

POLITICAL RISK INSURANCE: PROTECTION OF INVESTMENTS



1. INTRODUCTION

WHAT IS POLITICAL RISK AND WHAT ARE ITS CONSEQUENCES?

Political risk is the probability of disruption to the operations of multinational enterprises by political forces or events, whether they occur in host countries or result from changes in the international environment.

Recent events in the Middle East, North Africa, Venezuela, the credit crunch, its aftermath and the Eurozone crisis, illustrate that political risk in all its forms continues to pose a real risk to companies investing in emerging and, increasingly, developed markets. Such entities are unlikely to be immune from the potential risks posed. Political violence and instability, contractual breach (financial and otherwise) and the capricious actions of governments all militate against successful investment and, more significantly, the delivery of wider business strategies. For listed companies and funds the stakes are even higher. Ever-present pressure to deliver returns and increased share value to institutional investors and the exposure for directors/senior officers arising from a failure to properly discharge their fiduciary duties. A significant political risk event (which might have been mitigated) can pose searching questions for senior management. Political risk exposures relate to people, assets and contracts; political risk insurance (PRI) can offer risk mitigant solutions on all three fronts.

This guide outlines:

- Operation of PRI cover as a mitigant to equity and debt risk exposures
- Applicability of cover to investment fund portfolio investments
- Advantages and disadvantages of public versus private PRI markets
- Drivers for PRI cover and key issues for the placement process
- PRI case studies
- Mapping of a PRI cover placement process
- The PRI private insurance market and underwriting capacity
- Marsh's PRI credentials.

Key PRI covers include:

RISK	SOLUTION
Forced divestiture, expropriation or nationalisation of assets or losses arising from same	Equity cover
Unpaid loan repayment due to named political perils	Lender's cover
Losses from revocation of key licences or concessions	Licence cancellation / breach of contract cover
Default of public and private entities	Contract frustration cover / non-payment
Damage to assets or loss of revenue resulting from political violence or seizure by government	Loss or seizure of mobile assets

2. WHAT PRI CAN OFFER

EQUITY INVESTORS' AND LENDERS' PERSPECTIVE

Historically it is the large multinational corporates that have been the staple buyers of PRI cover. Protection against expropriatory action, governmental breach of contract and the damage, both physical and in business interruption terms, caused by political violence was obtained through the PRI market. The focus was primarily on risk mitigation. In recent years financial institutions, particularly banks, have been the mainstay of the market seeking non-payment cover and country "headroom" to enable them to do more business with favoured clients and markets. It is this "secondary" motivation which has increasingly come to the fore and which should interest investors and their lender partners.

EQUITY INVESTMENT

Equity investors whether private equity and infrastructure funds or multinational corporates whose focus, or that of their portfolio companies, is on emerging markets, are particularly well-served by the PRI sector and have much to benefit from buying cover to protect the balance sheet and cash flow of an asset. Underwriters are familiar with those geographies likely to be susceptible to political risk of one kind or another, and investors reassured that suitable risk mitigants are in place across a portfolio may prove willing to maintain or increase their participation. Moreover, a "hedged" investment opens up the potential for new investments in the same market.

There is a clear willingness, particularly from the private insurance market, to draft bespoke insurance contracts and take the time to understand the insured as well as the insured risk.

LENDERS' INTEREST COVER

Equity investors are not the only parties to capitalise upon PRI use. PRI facilitates deals through the protection it affords lenders. Lenders' interest cover protects scheduled repayments under an insured loan, where those repayments are prevented by a named political peril. As such equity investors' ability to access PRI both for its own account and for that of its lenders is potentially a competitive advantage. The leverage typical of private equity type transactions means an inducement to lender participation might be the difference between a deal's economics holding up or not.

PRI BENEFITS

Used thoughtfully and systematically PRI can bring a host of benefits:

- Direct risk transfer and mitigation
- Transaction facilitation through access to new capital to support expansion – both that of insurers and lenders/investors
- Management of country and counterparty limits
- Wider portfolio management
- De-risking transactions and roles for senior management
- Confidentiality.

