; copious wealth (in the form of astronomical remunerations and benefits);

succession sagas like those of ancient empires; financial products like magic spells, with *alphas*, *betas* and the likes.

The world of macroeconomics was akin to a fairytale, and not only because of the abused analogy with Goldilocks. At a time of extreme exuberance, prudent behaviour was scorned upon. Basic rules on economic fundamentals did not apply anymore, at least in industrialized countries. For emerging markets, a 3% current account gap had always been a receipt for disasters. In the case of industrialized countries it was believed that any current account deficit could be sustained almost indefinitely. Deep and sophisticated modern financial markets were the justification. Indeed they could allow distortions to last for much longer periods; however they could not prevent the crisis.

Shorting assets that move too far away from fundamentals, is part of the system of checks and balances. However such a financial strategy may be ineffective when very deep markets can sustain a certain direction of financial flows for very long times, amplifying the distortions. When bubbles start to burst, however, shorting may hurt by making market corrections both more sudden and more dramatic. It is then that shorting gets all the blame. Markets may not adjust smoothly, but adjust they must eventually: when the bubble bursts this occurs through major and painful adjustments and is called "a crisis". Even for the largest economy, what goes up too far at some point must come down, and in the process drag down the rest of the world. While the much heralded decoupling of emerging markets proved to be short-lived and anyway partial, it became clear that fundamentals still matter. Emerging countries that responded better to the spreading of the crisis were those with better macro fundamentals. Is there any surprise in this statement?

Will the world be a safer place in the future? For the time being the answer is, no. After a short period of chest-beating and soul-searching (should we pursue profit

or happiness?), the financial sector is back to the old habits. The efforts of governments and central banks to save the world from disaster have succeeded; they rescued the agents that caused the mayhem. Financial institutions however still carry billions of bad assets on their balance sheets and new write offs loom ahead[9]. Spared to fight another day, the financial industry still plays by the old rules: the VaR of the top five American banks is higher today than before the crisis. Should a new crisis erupt, a renewed bail-out will find little sympathy from taxpayers around the world. Let's assume that common sense will eventually prevail and new rules and regulations will bring about more prudent behaviour in the financial sector. This will not suffice.

The other side of the adjustment will have to occur in global imbalances; this will entail slower global growth. It is realistic to assume that in a world with lower global leverage growth will slow down. At the same time adjustments will have to occur in the major economies, as macro disequilibria need to get corrected: for some countries this will imply a more balanced trade structure (i.e., for the USA more export and less consumption of imported goods), for others higher domestic demand (i.e. China). The enormous public debt that has been created to bail-out the financial industry and sustain demand will have to be scaled down over time[10]. Adjustments will not be neutral on the growth prospects.

The past few months have seen global economic risk shifting, in relative terms, from emerging to industrialized countries. Global distortions have two different signs: in this juncture, and contrary to what common sense would predict, the large deficits are with industrialized countries (e.g. the USA). Many emerging markets show large surpluses (e.g. China). Some industrialized countries, in a couple of years, will join the league of the most indebted nations. Quite an achievement, considering

[9] According to the latest IMF Global Financial Stability Report, expected additional bank write-downs amounted last October to 1,500 billion dollars.
[10] IMF (2009) estimates that in 2014 the ratio of general government gross debt to GDP for Advanced G20 countries will be about 118% (78% in 2007).

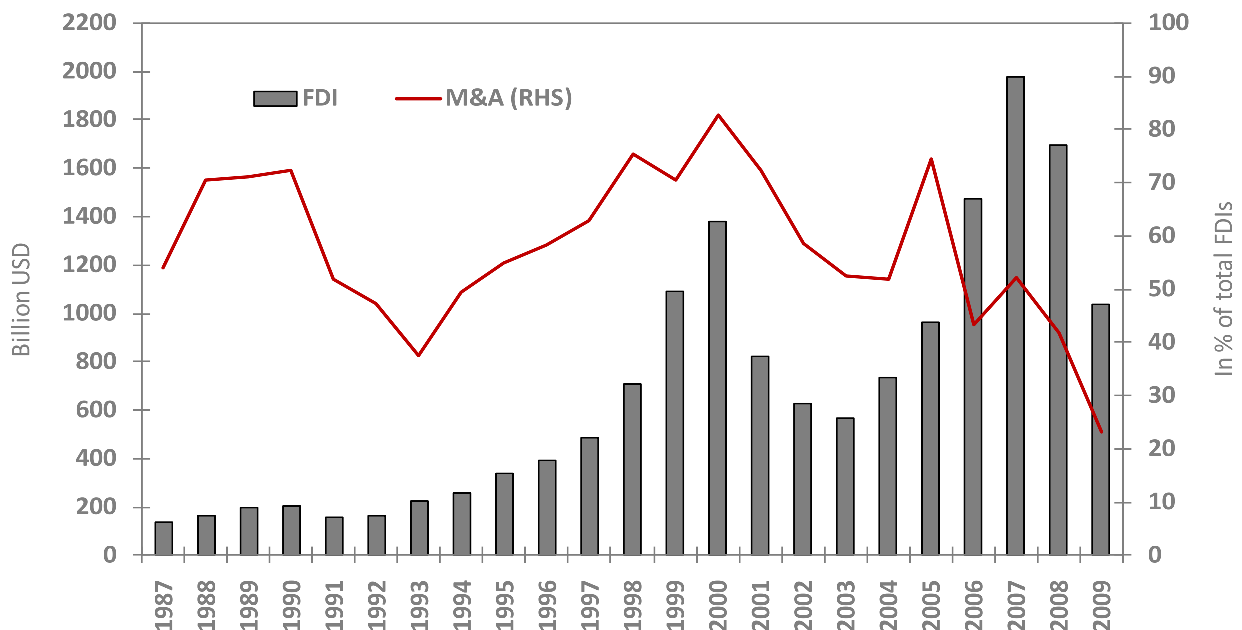
what it has taken for some other countries to get there in the past: decades of mismanagement of public resources. Such a performance should awake the rating agencies and spur some rethinking about countries with AAA ratings. The concept of country risk starts being applied to advanced economies whose “safe haven” status is shaking. Several emerging markets, on the contrary, have sounder macro fundamentals; solid banking systems, the result of more conservative Central Banks regulatory policies; vast domestic markets largely untapped; lower cost of labour and often lot of commodities. Add all this up and answer the question: where would a foreign investor rather be?

