N.43304
R.41947

RISK MANAGEMENT FORUM

AEAI/RIMS International Conference
October 15-18, 1989
Monte - Carlo

Please respond to

WEDNESDAY, OCTOBER 18,1989

SESSION NR 25

# MANAGING FINANCIAL/POLITICAL RISKS

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1 - A few definitions.

2 - Insurance of political risks from different points of view :

. the exporter

. the contractor

. the investor and the financial institution

3 - Insurance markets for political risks :

. state schemes

. private schemes

. a multinational scheme : MIGA

4 - Capacities available.

5 - Underwriting : conditions and warranties.

6 - The future.

What is exactly a political risk ? This word encompasses a wide serie of meanings and it is advisable to try to give a definition for it. In 1982, Mr William OVERHOLT in the review EUROMONEY indicated that "POLITICAL RISKS are the possibility of political events which could reduce the organization's assets, disrupt or impede its operations, or endanger its access to markets".

In different words, a well known expert in political risks, Julian RADCLIFFE produced an other definition which reads : "A political event caused by the action or omission of a government which is damaging to a corporation, arbitrary or discriminatory, and in defiance of generally accepted principles of international law".

To these excellent definitions, I would add a simple word which is the "Fait du Prince". The Prince, that it to say the political power may be tempted to act according to his own wishes, in certain circumstances, and does not feel compelled to abide by well known international regulations. In the quaint old Victorian days, one would have felt that sending a light cruiser would bring a reluctant payee to heel, but these days are long gone. This means that a private or a public organization, even sometimes a government controlled enterprise, may find itself in a position of not being able to recoup a sum of money or an asset abroad. To be eligible to insurance, the occurrence of a political risk cannot of course be influenced by the action of a private party. Otherwise it could no longer be termed as a political risk.

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There are so many perils normally regarded as political risks that it would be foolish in such a short period of time, to try to mention them all in a comprehensive way.

I will therefore limit my exposé to those political risks which affect normal or near normal trade operations which is after all the concern of a Risk Manager. I will also confine myself to describing the various methods by which those perils may be the subject of an insurance policy : there are other risks which cannot be eligible to insurance and therefore would normally be dealt with through a political risk management procedure. My colleague, Mr TAVECCHIO touched on some of them in the most professional fashion.

From thereon we can draw 3 main lines :

A - The protection of the exporter with regards to goods or services, and the protection of the importer in his dealings with sources of supply.

B - The protection of the entity operating abroad, i.e. the contractor.

C - The protection of the investments made, and the protection of personnel detached locally.

A - PROTECTION OF THE EXPORTER :

1° - Losses suffered from non payment for goods after they have been received by the foreign buyer. These buyers may be either public buyers or private buyers but the cause of the insolvency must originate from a "Fait du Prince".

2° - Exchange transfer or currency inconvertibility insurance which will come into force when an order in the buyer's country prevents, restricts or delays the transfer of funds to the assured's country.

3° - Cost of commissions which are due to intermediaries, even when the contract is interrupted or when a public buyer becomes insolvent.

4° - Contract frustration or unilateral breach of contract insurance i.e. failure of a public sector buyer to honor a legitimate contract.

5° - Unfair contract termination by the buyer or repudiation by a buyer refusing to honor his part of the contract, or when losses are sustained by the assured on a reciprocal or collateral contract.

6° - Unfair calling of bonds by the buyer when the assured has given no cause for such a call, or when the calling of bonds appears to be justified but outside the control of the assured. Those bonds may be of different types and nature, for instance : advance payment bonds which guarantees the buyer on the down-payment made by him before work may begin ; bid bonds, performance bonds, maintenance bonds, guarantee bonds.

7° - Arbitration award refusal which is the failure of the buyer to honor an arbitration award, or court judgement obtained in favour of the assured. The mere refusal by the public buyer to submit himself to a trial which was a clause of the contract, may also be covered.

8° - Losses sustained through non-delivery of goods which are a counterpart in a chain of barter trade agreements.

9° - Export or import restrictions, cancellation or non-renewal of an export licence, or implementation of a law which prevents the export of goods or provisions of services, thus rendering impossible the due performance of a contract by the assured.

10° - Coverage against war or civil commotions, however only under certain strict conditions.

B - PROTECTION of the CONTRACTOR :

. Confiscation, expropriation or nationalisation of assets by the foreign government be it buildings, mobile equipment or goods.

