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The political risks insurances on investments

Some risks are dependent on local politic parameters upon which investors don't have a good hold on. However, there are some solutions to transfer those risks.

A decision to invest relies on commercial, technical and financial data coming under the investor know-how and the atmosphere describing the political environment and its perspectives.

For an investor, the political risk comes from the social and economical environment which makes it hard to have a good anticipation on the impacts. If the analysts do have an opinion on political risk, it is more about the general climate in politics, administration and finances.

However, such information dealing with the local politicians and their strategies as well as the macroeconomic parameters influencing political and social evolutions, are not determining the investor's and its goods direct security. This information is an indicator of the general business climate.

The events hardly ever occur as expected.

The political risk form

The first family of risks deal with the privatization of the company ownership: confiscation or difficulty to operate on the long term. In this case, the will to damage the company ends up in the end of its activities or to deprivation (non renewal of export and import licences, harbour authorizations, paperwork, irregularly provided energy…)
The changes in regulations are into this scope when it deals with discriminatory measures towards one or more international companies. The political risk can also come from a government incapability to safeguard peace which leads to the destruction of assets because of political violence: riots, civil wars, international conflicts, acts of terrorism…
The government incapability can also deal with the financial conditions of the activity; convertibility loss, hard execution of financial transfers (reimbursements, dividends…)

For those three families of risks, specialized insurers propose covers. However, when the local firm is individually victim of repeated and unjustified controls, it is not considered a disaster unless the investor can prove that he has to cease his activities in the specific country and that there is a direct link of causality. Hence, this risk is only covered in case of forced desertion.

Some insurers do accept in some circumstances, to guarantee the operating loss, that is to say to indemnify the consequences on the operating account if one of the generated facts previously presented happens. For such a kind of cover « sur-mesure », the specialized broker will be able to adapt the market products in order to optimize the policy structure according to the activity specificities as well as the investor's international strategy of implementation.

The recent case of the Ivory crisis is a good illustration of what can happen to a foreign company in a disturbed environment. The types of violence giving rise to material

destructions are easy to picture: looting, machinery breaking, requisitioning of vehicles. The confiscations that occurred since 2000 were a lot more discrete.

When governments change, the prior transactions (privatizations, market contracts) are being disputed, and the force is then used to expel with submachine guns « in the name of the law », occupants suddenly judged as none legitimate. As a result, a French Building company couldn't take advantage of its investments more than a few months (2000). Moreover, the geographical partition at the end of 2002 split the Northern activities with the Abidjan port giving the idea to the « rebels » that the property was vacant. As a result, the Vakoua sawmill and the Ity Gold mine were lost by their owner.

Transfer or keep the risk?

The choice to keep or to transfer the country risk to an insurer can happen according to various criteria:

- **The low capitalistic activities** don't usually need to secure investments. However, when it deals with commercial activities, they often are a favourite target during riots. In this case, it is then enough to get a specific insurance for stocks when they are located in sensitive areas.
- **The high capitalistic activities** are hardly penalized when an incident makes the loss of the production tools. Hence, it is highly recommended to transfer the risk to someone else. (It is even more the case as most of the time, the return on investments is low).
- **When the return on investment is quick**, it is not necessarily pertinent to subscribe for insurance on the initial investment. The cover for the operating margin gets very important in this case, as long as there is a simple method of calculus when a sinister happens.
- **When the head office is highly dependent** on the external production (commercialization, integration in the production chain) it is vital to plan an insurance « loss of production » to avoid that an activity stopping due to political reasons in one of the foreign subsidiaries creates a severe degradation of the head office.
- **When a group has settled in various countries**, it has long been considered that the investor was covering a form of risks division and that the individual loss of each investor was not significant. However, a loss remains a loss and if each entity of a large group had to consider itself as a simple drop of water in the whole, large groups wouldn't survive long.

Since the investors have understood that insurers adapt premiums when they cover an investments portfolio, and that those related to the total insured capital can be divided by 2, 10 or even 100 according to the geographical diversity of risks, the amount of establishments and their spreading about, the multinational companies get covered with « World » policies. One exception is a French public institution considering that auto insurance is more pertinent as the premium is low.

As a matter of fact, the political risk is a **« catastrophic » risk** upon which the large numbers law cannot apply. As evidence, the multinational companies having captive insurance for their current risks are unsure about including a too wide part of political risk.

The shareholder point of view. As long as shareholders, auditors and bankers don't have a good knowledge of existing policies, there is impunity about neglecting the cover of such a risk and upon confiscations already quoted no cover was forecasted. The managers could have been held responsible, if insurances on fire were not subscribed, which is still not the case in France for Political risk. Most of the time, the people responsible for the project would rather seek direct profitability and avoid paying superfluous premiums, not considering the shareholders risks, which modelization is not easy.

The political risk insurance is also a financial tool, and it can be determining to succeed when finishing off a financing or when reducing the global cost when Banks don't have their provisions obligations anymore. When the head office guarantee is needed for an exotic investment, the use of an insurance policy enables to unburden the parent company from all the political generating facts while « cleaning » its financial states column out of the balance sheet.

How do insurers decide to cover or not to cover?

The insurers decision whether or not to cover a risk can be astonishing and it's important to understand the logic. Insurers want to first check the image of the investor, its know-how and its professional experience in the sector in which he is investing his reputation, his negotiations methods and his behaviour in business. They want to have a long term relationship with the help of the broker.

They will focus on the hosting country later on and still in parallel with the activity: it is the interactive couple which is determining. Hence, the political risk sensitivity is the result of a combination of interactions linked to a more or less strategic activity for this country and also to the technical nature of the know-how which makes the operator more or less easy to replace.

Before commenting on a risk, the insurer looks closely at his capacity of recovering the indemnified amounts. Hence, when the investor has to exit after damage, the insurer becomes the title holder of the local company. The more or less good knowledge of the country is important as well as the long term nature or not of the investment. In some heavy industries or in the intensive agriculture, the stopping of an activity can be harmful.

In this case, after indemnification, the insurer becomes the owner of an investment which has no value anymore, and it deprives him from any means of recovery. In tough countries, the insurer can adopt the strategy to insure a sufficient number of risks being different in this country to raise the amount of the premium. As the private market gets developed, the products evolve under the competition pressure to respond better to the investors needs.
Nowadays, as a specialized broker, I can say that any investment, if pertinent from the investor's eye, has to find some kind of a cover.

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