The conclusion is that the outlook will be bleaker for industrialized countries than emerging markets. According to a Reuter analysis: “*PR is becoming a growing concern for investors in the United States as the government plays a larger and more controversial role in private enterprises because of the financial crisis”.* Will this imply that the demand for PRI will increase in the first group and decline for the second one? Not necessarily so. The perception of PR will not change and will continue to be associated with doing business cross-border, especially in developing and emerging countries. It will continue to be a tool to support FDI in “difficult” countries.

Globalization will continue and it will survive this crisis, maybe the directions of trade and investment flows will slightly change, the intensity will diminish. In the short term flows of FDI will decrease everywhere, as a result of reduced financial resources to invest as well as lower propensity to invest. However, the fundamentals behind the growth of global trade and investments are unscathed and will continue to support the trends experienced in past decades. In relative terms, emerging markets will be the driving force of global growth, even more than in the past.

Evidence already shows that global FDI flows have been severely affected by the economic and financial crisis. 2007 marked the end of the cycle in international investment that started in 2004 and saw world Foreign Direct Investment (FDI) inflows reaching a historic record of almost $ 2 trillion. Inflows fell then to $1.7 trillion in 2008 and $1 trillion in 2009. The fall in global FDI in 2008–2009 is the result of two major factors affecting. First, investments have been reduced by a fall in the access to financial resources, both internally – due to a decline in corporate profits – and externally – due to the lower availability and higher cost of finance. Second, the propensity to invest has been affected negatively by economic prospects, especially in developed countries. International green-field investments and cross-border M&A transactions, that were less impacted in 2008, are now increasingly affected as a large number of new investment projects are presently being either cancelled or postponed. The share of M&As on total FDI flows decreased to its minimum since 1987 (23.1% in 2009, down from 41.7% in 2008).

Fig. 2 Global FDIs and the weight of M&As



Source: SACE calculations on Unctad data.

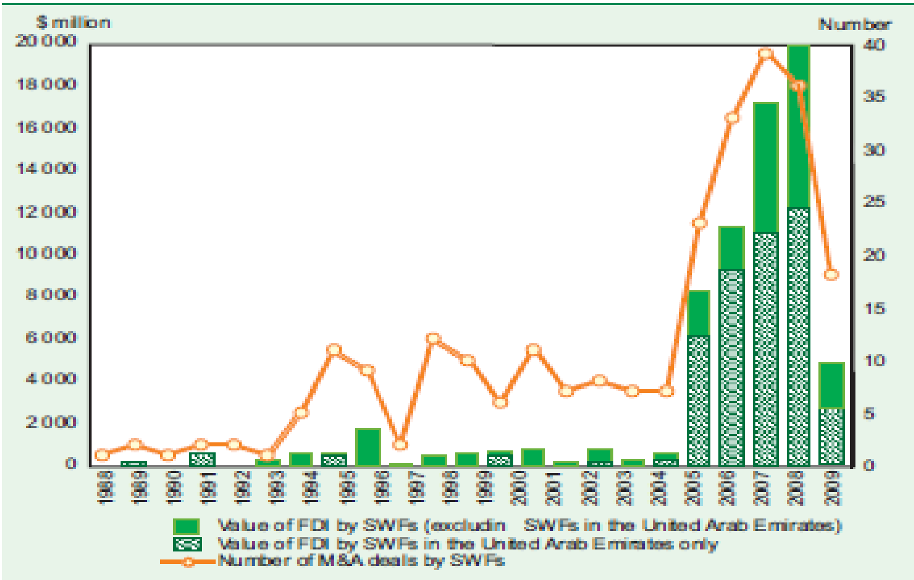
The crisis has changed the FDI landscape: developed countries have been most affected with a significant decline in FDI, while investments in developing and transition economies surged. Such a geographical difference vanished in 2009, with a general decline across all economic groups. Among industries, FDI flows to financial services, automotive industries, building materials were the most significantly affected. However, the consequences of the crisis quickly expanded to all sectors with few exceptions. Some favourable factors will emerge over the medium term, even as a consequence of the crisis itself. Investment opportunities will be triggered by cheap asset prices and industry restructuring and a resilient trend in the internationalization of companies. The exact starting point of the recovery depends on a series of uncertain factors such as the speed of economic and financial recovery, the effectiveness of public policy in addressing the causes of the present crisis, the return of investor confidence and the ability to prevent protectionist tendencies.

Overtime, the impact of the crisis will move from being an economic problem to being a political problem. When an economy is in a downturn, the government has less resources available to deal with issues when they arise, potentially leading to political instability. Several Eastern European countries are already seeing political unrest, a rise in currency transfer and sovereign non-payment risk and an increase in widespread protests and street disturbances. Global political instability is rising fast and creating yet another challenge for companies doing business around the world. In the mind of many economic agents, political risk is associated with emerging countries, as if doing business in Europe, the US or Japan had no downside. How would we justify the pressure put by the US government on a quick settlement for two automobile companies through Chapter 11 if we were the bondholders? What definition of PR would be offered by AIG's Mr Greenberg[11] if asked? How would we define the sudden change in renewable energies policies in Spain if we had heavily invested in that sector? These questions are no longer important only to the developed

[11] See Wall Street Journal, January 9, 2010.

world investors but also to emerging market ones, whose Sovereign Wealth Funds have had an increasing role in explaining global (and also to advanced economies) FDI trends.

Fig. 3 Global FDIs: the role of Sovereign Wealth Funds



*2009: January-June.
Source: Unctad .

4. Global political risk and the concept of tail-risk

Ideally we can think of risks as being positioned along a straight line: at one extreme we have pure actuarial risks; in the middle financial risks distributed on large portfolios; and the other extremely lumpy, political risks. The first group of risks meets the criteria of the "Law of large numbers" and is not the subject of this paper. The second one can approximate a normal distribution, but with unknown (fat) tails. The third one can not be expressed statistically at all.

The financial risk of a large portfolio is, technically, a movement around an expected outcome: upward or downward. Investors (any economic agent undertaking a transaction with a view of making a profit) are prepared to benefit from upward changes that increase actual profits compared to expected ones, but they try to limit the downside risk. The expected return on the portfolio is estimated through the history of past returns and volatility; to the extent the past is not a good guide to future performance, the tail-risk of the investment can be several standard deviations higher than estimated.

At the extreme of our hypothetical line, PR is not an insurable risk: *"We do not know what the probability is of future direction in Russia's economic or political policy. The use of the word risk to cover uninsurable contingencies conveys a spurious precision, which comforts the market, but has basis in science"*[12]. Insurable risk must meet specific criteria:

(i) It must apply to a large number of homogeneous exposures to respond to the law of "large numbers". Political risks are often very lumpy;

[12] Skidelsky (2009).

