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Political Risk in Infrastructure Projects

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POLITICAL RISK IN INFRASTRUCTURE PROJECTS

Political risk is a generic concept addressing the risks to investments and contracts from political change or instability. It encapsulates various aspects, including regulatory, legal, and credit risks. To best manage a continually changing global political landscape in both developed and developing economies, more and more investors in infrastructure development projects and operational assets are building political risk assessments and mitigation strategies into their project decision-making processes.

When considering new infrastructure opportunities in a foreign host nation, many investments will have a potential vulnerability to political risk. This risk can become heightened for a foreign investor that needs to commit its equity for a long time period, as projects tend to be illiquid and project payback periods are often longer than for other sectors. The risk of a future host nation government's new agenda and popular mandate for change can disrupt the underlying base case model for long-term investments in emerging markets. Even in a developed region such as Europe, the perception that the continent is home to a safe haven of financially and politically stable states with a low vulnerability to social upheaval has been turned on its head.

The sovereign crises of several EU members, the nationalization of financial institutions, currency transfer and monetary restrictions, and successive political changes in the face of tough economic adjustments have each played their part in dispelling this myth.

As developers, equity sponsors, and debt providers discover the less traveled roads of developing economies, what was once an exotic asset class now stands on the verge of becoming mainstream, as a greater number of institutions and funds seek long-term assets that offer higher returns to offset flat or negative interest rates in the bond market.

In those areas where demand for infrastructure projects is most acute, the greatest challenges for investors include the stability of the political environment, fiscal surplus, and the rule of law.

As more developing economies deliver stable legal and regulatory conditions to attract longer-term direct foreign investment, the opportunities for bankable new projects have never been so potentially attractive.

LIFE CYCLE

When looking at the life cycle of an infrastructure asset, starting from the investment decision and its economic and political premise, the first challenge for any infrastructure investment is its need for financing. When the asset is in a developing economy, lenders will often be constrained by the regulatory cost of long-term capital and their own appetite for the specific country or sovereign risk. While debt will stand senior to equity, these circumstances may force sponsors towards taking a larger share of the risk.

During the construction phase of a project, the outright risk of expropriation is unlikely, since there would still be considerable costs to be managed; however, the threat of disruption to the project remains, whether through terrorism, war, or political violence. Of particular consideration is the wave of losses and project interruptions witnessed in Libya over recent years. These gave rise to several projects' execution phases being "frustrated" due to political events on the ground, as well as financial-type risks such as the unfair calling of project bonds and guarantees and credit/non-payment risks. What were once deemed isolated events have given rise to a contagion of religious extremist groups (such as ISIL) across regions of North Africa and the Middle East, with affiliated threats elsewhere in the world to perceived western interests.

The construction phase of any infrastructure investment is always challenging for lenders and sponsors as debt and capital are drawn down and cash flow is negative. While some risks during this phase can be mitigated through bank guarantees and insurances, etc., each participant looks to the other to shoulder the risk. Ultimately, the main burden falls on the equity investors, who provide the first "line of defense" for the other stakeholders against the occurrence of political and regulatory risks.

During the operational phase of an infrastructure asset, the exposure to investors may also align to contractual risks and deliverables committed by the investor to the host country, whether to the government, the regional/municipal government, or state-owned enterprises. Here exists a risk of expropriation or breach of contract, and such events do occur and have done so with increased frequency in recent years. Governments that host foreign-owned infrastructure projects have become increasingly sophisticated in the face of globalization, and manifold complexities now tend to affect regulated industries (like infrastructure), which are the most vulnerable to being tampered with, due to political action.

POLITICAL RISK INSURANCE

The potential impact of political risks for infrastructure assets is wide, and political risk insurance (PRI) is one of a handful of mitigation tools available to limit investors' exposure to the financial consequences of these risks.

In considering how to mitigate such risks with insurance, a comprehensive assessment of covered risks and their triggers can be beneficial. Otherwise, the investor may fall short on mitigation by short-cutting the appropriate insurance coverages on the basis of cost. Eventually, difficult questions might arise, such as: Is damage resulting from ISIL action a covered act of narrowly-defined terrorism, or is it war? Does the property all-risks policy provide insurers the right to cancel the political violence coverage at short notice?

When political risk is assessed by specialist insurers, it is often surmised that the primary focus is on the host country risk – the geography in which the project will be located. While country risk is obviously a key consideration, it may be surprising that insurers' foremost focus is on the insured. This fundamental starting point is key as insurers scrutinize the past experience of equity investors, their current financial resources, and know-how in managing projects that inevitably don't play out according to plan. The stakeholders will first look to the investors for support, who may in turn look for public support or partnerships. Lenders will, of course, consider the amount of debt to equity as well as the nature of any guarantees supporting the project. The strength of that support may be vulnerable to unpredictable future change, which may be politically driven or founded on regulation which, in the case of financial institutions, has hampered their willingness to take risks.

EQUITY INVESTMENT

Infrastructure funds, private equity, and pension fund investors with a focus on emerging markets are particularly well-served by the PRI market and have much to benefit from buying cover to protect the balance sheet and cash flow of an asset. 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 party as well as the insured risk.

LENDERS' INTEREST COVER

Equity investors are not the only parties to capitalize upon the use of PRI. PRI facilitates deals through the protection it afford lenders. Lenders' interest cover, meanwhile, protects the insured lender against non-payment of scheduled principal and/or interest under an insured loan, where those repayments are prevented by a named political peril. As such, an equity investor's 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, including:

- Direct risk transfer and mitigation.
- Transaction facilitation through access to new "non-competitive"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.

The foremost focus of political risk insurers is on the characteristics of the equity investor who needs cover, as opposed to the geography in which the project will be located.