3. INDUSTRY SECTOR RISKS

Equity investors will often assemble a portfolio with a deliberate spread of industry sector types and geographic exposures across their funds. Despite this diversification a portfolio of investments focused on emerging markets will retain a vulnerability to political risks.

The table below provides an overview of key industry sectors, political risk exposures and headline points to the ways in which PRI can mitigate these risks, crucially, helping to strengthen financial certainty of a portfolio's operational risk.

SECTOR	DESCRIPTION	EXPOSURE	PRI PRODUCT
Financial Services	<ul style="list-style-type: none"> Banks Diversified financial services 	<ol style="list-style-type: none"> Interbank / branch loans Project finance loans Re-financings Property perils Asset confiscation / expropriation Inability to repatriate dividends / loan re-payments 	<ol style="list-style-type: none"> Non-payment / contract frustration (for public / state-owned buyers insurance) Political violence (incl. terrorism) and business interruption cover Equity cover Currency inconvertibility / non-transfer
Industrials	<ul style="list-style-type: none"> Manufacturing Chemicals Plant / Processing 	<ol style="list-style-type: none"> Accounts receivables Property perils Asset confiscation Revocation of operational licences / permissions 	<ol style="list-style-type: none"> Non-payment / contract frustration insurance Political violence (incl. terrorism) and business interruption cover Equity cover Licence cancellation cover
Utilities	<ul style="list-style-type: none"> Power Water Gas Telecoms 	<ol style="list-style-type: none"> Asset confiscation Licence revocation 	<ol style="list-style-type: none"> Equity cover Licence cancellation cover
Real Estate	<ul style="list-style-type: none"> Commercial Retail Leisure 	<ol style="list-style-type: none"> Asset confiscation Political perils preventing loan repayment to lenders Property perils 	<ol style="list-style-type: none"> Equity cover Lenders' interest cover Political violence (including terrorism) and business interruption cover
Business Services	<ul style="list-style-type: none"> Supply chain logistics IT Business process outsourcing 	<ol style="list-style-type: none"> Accounts receivables Property perils 	<ol style="list-style-type: none"> Non-payment / contract frustration cover Political violence (including terrorism) and business interruption cover
Consumer	<ul style="list-style-type: none"> Retail Wholesale 	<ol style="list-style-type: none"> Accounts receivables Property perils 	<ol style="list-style-type: none"> Non-payment / contract frustration cover Political violence (including terrorism) and business interruption cover

Whilst many companies will be susceptible to some form of political risk, the level of risk will vary according to geographical context and other variables. An investor's own risk appetite will also govern the purchase of insurance. What we hope is clear is that the suite of PRI products is sufficiently broad to support all manner of companies, whatever the sector, whilst operating in challenging environments. Our expert PRI team at Marsh is available to advise on the suitability and availability of those products, procuring cover as required.



4. APPLICATION OF PRI AS A RISK MITIGANT

KEY DIFFERENCES BETWEEN PUBLIC AND PRIVATE INSURANCE MARKETS

Historically private and public insurance markets did not cooperate closely. However, for example, in the infrastructure sector where project values are often large and tenors long with uncertainty of payback as regulatory and legal frameworks change with government changes, we have seen this pattern shift as the demands on equity investors and their lenders increase.

A review of the reinsurance arrangements for Multilateral Investment Guarantee Agency (MIGA), or the membership of the Berne union whose 50 plus members provide support for export credit and foreign investment insurance demonstrates the close relationship between both markets. The confidentiality provisions in private market insurance means that the extent of cover available is often little known or understood.

In reality private market solutions often mirror those in the public market – non-cancellable for their policy term, with similar heads of cover and the use of private markets by public markets for reinsurance on a follow the fortunes basis demonstrates how closely aligned the two are.

Marsh is a major producer to MIGA and private markets. We are also broker to three Multilateral Development Banks (MDBs) and several Export Credit Agencies (ECAs). We are not compromised in providing the best solutions for our clients' sometimes with differing interests on the same transactions.