(ii) The expected loss must be definite, known in time, place and cause. Specific PR events can be the result of long disputes (creeping expropriation), often needing arbitration (breach of contract), resulting in hard to estimate losses (what's the value of the expropriated asset?), or a consequence of unpredictable events (civil unrest);

(iii) The loss must be accidental. In a PR the insured interacts with the source of the risk-generating event (often a foreign government/buyer) and can influence the final outcome[13];

(iv) The loss must be calculable. PRI events cannot be expressed in terms of probability of loss or by applying actuarial methods.

For any investor, estimating the risk of a single long-term project is impossible. Quoting from J. M. Keynes: "*Our basis for knowledge for estimating the yield 10 years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the city of London amounts to little and sometimes nothing*". Investors (and their insurers) are facing major uncertainties, and political risk is one of them. Many laymen will use risk and uncertainty interchangeably and even professionals might disagree on the differences[14].

Uncertainty cannot be gauged by past occurrences, it is not statistically measurable by a normal distribution, and it reflects a number (often very large or even infinite) of possible different states of the world, of alternative scenarios. If a probability is assigned to those scenarios, it is the result of a subjective view rather than being based on statistical evidence. *"Although both actuarial and micro-*

[13] In their article "The Hidden Risks in Emerging Markets", W. Henisz and B. Zellner quote an insurer as saying: *"…if you back the right assured, you can usually keep problems from occurring in the first place – and if they happen, you have an excellent chance of mitigating your loss"*.

[14] Frank Knight (1921) made an important distinction between risk and uncertainty, where situations with risk are those when outcomes are unknown but the ex-ante probability distribution is known; when that distribution is unknown – when there is uncertainty – the situation may be very different.

forecasting models rely on historical data, the analogy between actuarial models of life, property and casualty insurance and insurance of complex derivatives (credit risk, liquidity risk, market risk, legal risk, catastrophic risk, regulatory risk, compliance risk, reputational risk) is false. Insurers relying on a false analogy are spreading into a world beyond actuarial risk"[15].

In uncertainty, social behaviour is part of the deliberation; interdependence of humanity is a major factor. This reality cannot be entirely accounted for by simply assuming that events are "non-linear", such as for the Chaos Theory, an approach that rejects the symmetry of the "Bell Curve" as a description of reality, and assumes that results are not proportional to such a curve. Forecasting based on non-linear models is subject to the same hurdles that stand in the way of conventional probability theory: the raw material of the model is the data of the past.

Past data from real life constitute a series of events rather than a set of interdependent observations, which is what the laws of probability requires. What history provides is only one sample of the economy and the capital markets, not thousands of separate and randomly distributed events. Even though many economic and financial variables fall into a distribution that resembles a "Bell Curve", the picture is never perfect. Once again resemblance to truth is not the same as truth.

Why do entrepreneurs undertake new investments if they have no clue on the likely return from them? Keynes provides the answer by calling upon the "animal spirits". Animal spirits do not imply irrational behaviour, they rather reflect the fact that entrepreneurs have the ideas that spur the investment, the drive to realize it and the ability to take advantage of upside risk and mitigating downside risk as events may require. In other words, entrepreneurs have creativity. According to Albert Hirschman: "*Each project comes into the world accompanied by two sets of*

[15] Skidelsky (2009).

partially or wholly offsetting potential developments: i) a set of possible and unsuspected threats to its profitability and existence; and ii) a set of remedial actions that can be taken should a threat become real. (….) Creativity always comes as surprise to us; therefore we can never count on it and dare not believe in it until it has happened. In other words, we would not consciously engage upon tasks whose success clearly requires that creativity be forthcoming"[16].

[16] Hirschman (1967).

5. Pricing political risk: a statistical approach or "an art"?

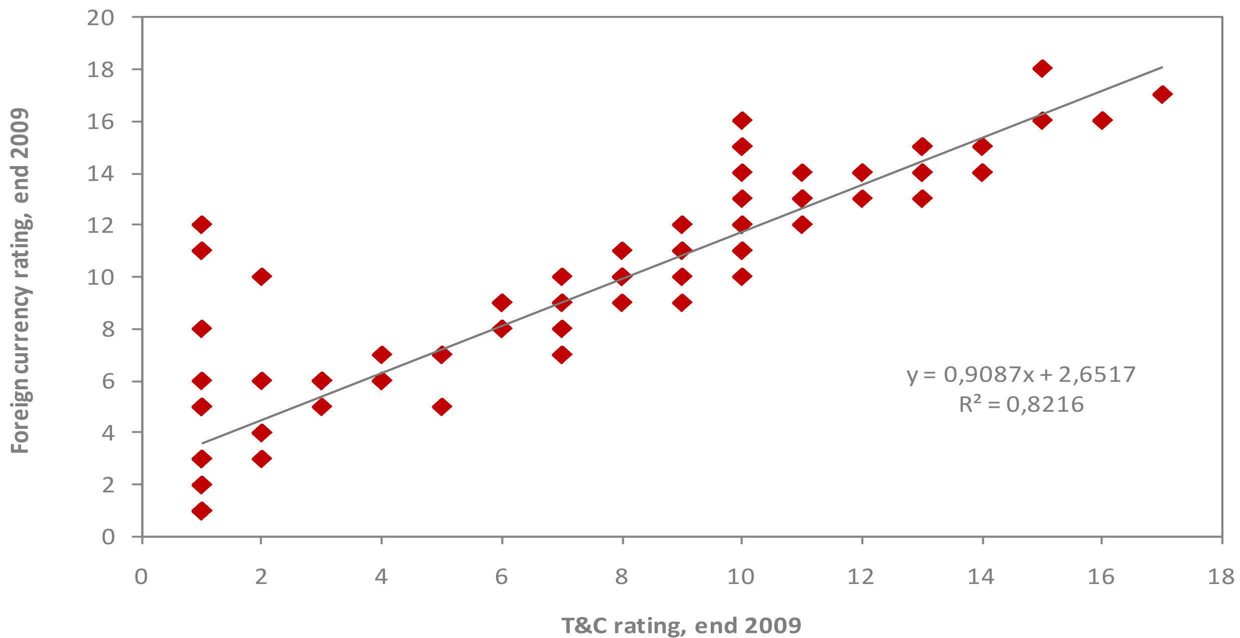
Despite all the above, PRI is available on the market even if its economics and pricing remain arcane. At least, two pricing approaches can be identified on the market:

(i) **One method uses market available indicators and adjusts them to reflect "basis" differences on risks.** Available indicators are CDS, yields and spreads for sovereign risk, ratings. As they reflect credit risk more than political risk, their correlation can be rather limited. It is stronger for PR events of economic nature; it might be negligible for others. The risk of convertibility and transferability of foreign exchange risk can have the highest correlation as it depends on a country's macroeconomic and financial situation (above all, its balance of payments situation; Fig. 4). However, if and when a crisis erupts, it can evolve along different trajectories: a banking crisis, a sovereign default, a large devaluation or the introduction of forex restrictions. If the balance of payments is untenable, the situation might play out differently depending on the foreign exchange rate system in place: a country with a flexible foreign exchange rate would be less likely to introduce controls compared with a country with a hard peg. Other PR events (expropriation, nationalization, civil unrest, etc,) are little linked to the credit risk available indicators. Measuring PR using credit risk information is like trying to answer the question whether a train is faster or a chocolate sweeter. Even if you adjust for basis difference (is it coal-fired train or milk chocolate), you still end up with implausible outcomes.

(ii) **The second method is by trial and error.** Starting from the recognition that pricing PR is almost impossible, the chosen approach would be more of "an art". Of course, there are sound and hard analyses behind the assessment of a

risk: PR insurers do not go blindly into selling policies, they do analyze all pertinent matters (economic, social, political; historical, perspective; macro policies and micro behaviour) and come up with reasonable scoring systems (Figg. 5, 6 and 7). These findings can help compare different countries and events by allowing them to be ranked (there can be at least an "ordinal" measure, but not a "cardinal" one); checklists make sure all variables are taken into account; tree-decision making helps work out plausible relations. Yet, there is no actuarial number that can be used to quantify the final risk; there is not a probability distribution. The price thus arrived at has to be often checked with other market players, by seeking their participation in a reinsurance program.

Fig. 4 Transfer and convertibility risk ratings: high correlation to foreign currency ratings*

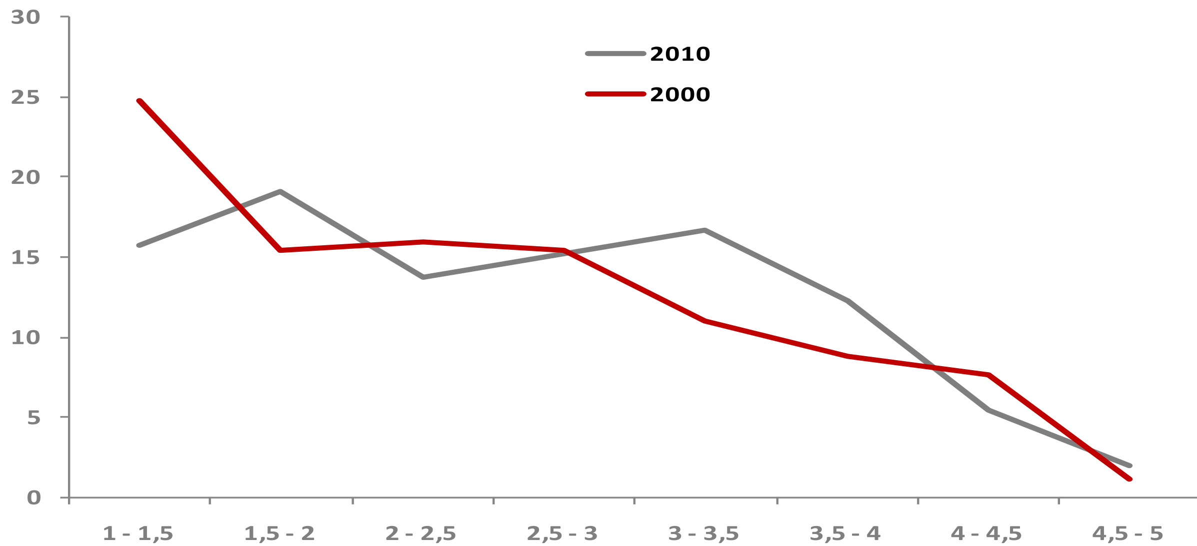


*1= AAA; 2=AA+;…….18=CCC.
Source: SACE calculations on S&P's data.

The world is still a risky place. Figure 5 shows that over the last decade the distribution of countries by level of security risk has not changed much, with a further deterioration in the group of countries which were considered as "medium risk".

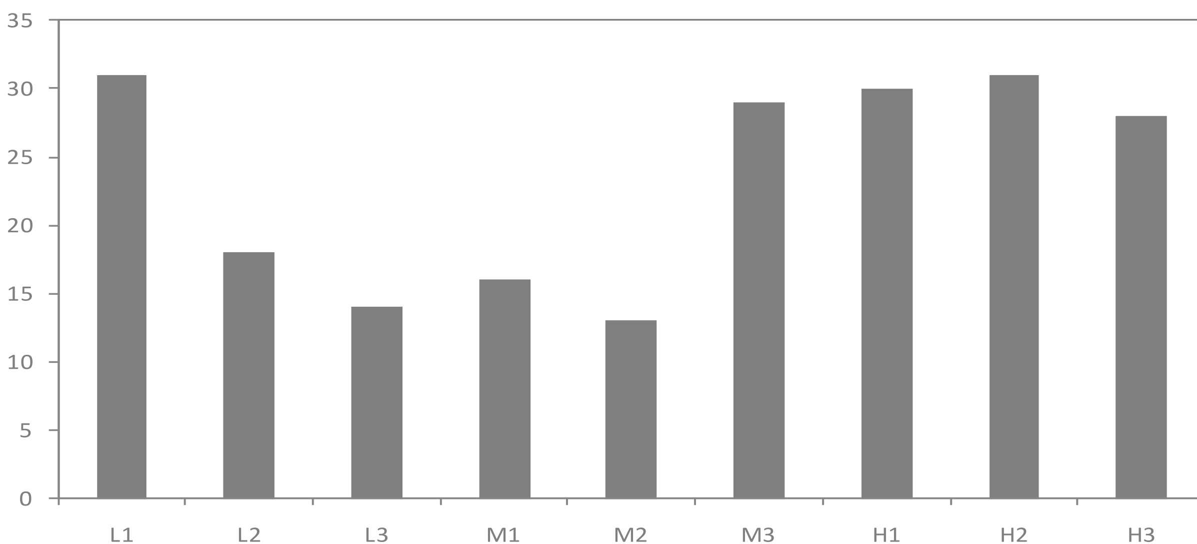
Figure 6 shows that out of a group of over 180 countries, risk of expropriation is medium-high in more than half the countries. The assessment is different for political violence risk where there is a higher number of countries with low scores and quite a relevant number in the medium-high range (Fig. 7).