. Confiscation or nationalisation of shares held by the entity in other local subsidiaries.

. Political violence or arbitrary detention of staff until a ransom is paid.

. Extorsion and kidnapping.

C - PROTECTION of the INVESTOR who by the way may be a financial institution :

. Confiscation or expropriation of properties, shareholdings or loans provided by the assured.

. Inconvertibility of dividends or profits due for rapatriation by the assured.

There are other perils which may come under the general heading of Political Risks, but those which I have just cited are the ones for which Risk Managers of international corporations, or just exporters are likely to get cover under an insurance contract. We could just mention "en passant" computer crime, electronic or industrial espionnage, bomb threats which in certain cases may be regarded as political, depending on whom commits them. Some of these perils may also be eligible for insurance.

Let us examine now where are the markets which provide suitable coverages for political risks. Most European countries have long recognized the need to provide their national exporters with suitable coverage regarding political risks or "fait du prince". This is the case in countries like Belgium, Germany, France, England, Holland and many others, where state schemes were set up in the few years which followed the end of second world war.

Why were these schemes mostly set-up by public will ? Just because at this time underwriting political risks was thought to be so difficult to assess that the likely adverse consequences had to be borne in the end by the taxpayer. How to take into account and apply a yardstick to the whims of a Colonel recently promoted to a Head of State situation, and wishing to show his strong will to his compatriots by blocking all exchange transfer or confiscating foreign assets. Undoubtedly there was also some nationalistic temptation by Western governments to orientate their rates and conditions to promote their <u>own</u> exports, and exert strict guidance to make sure that only such coverages that met their criteria in terms of foreign policy would be eligible for their attention. As a result, it is not surprising that most state political risk schemes have been operated at a loss, and therefore regarded as pure subsidies to export. This has been the case for many companies such as COFACE in FRANCE, DUCROIRE in BELGIUM and E.G.C.D. in ENGLAND.

Of course since these foreign policies could not be coordinated between the various countries of EUROPE, exporters began to claim that they were often at a disavantage with their competitors which were said to be benefiting from better insurance terms and conditions. There is no doubt that this situation will pose certain problems after 1990 since many questions remain insolved in the European regulations.

These state schemes relating to credit risks have been operated as I said under rather strict conditions, and shown some lack or flexibility which led to the opening of markets operated by private insurance in LONDON with the Lloyd's Market, in the United States with A.I.U. and CIGNA, in BELGIUM with LES ASSURANCES DU CREDIT, and more recently in FRANCE with the P.A.R.I.S. Group which is a body providing coinsurance from well known companies such A.G.F., U.A.P., M.G.F. and GAN, or in LONDON with PAN FINANCIAL allied to SKANDIA and YASUDA from JAPAN. These markets have displayed a flexibility that was missing and have taken pride in considering every possible proposal, with the only condition that the underwriting principles should be respected and the scheme operated had a profit since no public subsidy was to be envisaged.

This newly emerged market has displayed many outstanding qualities :

- Risk assessment made by independant underwriters free from state guidance, and having at their disposal a wealth of information coming from reliable and long trusted sources.
- Policies made to measure and "keeping their ears to the ground" if I may say so, and displaying as little rigidity as possible.
- Rates produced with no preconceived criteria with only in mind the probability or likelihood of the risk occurrence.

- Risks placed or reinsured mostly in ENGLAND or in the U.S.A., and therefore offering clauses inspired from non written law and jurisprudence.

We can easily deduct from these general lines that those schemes are relatively costly and would only be used when the national or public schemes cannot be utilized.

Apart from public and private sectors which we have examined, a multilateral agency has emerged in NEW YORK City, called MIGA : it was funded by a number of countries and provides coverages for the bigger international schemes.

When the exporter decides to purchase a political risk insurance policy underwritten by a state controlled insurance company, the procedure is rather simple since the rates are generally set out in advance and are not negociable. The policy clauses are ready made, but can be however amended on special request. Possibilities to obtain coverage for certain countries vary according to decisions made by local governments or authorities.

The private schemes for political risks offer a much greater flexibility and their scope for cover is very wide. There are several factors which guide the private underwriter's decisions when fixing the rates bearing in mind that statistical information just does not exist as it does in other classes of insurance :

- Status and apparent solvency of the buyer, previous experience sustained by the client in the market and quality of the terms of the contract.
- Length of time during which the protection is needed, volume of the client's business currently insured by the underwriter.