PRIVATE MARKET ADVANTAGES

- No national promotion of exports with restrictions to foreign supply and local value creation. Agencies often require new investments
- No national content requirement (or fixed pricing) - ECAs tend to require the insured transaction to be an export from the underwriter's country

- Lesser emphasis on social, environmental or public policy interests
- Structural flexibility - insurers may be subordinate to lenders and may or may not require a pledge of shares. The latter is a must have for public markets
- Cover can be applied for (and purchased) at any time
- Bespoke policies ("tailor-made" for each insured)
- Competition between insurers (on price and coverage)
- Speed of underwriting response
- No costs before signing
- A syndication market - this can lead to more aggregate underwriting capacity but differing terms due to individual insurer appetite, reinsurance requirements or commercial flexibility, so this can be more complex than a one stop shop public market. It is critical to identify a respected committed lead insurer
- Pricing flexibility, including opportunity to layer cover
- Confidentiality
 - private market insurance remains confidential
 - agencies advertise the existence of insurance protection which may affect the host country perception of an investor.

DISADVANTAGES OF PRIVATE MARKET

- No AAA rating (but several AA and most still A or better)
- Conditionality fundamental (not a financial guarantee, although ECA Guarantees retain conditionality)
- Onus of proof rests with the insured (international market only)
- Capacity issues (pricing is supply and demand driven)
- Tenor - private market appetite generally limited to 15 years, non-cancellable
- Basel II compliance (for lenders) - ("Lloyd's" Exclusions may be restrictive compared with company markets)
- Public agencies may be unwilling to share their preferred creditor status
- Claims - it is key to ensure private market cover does not enable insurers to adopt a differing claims stance with respect to loss mitigation and recoveries

5. DRIVERS FOR PRI COVER AND KEY ISSUES FOR THE PLACEMENT PROCESS

- PRI insurers attach as great an importance to the owners and other stakeholders they insure as to the operational businesses they insure. Cover may be provided on a single or multi-year non-cancellable policy, presenting challenges to any insurer, so their focus will initially be on who is the insured, the quality of corporate governance and their experience in the sector and / or country. A detailed picture of both the asset and the parties involved is an essential part of an underwriter's due diligence and the means by which he will become comfortable with the risk.
 - Syndication of risk - energy and power, mining, transportation and the construction industry are all major buyers of PRI insurance to protect both equity investors and debt providers. Cover sought is for both equity and debt protection and purchased from the public and private markets. It is critical that clients are advised by intermediaries who can point to strong relationships with all capacity providers and are attuned to their respective appetites in order to best serve their clients.
 - Subordination of equity to debt – where shares are pledged to lenders this can prove problematic for some markets whose eligibility criteria ruled this out. Early cognisance of this can be critical to garnering market support for the transaction.
 - Disclosure – the disclosure exercise prior to binding a PRI policy is substantial and the manner in which it is handled can be critical to earning the trust and buy-in of insurers. Supporting documents include among others, principal contracts to be covered including any debt instruments, background to the insured businesses management team, operational procedures, and experience in the host country.
 - Insured and insurer relationship – open communication is key to successfully obtaining PRI cover and we at Marsh encourage and foster client-insurer relationships as a means of building the requisite level of trust between the parties. PRI insurers regard themselves as stakeholders in the businesses they insure and ongoing communication throughout the placing process makes for a smoother transaction.
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6. CASE STUDIES - PRIVATE EQUITY PRI POLICIES

POWER DISTRIBUTION SECTOR

Marsh's Political & Structured Credit Risk (PSCR) team placed a large, complex policy for a UK private equity business, using underwriting capacity in the private insurance market.

This recently acquired insured asset in the power distribution sector had previously enjoyed the benefit of an investment guarantee from MIGA. However, the leveraged nature of the acquisition financing, and the attendant subordination of equity to debt, removed the capability of public agencies to provide continued PRI cover, along with a number of private market insurers who might usually be considered natural lead underwriters for this industry sector.