Fig. 5 Security risk scores*: country distribution by score classes (*in % of total number of countries*)



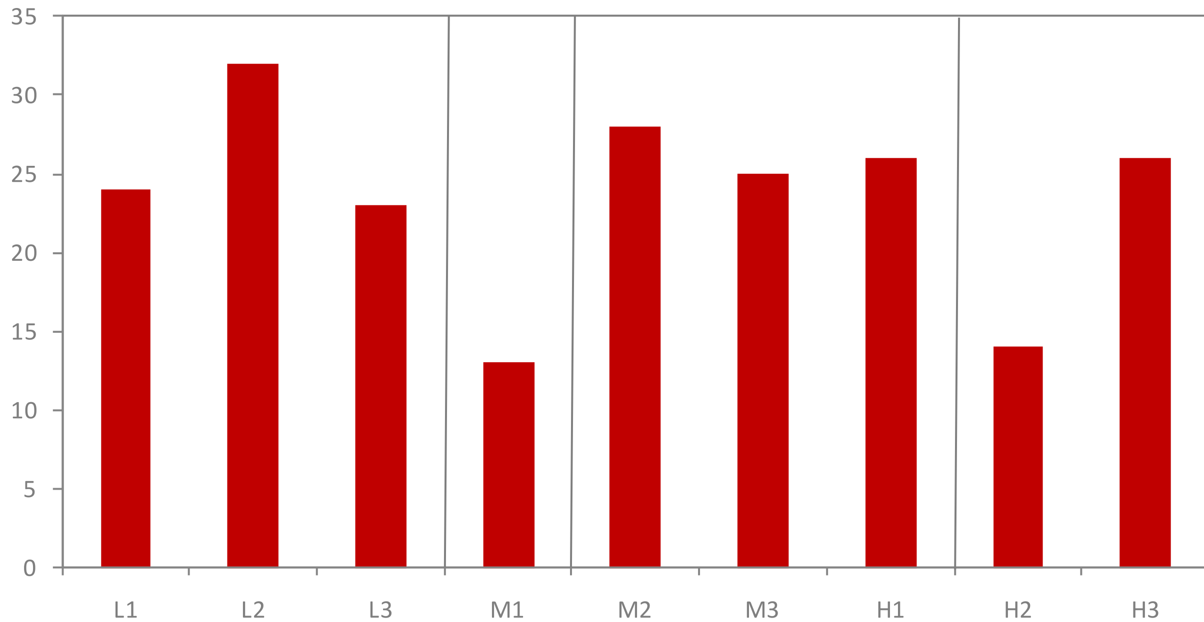
*1 minimum risk, 5 maximum risk. Security risks include: civil unrest; crime; terrorism; external security threats.
Source: SACE calculations on Global Insight data.

Fig. 6 Expropriation risk score* (an ECA's view): country distribution by score (*number of countries, 2009*)



*L1 minimum risk, H3 maximum risk. Expropriation risk includes: rule of law; property rights; government intervention; control of corruption.
Source: SACE.

Fig. 7 Political violence risk score* (an ECA's view): country distribution by score (*number of countries, 2009*)



*L1 minimum risk, H3 maximum risk. Political violence risk includes: rule of law; voice and accountability; political stability and lack of violence, crime and terrorism.
Source: SACE.

A risk matrix for pricing should estimate the impact of several factors. The probability of default would depend upon the country's situation, for the various risk events, global and location-specific; its track record and likely evolution; the nature of the sector; the size, visibility and strategic importance of the investment; the experience of the investors in managing conflicts, amongst others. The recovery rate would be a function of the wording of the policy (often insurers use "positive" and "negative list" to define insured events); legal recourse or arbitration for a default event; risk mitigants; collaterals; risk-sharing; formulas. This entails more a checklist than a precise statistical approach.

6.Why buy political risk cover?

The second question is what's the motivation to buy PRI? The golden rule of risk management is that each risk should be managed by the party most effective at doing so. In principle, manufacturing firms should focus on producing and marketing, leaving the management of other risks to specialized insurers. Banks, as intermediaries that can match different sides on a transaction, should offer market risk (currency and interest rates) protection. Insurance companies should focus on other sources of risks, such as credit risk. As we shall see shortly, political risk, besides private insurers, seems to be better managed by government-linked entities or multilaterals.

Agents tend to associate PR with the risk of conducting cross-border business (i.e. transactions that take place in a different political and economic environment) without a clear differentiation across risk events. The perception and sensitivity to PR is obviously extreme in countries with weakest economic fundamentals, fragile institutional structures and unstable governments. The preoccupations of conducting cross-border risk include:

- i) counterparty risk (sovereign, sub-sovereign, banks, corporate);
- ii) foreign exchange risk (devaluation);
- iii) foreign exchange controls (convertibility and transferability of currency);
- iv) government interference in the business conduct (various forms of expropriation);
- v) breach of contract or wrongful acts on specific transactions;
- vi) other changes in policies (be they discriminatory or non-discriminatory);
- vii) instability (terrorism, acts of war); etc.

PR is present in both emerging and industrialized countries. Covering counterparty risk in industrialized countries, for example, is done through credit insurance. Foreign exchange risk protection can be cheaper for most traded currencies of major economies. But it would be rather unusual to seek protection for government interference in advanced countries, even if this can not be ruled out.

In the past decades markets have developed many new risk products; much of the innovation has come from the banking industry or insurers that have promoted financial guarantee products. Among the new product lines, CDS have shown the most rapid increase becoming a key credit risk management tool. They have been offered not only by banks but also insurers such as AIG. CDS has been used to cover some dimensions of political risk (credit risk related to the issuance of bonds by sovereign and sub-sovereign borrowers as well as by major banks and corporates in emerging markets). Another rapidly growing line of business has been the protection offered by mono-liner insurers, offering credit enhancement on certain securities (municipal bonds) or portfolios of securities. The offer of more traditional PRI has also increased but never experienced the growth of other credit tools.

The offer of new products has grown increasingly detached from underlying asset, because of the pooling and re-pooling of the asset and the speculative/arbitraging use of the protection. The recourse to risk management tools to protect and manage the underlying transaction has become a minority component in the overall market as other uses have become paramount. The volume of derivatives has become much larger than the underlying asset; the volatility of the protection has enormously increased; the counterparty risk of the insurers has been put to serious stress, as in the case of AIG. The crisis of 2008 and 2009 has caused the collapse of this house of cards and raised serious doubts on past risk strategies and above all the ability of risk protection to cover their positions.