- Volume of payments outstanding.
- Stability of the buyer's country.
- Security of transfer and types of banks involved.
- Importance of the products or services rendered to the buyer's economy (i.e. are they vital pharmaceutical drugs or just toys).

Before rendering his verdict as to the terms, conditions and warranties of his quotation, the underwriter will expect the candidate-assured to disclose his knowledge of all relevant and pertinent facts in the "utmost good faith" principle, that is to say the old "uberrimae fidei". If this situation does not happen either no quote will be submitted or even worse, problems may arise when the claim is submitted. This is why the help of a broker specializing in credit and political risk insurance is highly advisable when discussing the terms of a policy : only he who knows the intricacies of a somewhat difficult and technical field, will ask the relevant questions enabling the insured to dodge the mines laid about by the untruthful buyer.

Terminology has to be understood : for instance it is necessary to circumscribe the terms of expropriation, embargo, inconvertibility, calling of bonds, so that both insured and underwriters understand what are the exposures the policy is intended to cover.

The intervention of a specialized broker is all the more advisable that the cost of his work is included in the premium.

What about the capacities available in this private political risk market ? As you will have heard earlier on, this market is operated at a profit : underwriters are not terribly keen to compete between one another and the  there is no guarantee for a given capacity to last for any length of time. Quotations are normally valid for a few days and particularly if the risk is to be covered in some "tricky" countries ; capacity may be used up suddenly by a spate of requests : for instance, the recent upheavals in CHINA triggered a flood of requests on the LONDON market, and capacity could not have been obtained should all those requests have materialized in firm orders. However if one wants to be sure of getting capacity following the supply of a given rate, a commitment fee may have to be paid in advance. I cannot stress too much the emphasis on the voluntary aspects of the political risk private market, and there is always a danger that if profits go down then capacity would be channelled to more profitable types of insurance.

Some risks cannot be insured although of course what I am saying today might not to be valid tomorrow, because things change so quickly. But today it is not possible to obtain genuine insurance covering fluctuations of currencies, violation or non-respect by the insured of local laws, product disputes or non-performance by the exporter, wrongful or dishonourable acts by the insured or its agents, claims relating to foreign wars between 2 or several of the 5 great powers. An attempt was made a few years ago by CIGNA to cover some sovereign risks of a well known American bank : the premium was paid, but the leading underwriters found themselves in a position where they could not muster enough following. Therefore, the policy had to be cancelled and the premium paid back to the insured.

What is the scope for political risk insurance in the years to come ? There seems to be a great future for this type of coverage for obvious reasons :

- increasing state of debt shown by the developing countries ;
- multiplication of barter trade agreements ;
- increasing political unrest ;
- indulgence to religious fanatism or frustration due to a widening economic gap ;
- declining of cash availability throughout the world ;
- vulnerability of equipment, electronic data processing equipment, and as recent history sadly showed, vulnerability of aircraft.

Provided no major catastrophes occur in the next few years, new insurance markets will emerge perhaps through a better cooperation between state schemes and private schemes. For instance, it is already known that government controlled schemes will have to get reinsurance from private underwriters, therefore inducing some mutual commitments on rates and wordings. The present cost situation when each time an operation is eligible for a state scheme, results in a premium being always cheaper than that provided by a private scheme, will gradually disappear.

Exporting firms will have to develop better political risk management techniques to analyze, mitigate and transfer risks either to third parties or to insurance, and must keep in mind that even when one resorts to insurance, protection offered is generally not 100%, and there are deductibles imposed in the policies as well as waiting periods before the payment of the loss takes place. Setting up a political risk management often starts by asking oneself simple questions, which of course I have no time today to dwell upon.

Risk management techniques will be particularly helpful for countries which show a traditional deficit in their balance of payments : in my own country, FRANCE, we seem to have exported in the past far too much to countries which show now little capacity and good will to pay back their debts.

Techniques for debt recovery will improve often with the help of independant consultants such as "CONTRACT and INVESTMENT RECOVERIES" which was formed in LONDON recently.

Unfortunately Mr President, ladies and gentlemen, political risks are here to stay and increase : no doubt there is a big scope for imaginative schemes, and for underwriters to provide a flexible service at a cost susceptible to be borne by the exporter.

Thank you for your attention.

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