Marsh's Political and Structured Credit Risk team was faced with the challenge of obtaining in excess of US\$100m of cover in an historically challenging sector without availability of key insurance market players, for a private equity fund manager with no history of placing PRI cover in the private market.

The heads of cover required for a five-year period were comprehensive in scope:

- Expropriation
- Forced divestiture
- Forced abandonment
- Breach of contract
- Operating licence cancellation
- Import embargo / licence cancellation.

Marsh's strategy was two-fold:

- Introduce the client to the political risk market emphasising its credentials in its chosen field and as a business partner
- Mentor the client in the discharge of its duties of disclosure and the significant due diligence exercise undertaken by insurers.

Marsh partnered extensively with the client to highlight its track record in investing in challenging business environments. The result was one of the largest single situation political risk placements in the market this year; a highly tailored policy closely addressing the client's needs and achieved against the odds with a broad panel of underwriters.

We are now in the process of analysing the client's wider political risk needs across its portfolio of companies.

CONSTRUCTION MATERIALS BUSINESS

Since 1996, an expropriation and political violence policy has been insured by the PRI market for a large construction materials company. The policy currently provides insurance across ten countries in North Africa and Asia, on a maximum aggregate limit of liability of EUR850m.

The policy operates on a three-year basis, with a cancel and rewrite option written into the policy wording. After 12 months have elapsed the policy is cancelled and rewritten for three further years, thus extending the length of the policy and providing greater security to the client.

The insurance cover provides the insured with protection against expropriatory acts which deprive the insured of their equity value in their investment, whilst also indemnifying them for property damage following acts of political violence.

7. EXAMPLE PROCESS CYCLE FOR PRI INSURANCE*



*TIMESCALE IS INDICATIVE OF A TYPICAL PROCESS CYCLE. PLEASE NOTE THAT IN OUR EXPERIENCE PRI POLICIES HAVE BEEN PLACED WITHIN EIGHT WEEKS, OR UP TO 24 WEEKS.

8. PRI MARKET CAPACITY

London is the core of the PRI market, with an additional underwriting presence in Singapore and Bermuda, as well as Paris and New York.

All PRI market insurers carry an S&P credit rating of at least 'A-'. Current market conditions display that the average tenor on a PRI policy is three years with a maximum of 15 years, dependent upon individual risk details. The market has an aggregate insurance capacity of around US\$1.2bn for expropriation / confiscation covers. It is estimated that the total premium placed into the PRI market is US\$1.5bn, with 75% attributed to London.

Risk appetite differs per insurer, but the market has a broad appetite, with a consensus to favour strategic sectors. The market does not specifically exclude any sectors, but inevitably claim experience means certain sectors / investment structures are less well received. When analysing an enquiry insurers look favourably to clients with emerging market expertise, as well as prior experience in the pertinent sector. Insurers will want to see evidence that the client has conducted extensive due diligence on the country of risk and sector. Additionally, insurers also appreciate those clients who demonstrate an awareness of their social responsibility within the foreign country.

**As at 1 March 2012*



9. MARSH'S POLITICAL & STRUCTURED CREDIT RISK TEAM

In choosing to work with Marsh we believe you will benefit from a team that has unrivalled experience and contacts in the field. With a team drawn from the worlds of insurance, banking, law and underwriting, we place business across the whole spectrum of risks.

In 2011 Marsh placed cover for five of the world's top 10 financial institutions by assets. Export credit agencies, multilaterals and trade development banks recognise and endorse this difference; we hold four exclusive mandates for these globally recognised institutions. We also manage two of the world's largest trade receivable programmes and manage the PRI needs of private equity and infrastructure fund portfolio investments. With a truly global reach and with resources to match we are in a position to take the time to arrive at the correct rather, than what might be considered a short term apparently, easy solution for our clients.



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Marsh was named 'Global Infrastructure Insurance House of the Year 2012' in Infrastructure Investor's Awards for fourth consecutive year.

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