Who is buying PR protection? A foreign direct investor, especially if involved in capital intensive ventures, with large initial sunk costs, is one of the most likely buyers of PRI in its stricter definition (CEN). Foreign investors are likely to cover their positions in a selective way, to limit peak exposure or to mitigate frequency losses. The largest multinationals, as in the case of the Oil Majors, tend to manage political risk internally, able as they are to raise the stakes at the highest levels with government counterparts, often with the explicit support of their own governments. Occasionally they might seek PRI to cover certain risk: peak ones or in especially intractable countries. Manufacturers tend to see PR as an operational risk for which they rarely seek cover, unless the operation is a very difficult country environment or on a project whose size might put at risk their own survival. However, it is generally recognized trend that PRI for corporations (mostly in the form of CEN) is not a growing business.

When corporations seek protection, they have two major goals: financial indemnification in case of an adverse event and "enhanced bargaining power". PRI protects the economic interests of a corporation in case of losses but the presence of the insurer is often seen as a deterrent to certain acts by the State in a third country. Avoiding disputes, litigations, or outright expropriation ex-ante is far more valuable than having an indemnification ex-post. This is achieved when the insurer is a strong player with political clout as in the case of ECAs and IFIs: being the instruments of government, they can raise the dispute to a level of equals. Quoting from a former MIGA Executive VP: *Historically, MIGA's leverage on the ground has enabled it to resolve a number of disputes between host governments and investors. Helping clients and hosts to solve problems encountered in Venezuela, Russia, Argentina, Nicaragua, Bolivia, Kyrgyzstan, and Nigeria, among others, has allowed, worldwide, productive projects to continue"*[17].

[17] Yukiko Omura quoted in Foreign Direct Investment Magazine: "Take cover to reduce risk", January 5 2005.

It follows from this that the key providers of PRI must be insurers that have the backing of the State or owned by States such as ECAs and IFIs. A company, especially if small, can hardly take up a government committing a violation. ECAs and IFIs can exercise moral suasion on the host-government to prevent it from taking arbitrary actions. States are the signatories of Foreign Direct Investment Protection and other Treaties, and are best suited to solve cross-boarder disputes. Some ECAs, for example, price their cover only on the basis of an existing bilateral Treaty with the country receiving the investment.

Obviously enhanced bargain can be achieved also through other means, for example by joining a local partner with a better understanding of the local environment or simply better connections and lobbying capacity. **However, if the "enhanced bargaining power" is a motivation for buying PRI, how should this reflect in the price for available cover?**

Banks that finance FDI or other cross-border transactions are also a likely buyer of PRI: in the current market, they have represented the major source of demand for PRI to cover their own loans (short term trade-related or more long term investment-related) or as a protection for their collateral (often a lending requirement). This demand for cover would mirror the motivations seen for the corporate.

When the cover is broader than a single transaction, it may respond to a "portfolio management" motivation: the reduced risk in the portfolio creates headroom for new commitments or for taking-up new exposure without necessarily keeping it on the books, thus satisfying the clients and making an intermediation margin without breaching country limits. Portfolio investors are less interested in some forms of PRI, as they keep their position extremely liquid (hot money). They usually hedge credit or market risks but not political events.

As banks have the largest and most sophisticated risk management structures, they use available cover to optimize capital allocation. Within their strategy, cross-border risk management is an important component. Banks have often a choice between allocating marginal capital to a new transaction and buying an insurance policy: this creates the "arbitrage" opportunity. If the cost of the policy is more than compensated by the return on the freed capital, banks will have an incentive to do so. Of course, in a perfect market such an arbitrage would not be possible, but we live in markets that are very far from being perfect. And the arbitrage could be even larger if the definition of mitigant is not clear: Central monetary authorities require certain capital allocation against country risks. This requirement can be waived buying some cover. But what cover? Core political risk insurance (CEN) and comprehensive cover are not the same thing; CEN offers no protection vis-à-vis the credit risk of the counterpart, be it private or sovereign. Yet it seems to allow banks to eliminate their country risk capital coefficient, while remaining exposed to a non payment due to the counterparty default. This is the "arbitrage" motivation behind the purchase of PRI.

Exporters are preoccupied with events causing a default on the payment due. The causes could be a credit or a political event. Dealing with unknown counterparts in an unknown environment raises both the counterparty and country risks. Without a proper track record new counterparts are difficult to assess, especially if they are non-sovereign; furthermore, risk events can be independent from the quality of the counterpart, stemming from uncertainties in the rules of the game, and particularly ownership and exchange rights, the enforceability of contracts or licenses, the wrongful calling of bonds, etc. Finally, the least developed the country, the more likely that other forms of risk will be higher including civil unrest, civil war, terrorism, etc.

In assessing and taking decisions about managing risks, companies should follow a logical set of questions along the lines of this checklist:

i) What risks are better managed internally and what risk can be better covered through market instruments? As we have discussed, some risks (market risk, political risk, credit risk, etc) find adequate offer on the market. By covering them, companies can focus on their strategic tasks (i.e. production and marketing);

ii) What size of the risks is proportionate to the balance sheet? The protection might not need to be complete, and the company might want to retain some risks on its balance sheet, to benefit from a potential upside or to optimize the cost of cover.

iii) What is the nature of the risk (peak, frequency) and how does it play on the company liquidity and solvency? As a corollary to the point above, a company might wish to protect itself from peak, excess of loss and other forms of extreme risks. To reduce the cost of protection, it might be willing to take a first loss or by protection on a portfolio of positions rather than single ones;

iv) What is the exact nature of the risks? Are they commercial/credit risks or are they political? Companies have to understand better the nature of the risk events in order to buy a protection that is effective and leaves little "basis risk". Unfortunately, many agents are still confused about the nature of credit events and the appropriate cover required to provide protection from them;

v) How will events play out to generate the risk? This is especially important for PRI cover as the events often must be defined ex-ante: terrorist vs. war cover; legitimate policies vs. discriminatory government measures; multiple events such as devaluation and breach of contract on tariff adjustment.