STRONG CAPACITY DRIVES BUYER'S MARKET FOR POLITICAL RISK INSURANCE

Abundant capacity and strong competition have contributed to a generally favorable marketplace for buyers of PRI globally in 2015. Despite growing concerns about global political and credit risks and a recent increase in loss notifications — which will likely translate into some losses for insurers later this year — insurers generally view political risk as an attractive line of business in which to compete.

GROWING CAPACITY

Capacity in the political risk marketplace has steadily increased over the last decade, particularly since the global financial crisis. Globally, market capacity now exceeds US$2 billion for a single policy, nearly double the available capacity just six years ago.

This increased capacity reflects a shift away from traditional property and casualty lines toward more profitable specialist classes of insurance. Many traditional insurance lines, such as property and directors and officers (D&O) liability, have become crowded with competitors, contributing to prolonged soft pricing and limited underwriting profits. Insurers have also been unable to generate much investment income because of recent low interest rates, leading them to expand their product offerings to find new sources of revenue.

Insurers are finding those revenues in PRI and other specialty lines that generally do not correlate with swings in the overall commercial insurance market. Combined ratios for political risk have generally remained below 100 for the last decade (with the exception of 2008 and 2009, at the height of the global financial crisis), indicating profitable underwriting results.

In recent months, insurers have seen an increase in both the frequency and severity of political risk loss notifications stemming from high-risk countries such as Libya and Ukraine. These notifications have been as a result of a number of triggers, including nonpayment, physical damage, forced abandonment, and currency controls. But the industry's outlook for political risk remains decidedly positive.

"The global political risk landscape continues to be shaped by falling oil prices, geopolitical tensions, and regime change, whether as a result of constitutional elections or otherwise," says Evan Freely, Marsh's Global Credit and Political Risk Practice leader. "But these trends have not yet translated into catastrophic losses for insurers. Combined with the lack of profitability in more traditional insurance markets, this has led many insurers to essentially elevate their focus on their investments in political risk."

One example of the industry's growing interest in specialty lines is the recent merger of XL Group and Catlin Group, which the two companies said would allow them to "add immediate scale in specialty insurance." The industry also continues to add underwriting resources in political risk.

For example, Tokio Marine Kiln announced the hiring of a trade credit and political risk specialist for Asia in 2015, while Mitsui Sumitomo additionally purchased Amlin. Lloyd's, Beazley, Markel, and others have also opened new offices in Dubai, with a focus on political risk and other specialties.

LOW PRICES SPUR INTEREST

This rapidly expanding capacity has buoyed competition in the marketplace, which has driven pricing for PRI in most countries to an all-time low. In turn, this low pricing has driven greater interest in the coverage among multinational investors.

"Although insureds can pick and choose specific countries to insure, political risk can often emerge in unexpected places," says Mr. Freely. "For this reason, many companies are now purchasing multi-country PRI policies instead of single-country policies."

Multi-country policies can provide coverage for a specific region (for example, the Middle East and North Africa) or a longer list of countries specified by an insured. Purchasing a multi-country policy may also allow companies to insure countries where coverage is often difficult to secure or expensive on a single-country basis.

Most insurers prefer multi-country policies because they signal that insureds are not attempting to adversely select high-risk countries for coverage. As a result, these policies are often available with more favorable terms and conditions than single-country policies. Coverage can also be customized to cover a broad range of risks, including political violence, expropriation, currency inconvertibility, non-payment, and contract frustration and arbitral award default.

Meanwhile, multinational companies are increasingly self-insuring parts of their political risk exposures through their captives. The number of captive insurers writing PRI coverage nearly doubled from 2013 to 2014, according to *The World of Captives: Growth and Opportunities Without Borders*, Marsh's annual benchmarking report on captive insurance.

Although self-insurance can offer several benefits, political risk losses can be catastrophic. The cost of paying just one claim for the expropriation of assets could leave a captive insolvent unless it is well capitalized. Insureds should therefore think carefully about using a captive to underwrite political risk — especially given the current favorable conditions in the commercial marketplace. As political risks tend to be all or nothing (that is, an insured is unlikely to be partially expropriated, for example), indemnity is typically 100%.

CAPITALIZING ON A BUYER'S MARKET

Organizations sometimes defer discussions of catastrophic risk until they pose an immediate threat. But corporate boards and risk managers should consider how they can protect shareholders from potentially catastrophic exposures, including political risks, which can rapidly evolve from small-scale events into large-scale crises, potentially across multiple countries. When that happens, the effect on insurance markets can be devastating. Just days after a political risk threat becomes apparent, coverage may be unavailable for purchase or cost-prohibitive.

That's why it is important for those organizations that have not historically purchased PRI to consider doing so in the current favorable marketplace. For companies that already purchase coverage, now may be a good time to consider expanding a PRI program.

"A just-in-time approach to political risk can leave a company highly vulnerable when it needs coverage the most," says Mr. Freely. "Instead, multinational companies should plan ahead and take advantage of buyer's markets when they develop. Now is the time for risk managers to work with their advisors to negotiate favorable pricing, terms, and conditions to build effective insurance programs that protect their organizations' bottom lines."

The proportion of bank-financed projects has declined from 75% prior to the financial crisis to around 60% in 2014, as risk-weighted asset regulations restrict bank lending activity while pressuring the costs of funding.

About Marsh's Global Infrastructure Practice

Marsh's Global Infrastructure Practice provides clients with access to the full range of risk-based, analytical, and transactional support services available from Marsh & McLennan Companies, including risk advisory and insurance transactional services; commercial/market, operations, and capital planning organization; economics and regulation consulting; human capital; and investment analysis.

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