7.The outlook for Political Risk Insurance

Understanding the outlook for PRI entails agreeing on what the political risk is. Political risk, in reality is different things to different people. Let us start with sovereign credit risk. The nineties saw a major reduction of sovereign risk in emerging markets, with a tightening of spreads and early repayment of outstanding debt. The current crisis is affecting some groups of leveraged emerging markets (e.g. CIS and Eastern Europe), some specific debtors in Middle East (Dubai), and is making the situation in many other developing and emerging markets harder. The major effect though however is being experienced in industrialized countries: for some the risk of insolvency has become tangible, Ireland and Greece; for others, the risk of a downgrade is a distinct possibility (USA; UK). In general, in the coming months many industrialized countries will have to place on the markets an increasing amount of public debt, and are likely to pay higher spreads. The sovereign risk has increased mostly in industrialized countries, even if this will not mean for them necessarily a default risk.

Among emerging markets, particularly telling is the case of Dubai which highlights several issues that have so far remained behind the scene: the difference between an explicit sovereign guarantee and the implicit support of the State; the value of the guarantee or support if the debtor represent much of the Sovereign debt (i.e. the default of one part triggers the default of the whole); the exposure with other counterparties in the same country in presence of cross-default and cross-acceleration clauses. It will be much clearer in the future that “implicit support” may not be quite a proxy for Sovereign risks; what will define specific case will be the precedent not so much the rule.

The events of September and October 2008 have led the business community into a more realistic assessment of narrower political risk. In the 1990s businesses

adopted a benign view of the world. The collapse of the Berlin Wall seemed to promise a new era of peace and stability and a new world order based on the rule of law (the “End of History”). It has been abundantly clear for some time to PRI market professionals that this vision of the 1990s was not being realised. Global terrorism; resource nationalism; global warming; and now the economic crisis: all point to a new era of instability and disorder. Indeed we may well now have “more history” in front of us than behind us. However, insuring those risks will not be easy. As they often have a catastrophic nature, much will depend on how financial markets will recover and whether “good” financial innovation will not be chased out by “bad” financial innovation.

Despite progress in several emerging countries, many of the least developed countries remain highly risky. If the situation in Iraq has somewhat improved, Afghanistan and North Korea have probably worsened; so has the situation in Pakistan and Iran. Failed States are still in large numbers; many countries in the African continent continue in their trajectory of short successful periods followed by a reverse to instability and chaos. In Latin America populism is still deeply rooted in several countries. National policies vis-à-vis natural resources remain highly volatile in many countries, with periods of open foreign investment policies followed by periods of resource nationalization, breach of signed agreements and contracts.

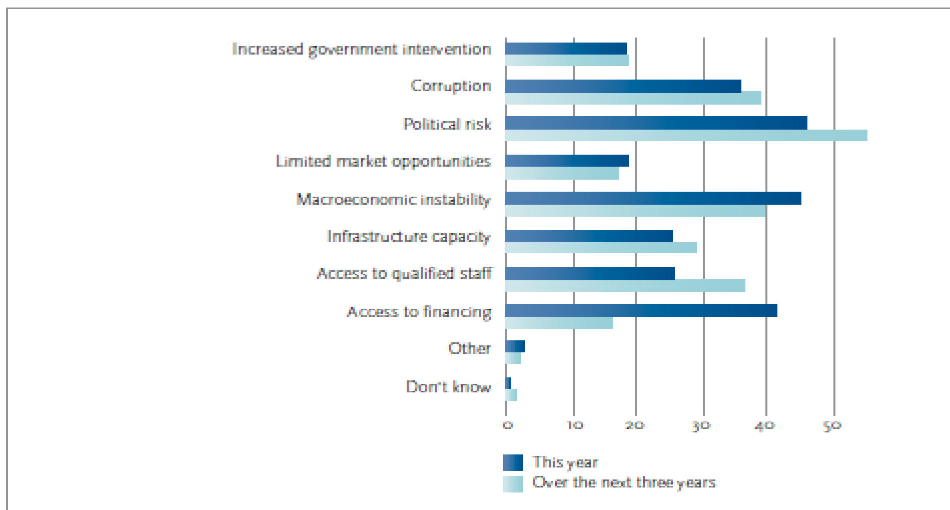
Many emerging markets have now introduced open foreign exchange systems, with floating rates reducing the need to introduce controls. However the risk has not completely disappeared, as witnessed by number of instances in eastern Europe, the CIS and elsewhere.

The new realism towards globalization is causing many companies to look again at what the PRI market has to offer. The PRI market has been through a significant phase of product development in the last few years, broadening the offer of risk

mitigants of sort, on top of the bubble in the CDS offer. War risk policies are now available for loss or damage due to a wider spectrum of events. Cover for expropriation goes well beyond the standard concept of direct expropriation of assets and it is mainly related to the creeping expropriation (i.e. Kashagan and Sakhalin projects). Transfer risk remains very tangible as a consequence of the deterioration of economic conditions even in countries such as Latvia and other CIS countries.

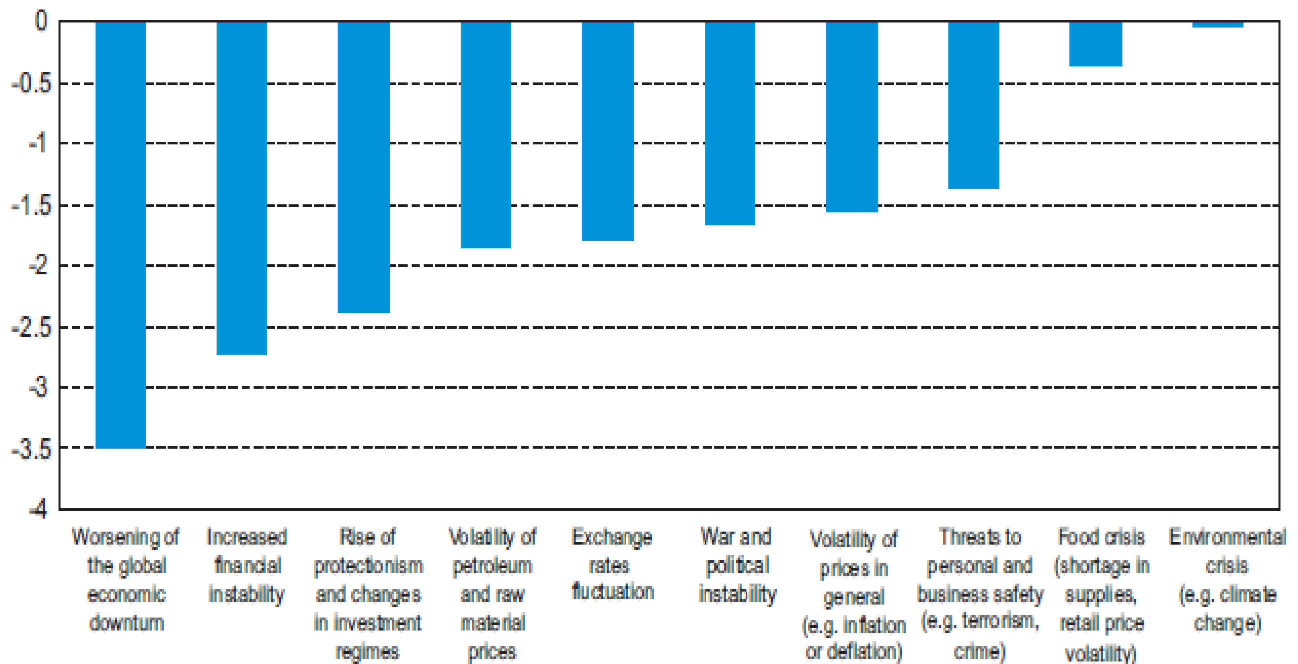
PR is not subsiding for the simple reason that in a global world the sources of instability are increasing and so is the number of players that can be affected by them. Political risks are being perceived as one of the greatest constraint on investment (Fig. 8), although survey results do not converge on this (Fig. 9); within them breach of contract and currency restriction are perceived as of most concern (Fig. 10). Those risks are hard if not impossible to predict; certainly we have no statistical instrument to foresee them. The tools to protect from the risks are increasingly sophisticated and this is positive. At the same time, their complexity creates uncertainty on the effectiveness of the cover: was the event a flood or a hurricane? Was it an act of terrorism or a war? Was the discriminatory act of a Sovereign or was it non-discriminatory? Is there a basis risk in the cover? Was it included in the policy wording? The presence of a multitude of providers of risk mitigants also raises the issue of the counterparty risk: will they be creditworthy when called upon?

Fig. 8 Political risks as major constraints to FDIs*: results from a survey



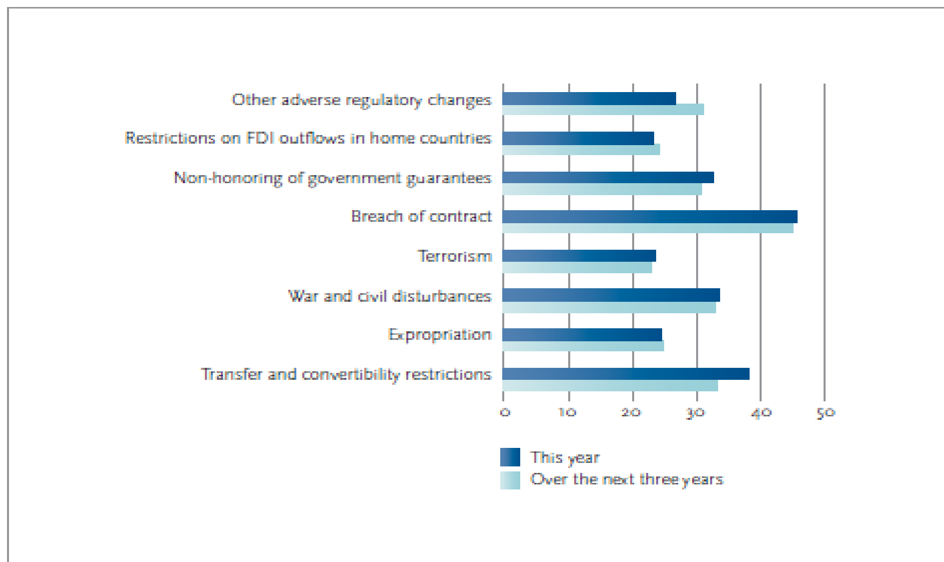
*Survey on 351 executives of Multinational companies around the world in June 2009.
Source: MIGA-EIU.

Fig. 9 Risk factors for FDI in 2009-2011*: results from another survey



*Survey on 241 company executives selected among the largest non-financial transnational corporations. Average values of responses: -4 large negative impact very probable; 0 negligible impact very probable.
Source: Unctad.

Fig. 10 Political Risks of most concern



*Survey on 351 executives of Multinational companies around the world in June 2009.
Source: MIGA-EIU.

As the risks are increasing, investors do not try to cover all of them nor do they find on the market all the cover they need. The demand for core PRI, which can be identified with CEN events, is not increasing and the offer still rest mostly with public ECAs. Private insurers that are active in the PRI market mostly cover events that are not strictly PR, ranging from credit risk (non-honouring by the Sovereign and trade-related) to breach of contract and bonding. The PR is high in industrialized markets, although it is not perceived as such and it is not covered by neither private or public insurers.

A great confusion still reigns in the field of PR: it is a small market, with many small product lines; without a consistent methodological apparatus. We talk a lot about it, but we seem to have very little understanding of it. **The only conclusion, at this point, is that the Political Risk Insurance is not an industry.** It is a set of products that cuts across many possible events, mostly cross-border and with a strong focus on emerging markets. As industrialised countries get riskier and many emerging markets get stronger; how will this "non-industry" develop?

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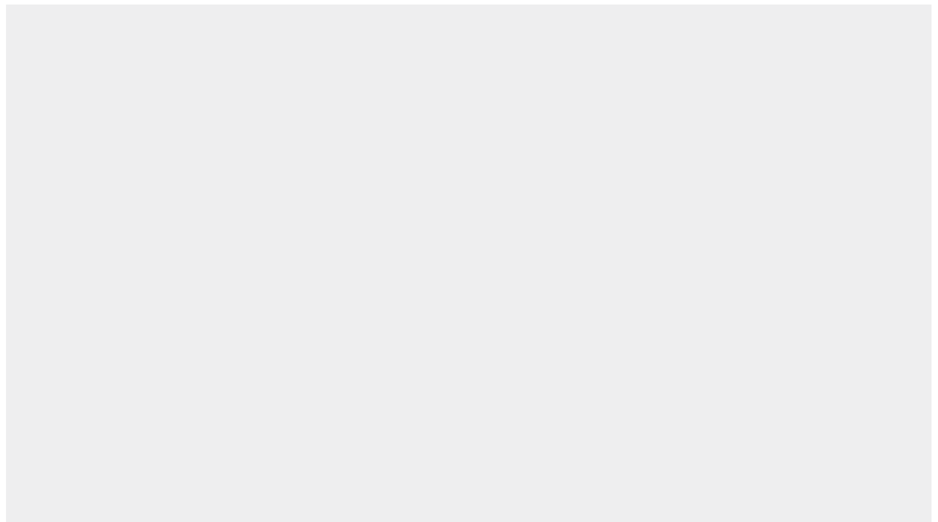

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